Real Estate Finance
Virginia Salesperson PLE Series

MODULE 1
Key Financing Terms

Learning Objective:

- Understand Key Real Estate Financing Terms

Real Estate Finance

This course presents basic financing concepts that Virginia licensees must understand to serve basic client needs. Key financing concepts addressed in this Course include: similarities and differences between mortgages and Deeds of Trust, sources of real estate financing, common types of real estate loans and financing agreements, and Federal laws that implicate real estate financing and consumer credit.

Financing
The term financing describes the process through which one purchases property without paying the entire purchase price in cash. To purchase real estate, the buyer must generally make a cash down payment. The amount that a borrower will finance is the purchase price minus the down payment.

Financial Institutions

A financial institution is an intermediary (middle man) that obtains funds from depositors and lends those funds to borrowers in order to earn a return (percentage rate). Common financial institutions include: commercial banks, savings and loans, insurance companies, and credit unions.

Federal Reserve System

The Federal Reserve System (also known as the Fed) is the central banking system run by the U.S. Government. The Fed consists of 12 district banks and a seven member board. The Fed was established to help manage the nation's economy by controlling how much money is printed, and by influencing the availability of credit and loans in the U.S.

This system does all of the following: conducts the nation's monetary policy, promotes the stability of the financial system, promotes the safety and soundness of individual financial institutions, fosters payment and settlement system safety and efficiency and promotes consumer protection and community development.

The Fed has a tremendous impact on real estate by:

- regulating banks' reserve requirements (a specified amount of money that must be held in cash);
- controlling the discount rate (which directly affects interest rates); buying or selling government securities (which can cause an influx of cash into the primary mortgage market to increase the number of home loans available); and
- supervising federal truth in lending and equal credit opportunity laws.

All nationally chartered banks must belong to the Fed and must purchase stock in the district reserve bank.

Primary Mortgage Market

The primary mortgage market consists of direct lenders, or those financial institutes that originate and service real estate loans. Direct lenders may sell loans in the secondary mortgage market.

Secondary Mortgage Market

The secondary mortgage market consists of institutions that purchase and sell existing mortgages. Two different, but complementary, forces led to the creation of this market: business entities with cash reserves in real estate, and financial institutions in the primary market that were in need of cash to originate loans. Secondary mortgage market institutions include: Fannie Mae, Ginnie Mae, and Freddie Mac (more on these institutions later in this Section).

PROGRESS CHECK 1

1. Which of the following is NOT true about the Federal Reserve System?
   A. It controls how much money is printed
   B. It consists of 9 district banks
   C. It is considered the central banking system for the US
   D. It influences the availability of credit and loans in the US

2. Which of the following affects interest rates and influences the number of home loans that are available?
   A. Supply and demand
   B. The Federal Reserve system
   C. The unemployment rate
   D. Construction costs

3. The ________________________ consists of institutions that purchase and sell existing mortgages.
   A. The Federal Reserve system
   B. The secondary mortgage market
   C. The primary mortgage market
   D. The Real Estate Board

4. Regarding financing, the amount that a borrower will finance is:
   A. The purchase price minus the down payment
   B. The interest rate multiplied by the down payment
   C. The interest rate multiplied by the purchase price
   D. The appraised price minus the down payment

MODULE 2
General Loan Concepts

Learning Objective:

- Explain the process of obtaining a home loan

Approving Real Estate Loans

Loan Application Procedures

To apply for most mortgage loans, the borrower must complete a standard federal form (Uniform Residential Loan Application, also known as the FNMA 1003 Form).

The borrower must provide the following: information on employment, salary history, monthly income, assets, and liabilities; authorization for the lender to verify all information; and an affidavit stating whether he intends to live in the property. Backup documentation also includes: W-2s; paycheck stubs; copies of the purchase contract, tax returns, benefits/retirement income statements; and bank statements. It is a federal crime to provide false information on (or as support for) the loan application.

Collateral

Lenders face a risk that borrowers will fail to repay a loan. Mortgage lenders minimize the risk of loaning money by requiring borrowers to pledge property as security for payment of the debt (known as collateral). In other words, should the buyer fail to pay the loan, the lender can recoup the loss by forcing the sale of the collateral (the property).

Qualifying Borrowers and Collateral

Even with collateral, lenders take risks when they loan money there are legal and regulatory costs associated with a forced sale (called a foreclosure) and inherent uncertainties in market prices.

However, lenders further minimize their risk by qualifying borrowers (analyzing the buyer's ability to repay the debt) and qualifying the collateral (estimating the value of the property). If the lender qualifies both the borrower and the property, the lender has determined that the risk of loaning money is reasonable, and the lender will loan the borrower a percentage of what the lender determines the property to be worth.

Pre-Qualification. Informal estimate (often over the phone and without documentation) of the amount that a borrower may afford to borrow.

Pre-Approval. Lender's conditional commitment to lend to a specific borrower (follows receipt and review of financial records and a preliminary approval process).

Loan-to-Value Ratio (LTV)

The loan-to-value ratio, or the "LTV," is a ratio between the mortgage loan amount and the sales price of the property or the appraised value, whichever is lower.

EXAMPLE: *A buyer pays $110,000 for a house that is appraised at $100,000 and an S&L loans him $80,000. His loan- to-value ratio is 80% [80,000/100,000 = 0.80 = 80%].*

The higher the LTV, the less money down the purchaser pays because the lender is lending a greater amount of the purchase price. Conversely, the lower the LTV, the higher the down payment for the purchaser because the lender lends a lesser amount of the purchase price.

Higher LTV means greater risk for the lender because, as lenders theorize, the more equity one has in a home (created by the down payment), the less likely one will default. If there wasn't a sale to establish the market value of the property, the lender would require an appraisal to determine the market value of the property.

Loan Interest Rates

Interest

Interest is the cost to borrow money. A lender charges the borrower a certain percentage of interest against the unpaid loan balance for the use of money. The total amount of money borrowed is called the principal. Simple interest is the most common method to calculate interest. It is based on the remaining principal.

In other words, the borrower only pays interest on the amount of money remaining unpaid. As the borrower pays down the principal, he owes less interest. The rate of interest that a lender can charge is based on the money market, but lenders may, and often do, offer rates that are less than the maximum.

Annual Percentage Rate (APR)

The cost of credit expressed as a yearly percentage rate. The APR of a mortgage includes the interest rate, points, mortgage broker fees, and certain other credit charges.

Rate Lock

A rate lock is a lender's promise to a borrower to hold a specified interest rate (with or without a certain number of points) for a specified period of time, usually while the lender processes the borrower's loan application. Also known as "lock-in" or "rate commitment".

Usury

Most states have enacted a ceiling on interest rates. Usury is the illegal act of charging an interest rate in excess to what the law permits.

Discount Points

Discount points are fees charged by lenders to borrowers in exchange for below market interest rates. Discount points are paid in a lump sum at the time of closing, and one point is generally one percent of the loan amount. Generally, lenders must charge eight discount points in order to raise an interest rate yield by one percent.

In other words, if a lender must get a 10% yield on a loan but the buyer wants a 9% interest rate over the life of the loan, the lender will charge eight points which are due at closing. As a result, the lender's effective yield on the loan is 10% and the buyer pays 9% interest over the life of the loan.

Loan Repayment

Reserve Account

A reserve account is an account used by lenders to hold, or reserve, money for future payment of items such as real estate taxes, hazard insurance, and deferred maintenance. Reserve accounts are also known as customer trust funds. Commonly, borrowers must pay a lump sum to the lender at closing in order to establish the reserve account. Thereafter, the borrower must pay a monthly portion of the estimated taxes and insurance costs into the reserve account.

PITI

In addition to monthly payments of taxes and insurance into a reserve account, the borrower must also pay a monthly portion of the principal (or amount borrowed) and interest on the principal. Collectively, all these portions make up the total monthly loan payment. The total monthly payment is referred to as the "PITI," or principal, interest, taxes, and insurance.

Equity

Equity is the cash value of property after deducting all debts. Usually, an owner's equity is the monetary interest she retains over and above the mortgage indebtedness.

EXAMPLE: *A buyer purchases a house for $100,000 with a $20,000 down payment and an $80,000 mortgage. The owner's equity in this house is*

$20,000. Ten years later, the owner sells the house for $150,000. Over the ten year period, she has paid down her mortgage amount by $40,000, leaving $40,000 owed on the original loan. This owner's equity, or cash value in the house, is now $110,000 [$20,000 original equity + $40,000 loan reduction + $50,000 appreciation = $110,000].

Home Equity Loans

A home equity loan uses a home's equity to secure additional borrowed funds. Home equity loans, or equity mortgages, are often set up as a line of credit commonly referred to as an open- end mortgage. The homeowner may borrow against this line of credit as needed, up to a certain amount.

The interest rate is usually tied to the prime rate and, although it is higher than the interest rate charged on most first mortgages, it is much lower than the rate of interest charged for money borrowed through a credit card. For this reason, many homeowners use equity loans to consolidate consumer debt, or to finance repairs and improvements on a home.

Reduction Certificate

A reduction certificate is a document that certifies the status of a loan. It states the amount of the loan that remains outstanding, the interest rate of the loan, and the date the loan matures. Mortgagees must generally furnish a reduction certificate to prospective purchasers when they assume payments of a loan or take title subject to an existing loan. As a result, the purchaser is assured of exactly what is owed on the loan as of a certain date.

PROGRESS CHECK 2

1. Discount points are paid in a lump sum at the time of closing, and one point is generally __________ of the loan amount.
   A. 0.5%
   B. 0.75%
   C. 1%
   D. 1.5%

2. A buyer pays $225,000 for a house that is appraised at $210,000 and an S&L loans him $185,000. What is the loan- to-value ratio?
   A. 80%
   B. 83%
   C. 86%
   D. 88%

3. What is another term for something that secures the payment of a debt?
   A. Deed
   B. Note
   C. Collateral
   D. Usury

4. "PITI" refers to:
   A. When someone feels sorry for another person
   B. An illegally high interest rate
   C. Hazard insurance specifically for sinkholes
   D. The total monthly loan payment

MODULE 3
Types of Loans

Learning Objective:

- Differentiate between the various types of property loans

BACKGROUND

Below are some of the most common real estate lending agreements made between borrowers and lenders.

Types of Loans

Straight Mortgage (Term)
In a straight mortgage, only the interest is paid during the life of the loan. The full principal payment is due at the end of the term. Also called an interest only or term loan, these types of loans were the only home loans available prior to the 1930's. After the Depression, lenders began using amortized loans.

Fully Amortized Mortgage
A fully amortized mortgage is a systematic method to repay a loan by making regular, equal repayments (usually monthly) so that the loan itself, and all interest on the loan, is reduced to zero by the loan's maturity. Although the amount of each payment remains the same over the life of the loan, the amount of monthly interest and principal fluctuates.

Partially Amortized Mortgage

A partially amortized mortgage is a mortgage with a series of amortized payments, followed by a "balloon payment" at maturity. The balloon payment is the entire remaining balance. A partially amortized mortgage provides reduced monthly payments at the cost of a balloon payment at the end of the loan's term, which is larger than any previous payment.

EXAMPLE: *Mr. Smith wants to borrow $60,000 to open a small convenience store in a rural community. The local banks only loan money for seven years on such projects. However, a fully amortized seven year loan would require payments much higher than Mr. Smith could afford. Because the bank determines that Mr. Smith poses little risk of defaulting on the loan, it agrees to loan Mr. Smith the money for seven years using a 20-year amortization table. This means that Mr. Smith's monthly payments will be much lower, but he will have a large final payment when the loan becomes due in seven years.*

Negative Amortization

Negative amortization occurs when the loan payments are insufficient to repay the interest. Such payments only cover that portion of the interest and none of the principal. Therefore, the loan balance increases rather than decreasing over the life of the loan.

Balloon Mortgage

A balloon mortgage is a mortgage in which the final payment is larger than any previous payment. The payment amount "balloons" on the last installment. Balloon financing permits lower monthly payments than fully amortized loans, at the cost of a final large payment at the end of the loan's term.

Adjustable Rate Mortgage (ARM)
An ARM is a loan that allows interest rates to float up or down according to a specified index. The interest rate is "adjusted" at certain time intervals (such as six months or one year), usually having a "cap rate" or maximum rate of change (such as 1%, or 4%).

Graduated Payment Mortgage (GPM)
A graduated payment mortgage is a mortgage in which payments begin low, but gradually increase over the life of the loan.

Blanket Mortgage
A blanket mortgage is a loan wherein the borrower pledges more than one parcel of real estate as collateral for the debt. Blanket mortgages usually contain a partial release clause, which allows an individual parcel to be released when a certain amount of the loan has been repaid. Builders and developers commonly use this type of mortgage to develop large tracts of land that will later be divided into individual parcels.

Open-End Mortgage
An open-end mortgage is similar to an open line of credit. There is a maximum amount that one can borrow, but the borrower does not borrow all the money at one time. Also, the borrower only pays interest on the actual amount borrowed. This kind of mortgage is used for construction loans where the builder borrows money as portions of the project are completed. Another example of an open-end mortgage is an equity line of credit.

Package Mortgage
A package mortgage is a mortgage wherein the borrower pledges personal as well as real property.

EXAMPLE: A home loan that includes the washer, dryer, and refrigerator as collateral is a package mortgage.

Renegotiable Rate Mortgage (RRM)

A renegotiable rate mortgage is a long-term loan with short-term renewal periods (such as 3-5 years) and adjustable interest rates. The long-term mortgage amount remains the same and the mortgagor has the option to renew.

Reverse Annuity Mortgage (RAM)

A reverse annuity mortgage allows elderly homeowners to receive monthly payments to meet living costs. They do so by borrowing on home equity. The homeowner receives periodic payments based on accumulated equity. The balance of a RAM, which never exceeds the value of the home, becomes due upon a specified occurrence like death of the borrower or sale of the home.

Shared Appreciation Mortgage (SAM)

With a shared appreciation mortgage, the lender loans money at rates below the current market interest rate in return for a share of the profit when the property is sold. In other words, the lender shares in the future appreciation of the property. The specific terms of the shared appreciation agreement must be clearly stated in the mortgage or DOT and in the note documents.

Junior Mortgage

A junior mortgage is any mortgage that is subordinate to a first (or prior) mortgage. In the event of a borrower's default, the first mortgage lender has a superior claim on the collateral (real estate) to satisfy the outstanding debt. Junior mortgages usually carry higher interest rates because they entail greater risk. Equity loans are usually junior mortgages.

Wraparound Mortgage

A wraparound mortgage is a new mortgage whose balance includes not only the money borrowed, but also the balance owed on an older, already existing mortgage. In this instance, the older mortgage is not paid off, but the new mortgage "wraps around" the older one, producing a single payment to satisfy both loans. The new mortgage is junior to the older one. The borrower pays the new lender and the new lender makes payments on the original loan. In this way, the new lender can protect his junior position.

Purchase Money Mortgage (PMM)

A purchase money mortgage, also known as seller or owner financing, is a loan by the seller to a buyer who usually cannot qualify for an institutional mortgage at the full purchase amount. The buyer often combines a purchase money mortgage with an institutional mortgage.

PROGRESS CHECK 3

1. A ________________ mortgage requires both real and personal property as collateral.
   A. Open-End
   B. Package
   C. Blanket
   D. Wraparound

2. A ________________ mortgage requires both real and personal property as collateral.
   A. Open-End
   B. Package
   C. Blanket
   D. Wraparound

3. In which of the following does the loan balance increase rather than decrease over the life of the loan?
   A. Fully Amortized
   B. Partially Amortized
   C. Negative Amortized
   D. None of the above

4. In a ______________ mortgage only the interest is paid during the life of the loan.
   A. Reverse Annuity
   B. Straight
   C. Package
   D. Open-End

MODULE 4
Sources of Real Estate Financing

Learning Objectives:

- Understand the Sources of Loan Money
- Differentiate between the primary mortgage market and the secondary mortgage market

---

Background

This section presents the variety of businesses, institutions, and markets engaged in the real estate financing market.

Conventional Loans

Conventional loans are not insured or guaranteed by the government like FHA and VA loans are (more on government loan programs below). Therefore, they represent a higher risk to the lender. However, conventional lenders can reduce their risk by using private mortgage insurance (PMI). In many cases, private mortgage insurance also allows the lender to loan more than the standard 80% loan-to-value ratio.

For loans requiring PMI, the lender charges the borrower an insurance premium that is due at closing, plus a small charge every year that the insurance is in force. Often, the borrower may terminate the coverage once the loan-to-value ratio drops to an acceptable percentage (usually 80%).

In addition, lenders must automatically cancel PMI coverage (on most loans) once the borrower reduces his mortgage to 78% of the value (77% for high risk loans), regardless of whether the borrower so requests.

EXAMPLE: *Mortgage Guaranty Insurance Corporation (MGIC), the largest private mortgage insurance company, insures the top 10% to 30% of the principal on loans made to qualified buyers. Because of federal regulations, ABC-S&L is only allowed to make loans based on 80% of the appraised value.*

A residence is appraised at $100,000, but the buyer can only make a $10,000 down payment. By insuring the top 10% of principal loan amount with a MGIC insurance guarantee, ABC-S&L is able to make a $90,000 (90%) loan without violating federal regulations (80% is secured by the property, the top 10% is secured by the MGIC guarantee).

Conventional mortgage lenders include: mortgage companies, S&Ls, commercial banks, and private individuals.

The Primary Mortgage Market

The primary mortgage market consists of direct lenders, also known as prime lenders or originators, who make mortgage loans directly to borrowers. Some primary lenders retain the mortgages they originate, but most sell their loans to other investors. By selling their loans, they liquidate their investment and receive additional funds to make more loans.

Most primary lenders continue to service loans even after they sell them. Servicing a loan includes: collecting monthly payments; disbursing funds to pay property taxes and insurance; supervising the loan; and handling delinquencies, early payoffs, and mortgage releases. For this service, they charge a collection fee. Sources of direct loans include savings and loan associations (S&Ls), commercial banks, mortgage bankers, mortgage brokers, and life insurance companies.

Commercial Banks

There are federal banks and state banks. Federal banks are chartered by the federal government and regulated by the Federal Reserve Board. As their name suggests, commercial banks primarily make loans to assist commerce, especially in the areas of business loans, home improvement, and short-term construction (interim financing).

Demand deposits (checking accounts) are the primary source of funds for commercial banks. Due to this focus, commercial banks must be more liquid than S&Ls, and their loan portfolios tend to be dominated by short-term, high-yield loans.

Nevertheless, commercial banks do participate in the residential real estate market in a variety of ways. Many are active on the secondary market selling home loans they originate and buying packages of loans at a discount.

Large commercial banks also have bank holding companies and trust departments that are active in the financing and ownership of commercial real estate developments such as shopping centers, large apartment complexes, resort properties, and the like.

Saving and Loan Associations

Savings and loan associations (S&Ls) promote home ownership and private savings. S&Ls often offer higher interest rates on deposits than commercial banks. All savings and loan associations must be chartered by the federal government or by the state in which they are located.

Federally chartered associations are regulated by the Office of the Comptroller of the Currency (OCC) and their accounts are insured through the Federal Deposit Insurance Corporation (FDIC).

The FDIC insures depositors up to $250,000 per individual account and per institution. State chartered associations may, but are not required to, subscribe to the federal insurance program. S&Ls make both conventional loans, and loans involving government backing, like the FHA and VA Programs.

However, the majority of S&L loans are conventional loans made on residential dwellings of one to four units. Conventional loans are loans that do not involve government programs. In addition to originating mortgages, S&Ls also buy and sell mortgages on the secondary market.

Mortgage Bankers

A mortgage banker (or mortgage company) may be a person, firm, or corporation. They are not banks because they do not take in deposits; however, they do originate and service mortgage loans. While banks and S&Ls use customer deposits for mortgage financing, mortgage bankers usually borrow funds for mortgage financing.

Mortgage bankers frequently borrow funds from commercial sources, make loans, and then package and sell mortgages at a discount to investors on the secondary mortgage market. To be profitable, mortgage bankers must lend in sufficient volume and sell immediately.

Mortgage bankers close loans in their own name, assume risks, and continue to service loans even after they are sold. This contrasts with mortgage brokers, who are true intermediaries and merely represent investors. Mortgage bankers make commercial real estate loans and are also major originators of FHA and VA loans.

Mortgage Brokers

Mortgage brokers are not lenders. They do not service loans in their own name. They are true intermediaries who arrange and close loans in the name of the lender. Borrowers usually contact mortgage brokers directly.

The mortgage broker then qualifies the borrower and the real estate project before contacting the lender(s). If she is successful in arranging the loan, she will charge the borrower a fee, usually in the form of a percentage of the loan.

Life Insurance Companies

Life insurance companies are concerned with risk and long-term stability. These insurance companies are some of the largest groups of investors in the commercial and industrial real estate markets. Accordingly, they invest mostly in large real estate projects and commercial properties such as multi-use office parks, apartment complexes, and shopping malls.

Life insurance companies also play a role in the residential real estate market. Traditionally, their involvement in residential mortgage loans has been only as a buyer of large blocks of packaged loans on the secondary market. However, they are increasingly originating residential mortgage loans on the primary market through mortgage brokers.

The Secondary Mortgage Market

Whereas primary markets originate loans to eligible buyers, the secondary mortgage market provides liquidity to primary lenders. Investors on the secondary market purchase mortgages for long-term investment.

Investors on the secondary market may purchase individual loans, but usually purchase mortgage-backed securities. When mortgage holders package a group of mortgages, they issue securities and each security represents a share in the package. The primary institutions in the secondary mortgage market are:

- Fannie Mae (FNMA)
- Ginnie Mae (GNMA)
- Freddie Mac (FHLMC)

Fannie Mae (FNMA)

The Federal National Mortgage Association, referred to as Fannie Mae, was originally organized as a federal agency that purchased FHA-insured loans. It has since evolved into a government sponsored private corporation and has become the single largest private mortgage purchaser.

Fannie Mae does not loan money directly, but instead generates funds for its secondary mortgage market operations by buying and selling FHA, VA, and conventional mortgages, and by selling securities, mortgage-backed bonds, and discount notes in the money market.

Fannie Mae stock was previously traded on the public stock market, but has since been delisted from the New York Stock Exchange. When mortgage funds are in short supply, Fannie Mae buys mortgages; when there is a surplus of funds, Fannie Mae sells mortgages.

Ginnie Mae (GNMA)

The Government National Mortgage Association (GNMA) is a government sponsored corporation without capital stock, which was organized to operate the federal subsidy housing loan programs.

During times of financial difficulty, high discount rates (imposed by the Fed), and high interest rates, Ginnie Mae and Fannie Mae work together to provide special assistance programs for low- yield, high-risk loans (primarily FHA and VA). This helps to stabilize national real estate financial markets.

Freddie Mac (FHLMC)

The Federal Home Loan Mortgage Corporation (FHLMC) is a government sponsored private corporation, which operates under the supervision of the Federal Housing Finance Agency (FHFA). Freddie Mac was organized to borrow money from pension and trust funds, to purchase mortgages and pool them together, and to sell bonds on the open market with mortgages as security.

However, FHLMC does not guarantee payment of Freddie Mac mortgages. To accomplish its mission, FHLMC purchases conventional mortgages, FHA and VA mortgages, GNMA mortgages, and conventional mortgage-backed securities from S&Ls and banks in the secondary market.

Seller Financing

Sometimes the seller, not a third party lender, finances a real estate transaction. A common method of seller financing is the land contract. A land contract is an installment contract for the sale of real estate. Under a land contract, the seller retains legal title to the property until or unless the buyer completes all installment payments.

The buyer receives equitable title while making installment payments. Upon the final installment, the seller transfers legal title to the buyer. This arrangement is also known as a contract for deed.

PROGRESS CHECK 4

1. Which of the following is NOT a primary institution in the secondary mortgage market?
   A. FHLMC
   B. GNMA
   C. ECOA
   D. FNMA

2. Collecting payments, paying taxes, supervising and handling delinquencies all take place while:
   A. Being a property manager
   B. Servicing a loan
   C. Acting as a principal broker
   D. Involved in a disciplinary preceding

3. Which of the following is NOT true about Savings and Loan Associations?
   A. They promote home ownership
   B. They offer higher interest rates on deposits than commercial banks
   C. They promote private spending
   D. They must be chartered by the Federal government or state

4. Under a land contract the buyer receives ___________ title while making installment payments.
   A. Legal
   B. Equitable
   C. Marketable
   D. Recorded

MODULE 5
Government Financing Programs

Learning Objective:

- Understand Government Loan Programs

Background

In addition to conventional loans made by private lenders, there are various government programs available to qualified borrowers. Government programs may insure and guarantee funds borrowed from a private lender. In limited circumstances, government programs can fund loans as well.

Federal Housing Administration (FHA)

The Federal Housing Administration (FHA) operates under the Department of Housing and Urban Development (HUD). It was created during the Depression in 1934 to stabilize a collapsed mortgage and housing market.

The FHA does not build homes, lend money, or set interest rates. Instead, the FHA insures long- term loans made to qualified buyers by FHA-approved lenders.

By insuring mortgage loans, the FHA enables lenders to make riskier loans, which subsequently enables more people to purchase homes.

The FHA only insures loans that meet specific criteria that it sets through various programs.

The FHA criteria covers: building structure, the method of construction, qualified appraisers, how to determine a borrower's credit worthiness, and minimum standards for lenders. It also sets the maximum loan amounts that it will guarantee for various regions of the country.

FHA and HUD do not set interest rates. However, most FHA programs require that a mortgage insurance premium (MIP) be paid for the life of the loan at closing. This one-time MIP may be paid in cash or may be financed by being added to the loan amount.

With an FHA loan, either the buyer, the seller, or a combination of the two may pay the MIP, loan origination fee, and discount points. In addition, the FHA did not restrict a buyer's ability to assume a loan originated prior to December 1986.

However, for loans originated between 1986 and 1989, buyers must satisfy credit worthiness review requirements. For loans originated after December 1989, buyers must be completely qualified before assuming a loan.

Primary market lenders qualify borrowers and property according to FHA standards, which are less stringent than conventional loan standards. Then, the lenders enter into various mortgage agreements (fixed rate mortgage, adjustable rate mortgage, etc).

The borrower pays FHA mortgage insurance for a limited period of time. In the event of a default, the lender makes a claim against the

FHA insurance policy for a portion of its loss. This reduces the risk of lending to certain borrowers.

FHA loans permit borrowers to make lower down payments (LTV) than typically permitted by conventional loans. Borrowers can pay as little as 3.5% down or 96.5% LTV. Such low down payments are possible because FHA insurance allows borrowers to finance approximately 97% of the value of their home purchase through their mortgage, in some cases.

FHA Mortgage Insurance

FHA borrowers must purchase FHA mortgage insurance. Borrowers pay an up-front mortgage insurance premium at the time of purchase (which may be financed), as well as monthly premiums that are added to the regular mortgage payment. For most homes, an up-front mortgage insurance premium of 1.75% of the loan amount must be paid at closing. This amount may be financed.

Thereafter, a monthly insurance premium is due along with the monthly mortgage payment. For all loans made after January 26, 2015, the monthly premium depends on the base loan amount, length of the loan (in years), and the LTV. Monthly premiums range from 0.45% of the loan to 1.05%. Monthly premiums are larger for loans with a higher LTV, higher base amount of money, and longer length of time to repay.

Eventually, monthly FHA mortgage insurance payments are no longer due. FHA mortgage insurance premiums terminate based on the length of the loan and the LTV. For mortgages with LTV ratios greater than 90%, annual premiums will be collected until the end of the loan term. For mortgages with LTV ratios less than or equal to 90%, annual premiums will be collected until the end of the loan term or 11 years, whichever happens first.

Qualifying Borrowers

FHA only insures loans when the home, lender, and borrower meet specified criteria. FHA criteria covers items such as: building structure, the method of construction, qualified appraisers, determining the credit worthiness of the borrower, and minimum standards for lenders. It also sets the maximum loan amounts that it will guarantee for various regions of the country.

Income: There is no minimum income requirement to obtain an FHA mortgage loan; however, one must prove steady income for at least two years. Seasonal pay, child support, retirement pension payments, unemployment compensation, VA benefits, military pay, Social Security income, alimony, and rent paid by family all qualify as income sources. Part-time pay, overtime, and bonus pay also count as income as long as they are steady.

Debt-to-Income Ratio: The FHA limits borrower's debt-to-income ratio to 31% for housing costs and 43% for housing expenses and other long-term debt. Conventional loans commonly impose a debt-to-income ratio of 28% toward housing and 36% towards housing expenses and other debt. In some cases, borrowers may qualify to exceed the FHA debt-to-income ratio if they meet certain compensation factors.

This may include:

1. A demonstrated ability to pay more towards housing expenses;
2. A large down payment;

3. A demonstrated conservative attitude toward using credit and the ability to accumulate savings;
4. Acceptable credit history;
5. Compensation not reflected in the qualified income calculation, like food stamps or similar government assistance;
6. A minimal increase in monthly housing expenses;
7. Substantial cash reserves;
8. Substantial net worth sufficient to pay the mortgage regardless of income;
9. Potential for increased earnings, as indicated by job training or education levels; and/or
10. Relocation of the primary wage earner.

Credit Score: FHA criteria are more forgiving than conventional lending criteria on the borrower's credit score (or lack of any credit history). Lenders must use FHA qualified appraisers to estimate the value and condition of real estate financed with FHA insurance. FHA appraisers must satisfy minimum professional criteria and follow FHA appraisal standards. While HUD does not regulate interest rates, it does set limits on the amount that it will insure.

Maximum loan amounts vary over time and by place, depending on the cost of living and other factors. Loan amounts are established from the average cost of homes in each marketplace, usually county by county. The FHA defines allowable closing costs that may be charged to the borrower. Each local FHA office determines reasonable and customary closing costs. All other costs in the transaction are considered non-allowable and generally paid by the seller when purchasing a new home or by the lender when refinancing your current FHA mortgage.

VA Guaranteed Loans

The Department of Veterans Affairs guarantees loans for eligible veterans that purchase, build, or refinance homes. These loans are part of a government mortgage assistance program established under the Servicemen's Readjustment Act of 1944. Under normal circumstances, the VA does not lend money. Instead, the VA guarantees loans made by VA approved lenders. Unlike FHA programs, the VA can also lend money through its direct loan program (only happens in extreme cases, where local mortgage money is not available to a qualified veteran).

The VA sets a limit on the amount of the loan that it will guarantee by issuing a Certificate of Eligibility to an eligible veteran. The certificate of eligibility does not guarantee that the veteran will qualify for a loan, but merely states his entitlement to participate in the VA Program. A Certificate of Reasonable Value (CRV) states the market value of the subject property based on a VA approved appraisal and establishes the maximum amount the VA will finance. VA loans permit eligible veterans to mortgage property with little or no down payment and without purchasing mortgage insurance.

Primary market lenders qualify eligible veterans and real estate according to VA standards. Primary lenders then enter into mortgage agreements with qualified veterans. If the veteran defaults, the VA guarantees it will pay a portion of the mortgage and the lender will pursue the veteran for the remaining balance.

VA Guarantee

The amount of the loan that the VA guarantees (pays the lender if the veteran defaults) is called the basic entitlement and is subject to change. The basic entitlement is a maximum amount adjusted locally based on the loan amount (currently, up to $36,000 for loans under $144,000, with a bonus entitlement of up to $68,250 for most loans over $250,000).

The lender (not the VA) determines the maximum amount of money it will loan to the veteran and the interest rate. However, the VA limits the amount of a loan it will guarantee, and will not guarantee any portion of loan that exceeds the reasonable value of the property (as specified by a VA certified appraiser in a "certificate of reasonable value"). While there is no maximum loan amount established by the VA, lenders will generally lend up to 4 times the amount of a veteran's entitlement without requiring a down payment.

Qualifying Borrowers

The VA imposes standards to determine which persons qualify for VA Guaranteed loans. Borrowers must serve a minimum amount of time (90 days in war time; 181 days in peacetime) in the U.S. armed forces without a dishonorable discharge. The VA sets a limit on the amount of the loan that it will guarantee by issuing a Certificate of Eligibility to an eligible veteran (requires proof of military service). The certificate of eligibility informs the lender that the borrower is qualified to participate in the VA Program, but it does not guarantee that a lender will actually loan the veteran any money.

Qualifying Collateral

Because the loan amount may not exceed the VA's estimate of the value of the property, the first step in securing a VA loan is an appraisal. A Certificate of Reasonable Value (CRV) states the market value of the subject property based on a VA approved appraisal and establishes the maximum amount the VA will finance for the appraised property.

Lending Restrictions

The VA regulates a veteran's closing costs. Although some additional costs are unique to certain localities, authorized closing costs generally include VA appraisal, credit report, survey, title evidence, recording fees, a 1% loan origination fee, and discount points. The closing costs and origination charge cannot be included in the loan, except in VA refinancing loans. Under a VA Guaranteed Loan, there are no mortgage insurance premiums.

The VA does not require a down payment if the purchase price or cost is no more than the reasonable value of the property, as determined by VA, but the lender may require one. If the purchase price or cost is more than the reasonable value, the difference must be paid in cash by the veteran.

The VA charges a first-time funding fee of 2.15% for most veterans (2.40% for reservists). If the veteran has previously obtained a VA home loan, the funding fee increases to 3.30% for the loan and for subsequent use thereafter. This is payable at closing or may be financed with the purchase price (fee may be reduced based on the amount of down payment).

If the veteran makes a down payment of at least 5 percent, but less than 10 percent of the purchase price of the property, the funding fee is reduced to 1.50% of the loan amount (1.75% for reservists). If the veteran makes a down payment of at least 10 percent, the funding fee is reduced to 1.25% of the loan amount (1.50% for reservists).

Assumption

VA Guaranteed Loans are assumable, even by non-veterans, and may be prepaid without penalty. Like FHA loans, interest rates are set by the lender, NOT the VA.

Rural Development and Farm Service Agency

The Rural Development and Farm Service Agency administers rural development and conservation programs under the U.S. Department of Agriculture. The Office of Rural Development loans funds directly and also guarantees loans by conventional lenders under certain circumstances.

Rural Housing Direct Loans are administered by the Rural Housing Service (RHS), a sub-agency in the Office of Rural Development, in order to directly fund loans to low- and very low-income households for homeownership.

Applicants may obtain financing to: purchase an existing dwelling, purchase a site and construct a dwelling, or purchase newly constructed dwellings located in rural areas. Mortgage payments are based on the household's adjusted income.

Rural Housing Guaranteed Loans are administered by the Rural Housing Service (RHS) to help low- income individuals or households purchase homes in rural areas. Applicants may obtain 100% financing from approved lenders, and in return, RHS provides a 90% guarantee to lenders in order to reduce the risk of extending such loans. Funds can be used to build, repair, renovate or relocate a home, or to purchase and prepare sites, including providing water and sewage facilities.

PROGRESS CHECK 5

1. In order to obtain a Certificate of Eligibility for a VA loan the borrower must show evidence of:
   A. A credit score over 700
   B. Collateral worth over 90% of the loan amount
   C. Military service
   D. Steady Employment

2. With an FHA loan a borrower can finance up to _______ of the value of the home.
   A. 88%
   B. 92%
   C. 95%
   D. 97%

3. Which of the following does NOT loan money?
   A. The office of rural development
   B. FHA
   C. VA
   D. S&Ls

4. Which of the following does NOT loan money?
   A. The office of rural development
   B. FHA
   C. VA
   D. S&Ls

MODULE 6
Mortgages and Deeds of Trust
Part 1

Learning Objectives:

- Delineate between Mortgages and Deeds of Trust
- Identify the various covenants and clauses found in mortgages

---

Background

With a basic understanding of financing concepts, the types of loans available, the sources of loan money, and government programs, we will now examine the primary contract vehicles that implement these concepts—mortgages and deeds of trust.

Mortgages and deeds of trust are the principal means of financing real estate. While both instruments lead to the same result (buyers may purchase real estate without cash), the difference between the two depends upon the laws in the state where the property is located.

Both a mortgage contract and a deed of trust create a voluntary lien on real property. That is, a property owner enters into a contract to borrow money and voluntarily agrees to hand over his real property to the lender if he fails to pay the debt according to the terms of the loan agreement.

Mortgages and Deeds of Trust

Lien and Title Theory

States follow one of two differing legal theories regarding the title to financed property. In states that follow the "lien" or "mortgage contract theory," the buyer holds title to financed property while the loan is being paid and thereafter.

However, in states that follow the "title theory," a neutral third party holds title to property while the loan is paid. Upon satisfaction of the debt, title then transfers to the buyer.

Mortgages

The mortgage is the primary financing instrument used in lien theory states. The parties to a mortgage are the mortgagee (the lender), and the mortgagor (the buyer/borrower).

There are two parts to every mortgage loan: the mortgage note (known also as a promissory note) and the mortgage contract. The mortgage contract accompanies the note, but is usually a separate document.

Promissory Note (Mortgage Note): The promissory note is the unconditional written promise to repay the loan, and is evidence of the debt that the borrower owes to the lender. A promissory note is signed by a maker (borrower) who promises to repay the bearer (lender).

The words “or bearer” makes the note negotiable. This means that the original lender may sell the note to another person. That person then replaces the initial lender with the legal right to demand repayment.

A note specifies the loan amount, interest rate, time and method of repayment, and obligation to repay. In order to hold property as collateral, a mortgage contract must accompany the note and describe a piece of property as security for the debt.

Without a mortgage contract, the note is only a personal obligation on the borrower without any specific collateral. The mortgage contract or deed of trust should always be recorded because it establishes a lien against real property. On the other hand, the note need not be recorded because it only establishes a personal obligation.

Mortgage Contract: The mortgage contract is a security instrument which establishes that the property is collateral to guarantee repayment of the debt. The mortgage contract involves two parties: a purchaser who pledges real property as security for the payment of a debt (mortgagor), and the lender who agrees to loan money to the purchaser (mortgagee).

The mortgage creates a lien against the real property it finances. States that require mortgage contracts are referred to as lien theory states because the owner retains possession, use, and title to the property subject to the lien—the lender holds no interest in the title. Mortgage contracts are written, bilateral, and executory contracts that run for a definite period of time.

Deed of Trust

States that follow a legal theory known as the “title” or “deed of trust” theory allow a third party to hold an interest in the title of financed property until the loan is paid in full. The fact that the owner does not retain legal title to the property is the primary difference between a deed of trust (DOT) and a mortgage.

A DOT is a contract that involves three parties: a purchaser (also known as the trustor) who pledges real property as security for the payment of a debt; the lender (also known as the beneficiary) who agrees to loan a portion of the purchase price to the purchaser; and a neutral third-party trustee to whom the owner surrenders bare title (also known as “naked title”).

With a deed of trust, the trustee holds a title interest in the property. The title interest that the trustee holds is referred to as bare title because it does not include the rights of possession and use, but only those rights necessary to carry out the terms of the trust. It is the owner who retains the rights of possession and use as long as the conditions of the DOT are met.

After the note is paid in full, the trustee re-conveys title to the borrower/property owner. If the borrower defaults, the trustee is authorized to sell the property and reimburse the lender (this may or may not require a judicial foreclosure, depending upon the state). Deeds of trust are written, bilateral, executory contracts that run for a definite period of time.

Lender Advantages: Deeds of trust have the following advantages to lenders over mortgage contracts:

- If the owner of income-producing property defaults on a loan, the lender is authorized to take possession of the property in order to protect it and to collect rents.
- The time between default and foreclosure is shorter.
- The foreclosure process under a deed of trust is less expensive and simpler than a court-ordered foreclosure process.
- Title is already in the name of the trustee, permitting the trustee to grant title to the purchaser after the foreclosure sale.
- After the foreclosure, there is usually no statutory redemption period (the period of time following foreclosure that the property owner may pay the debt).

Covenants In Mortgages And DOTs

Background

Covenants are unconditional and binding promises, which appear in contracts. The breach of a covenant usually entitles the injured party to take certain action or to collect specified damages. Most mortgages and DOTs contain the covenants in the following slides.

To Pay Indebtedness

A covenant to pay indebtedness is the borrower's promise to repay the loan according to the terms of the note.

To Pay Insurance

A covenant to pay insurance is the borrower's promise to maintain insurance coverage against damage or destruction of the financed property in the amount specified by the lender, with the lender named as the beneficiary.

To Pay Taxes

In a covenant to pay taxes, the borrower promises to pay real estate taxes and other assessments levied against the property. This is particularly important to the lender because unpaid real estate taxes become a lien on the financed property that is superior to the lender's position. In other words, in the event of foreclosure, taxes are paid from the proceeds of the property sale before the principal.

Of Good Repair

A covenant of good repair obligates the borrower to maintain the mortgaged property and keep it in good repair. In this covenant, the borrower also promises not to remove or demolish any buildings or other improvements without first obtaining the lender's consent.

Acceleration

An acceleration clause specifies that if the borrower violates the covenants of the mortgage or DOT, then the entire loan balance becomes due and payable upon demand. In other words, the life of the loan is shortened, or accelerated, to its end.

The lender may only accelerate the note if this clause is expressly included in the loan document. Also, the lender must give the debtor adequate notice (usually prescribed by law) and specify a time period to allow the debtor to cure the default.

Acceleration EXAMPLE: *A mortgagee might accelerate a note if the borrower failed to pay his installment, committed harmful waste, or failed to repair thereby seriously endangering the value of the mortgaged property.*

Prepayment

A prepayment clause may require that the borrower pay a penalty if the loan is paid prior to the original maturity date. However, as is the case with FHA and VA mortgages, this clause may also provide that there be no penalty for early payment.

Subordination

A subordination clause is usually found in a junior mortgage. It provides that if an existing first mortgage is paid or renegotiated, the junior mortgage will remain subordinate (will not become a first mortgage). Junior mortgage holders usually receive higher interest rates in exchange for their subordinate position.

Do not confuse a subordination clause with a subordination agreement. A subordination agreement is an agreement whereby a superior mortgage, such as a first mortgage, agrees to take a subordinate or junior position with respect to a new or future lien.

Power-of-Sale

In states that permit DOTs (title theory states) a power-of-sale clause provides a trustee the right to sell the property in the event of a default. Title theory states often allow the lender to directly sell the property at public auction without a court order.

Alienation

An alienation clause, also called a due-on-sale clause, provides that upon transfer of ownership, title, or interest (collectively known as alienation) of the property by the borrower, the lender may demand the balance of the debt.

In effect, this clause makes the loan “non-assumable” by a new buyer without the lender’s approval (more on assumption to follow). Some states do not allow due-on-sale clauses, unless the lender actually demonstrates that such a transfer would endanger its security, because they believe they are an unreasonable restraint on alienation (or an unreasonable limitation on the right to sell property).

Defeasance

A defeasance clause provides for the “defeat” or cancellation of the mortgage or DOT when the borrower has repaid the entire debt. The loan is thereby canceled and the borrower restored to his full rights of ownership.

However, keep in mind that the borrower must still record a satisfaction of mortgage or deed of release in order to clear the lien from the public record.

Exculpatory

An exculpatory clause may appear in a mortgage or deed of trust in a title or a lien theory state. The exculpatory clause states that the lender waives its right to a deficiency judgment.

A deficiency judgment is a court order against a borrower which declares that she is personally liable for a debt because the collateral was insufficient to cover the entire debt. This clause is rarely used.

Escalator
An escalator clause adjusts loan payments either up or down. The escalator clause may be used in a variety of situations.

EXAMPLE: *Commercial leases frequently require that rent payments be adjusted up periodically to cover increases in taxes and insurance. Also, many long-term leases adjust according to the consumer price index. An escalator clause may also be used in a promissory note to increase the interest rate in case of a late payment or default.*

Partial Release
Generally, developers use partial release clauses to release individual lots in a subdivision from a blanket mortgage on the entire development. This allows the mortgagor/developer to sell lots to buyers that arrange their own financing.

The buyer pays the developer a fee, the developer pays the lender a fee, and the lender releases the lot from the blanket lien that encumbers the entire development.

PROGRESS CHECK 6.1

1. In a lien theory state who holds the title?
   A. A third party
   B. The borrower
   C. The lender
   D. The county clerk's office

2. The ________________ clause states that the lender waives its right to a deficiency judgment.
   A. Exculpatory
   B. Defeasance
   C. Escalator
   D. Alienation

3. A promissory note is evidence of:
   - A borrower's right to payoff a loan early
   - A lender's promise not to increase the interest rate
   - The debt a borrower owes to a lender
   - An agent's promise to find a buyer a home

4. Only a junior mortgage would typically include a ________________ clause.
   A. Defeasance
   B. Subordination
   C. Prepayment
   D. Acceleration

MODULE 6
Mortgages and Deeds of Trust
Part 2

Learning Objectives:

- Differentiate between lien theory states and title theory states
- Understand the purpose and rules pertaining to foreclosure

Substituting Borrowers: Assumption And Subject To Agreements

Background
A buyer may purchase property by keeping the original loan in place and continuing payments in the original owner's place. This is done by either "assuming" an existing mortgage, or by taking property "subject to" an existing mortgage.

Assumption
When a buyer assumes a mortgage, she assumes personal liability for full payment of the debt. This means that if the loan is not paid and a foreclosure sale does not satisfy the debt, the new buyer who assumed the loan will be personally liable to pay the outstanding balance.

Such payments are court ordered through a deficiency judgment (more on foreclosure below). In most cases, the lender will hold the seller and the buyer as jointly and severally liable. This means that the lender may pursue either or both parties to repay the debt. In effect, the buyer becomes a co-guarantor with the original note maker.

Subject To

When a buyer purchases a home with an existing mortgage, he may buy the property "subject to" the mortgage. Unlike assumption, this means that the new buyer is not personally liable for payment of the debt. In the event the loan is not repaid and the property is put through foreclosure, the "subject to" buyer will lose the property, but will not be personally liable to satisfy any remaining debt.

That is, if the sale of the property does not produce enough money to satisfy the entire debt, the lender may sue the original mortgagor/ seller, but cannot sue the buyer who purchased the property subject to the existing loans.

Substituting Lenders

Just as it is permissible to substitute borrowers through assumption and subject to provisions, so too can one substitute lenders. The contractual concepts of assignment (transfer the rights in the debt to another lender) and novation (substitute one agreement for another—a lender may release a seller and substitute her with the buyer) allow the substitution of lenders and mortgage agreements.

Satisfaction And Foreclosure

Background

Ultimately, a mortgage or DOT is either timely paid- in-full or not. When one pays her loan in full, she has attained "satisfaction" of the loan. On the other hand, where one defaults on a loan or fails to make required payments according to the terms of the loan, the lender has the power to foreclose or sell the property. How satisfaction and foreclosure are carried out depends on whether the property is located in a lien or title theory state.

Lien Theory States

By requiring lenders to use the judicial process, lien theory (mortgage financing) states provide greater safeguards for defaulting borrowers than title theory states.

Satisfaction: In lien theory states, lenders (mortgagees) hold a lien on financed real property by right of the mortgage note, which is signed by the borrower (mortgagor). The mortgage note is personal property and the lender has no title interest in the pledged property. As soon as the mortgage note is paid in full, the lender returns the canceled note to the borrower along with a "satisfaction of mortgage" document. The borrower should record the satisfaction immediately.

Default: In the event that a borrower defaults on the loan (fails to repay or violates the terms of the loan), the lender may accelerate the due date of all remaining payments and initiate foreclosure proceedings. Some lien theory states permit the use of power- of-sale clauses in mortgage contracts. Power-of-sale clauses allow the mortgagee to directly sell the property at a public auction without a court order. However, most lien theory states require a judicial order before the property may be auctioned. Such court orders are called judicial foreclosures.

Judicial Foreclosure: In order for a lender to foreclose in most lien theory states, the lender must usually file a lawsuit naming the defendants, identifying the debt and the mortgage securing the debt, and presenting evidence that the loan is in default. The lender asks the court to order for the property to be sold at a public auction, and for the proceeds from the sale to be used to pay the lender. The defendants are officially notified of the pending legal action, and the public is notified through a lis pendens, which is a recorded notice of the pending legal action entered into the city's public record.

The defendants then have a chance to reply. After a hearing, and if she finds reason to foreclose, the judge will order that the property be sold by public auction. The public auction may only occur after a prescribed advertising period in public places and in a local newspaper. The sale is conducted at the property or at the county courthouse. The delinquent borrower has the right to redeem his property up to the time the bidding starts by paying the debt. This right is known as his equity of redemption.

Purchase at Auction: If the property sells for a greater amount than all of the claims against it (taxes, mechanic's liens, all mortgage holders, etc.), the delinquent borrower receives any excess funds. When anyone other than the delinquent borrower buys property at a public auction, he receives a referee's deed or a sheriff's deed. These deeds eliminate all unpaid junior liens against the property. However, if the original borrower buys the property at auction, junior liens remain in place.

Statutory Redemption: Statutory redemption laws exist in most lien theory states. Statutory redemption laws give the foreclosed borrower anywhere from one month to more than a year to pay his judgment in full and redeem title to his property. During this period, the high bidder receives a certificate of sale that entitles him to a deed if the original owner fails to redeem the property within the statutory time period.

Title Theory States

Because lenders need not obtain a judicial order for foreclosure, title theory states generally afford fewer protections for defaulting borrowers.

Release Deed/Deed of Release: If the loan is paid in full, the lender sends the note (marked “paid”) to the trustee along with a request for reconveyance of the title. The trustee then issues a release deed (also known as a deed of release or certificate of satisfaction) to the borrower, which reconveys title to the borrower. The borrower records the release on the public record in order to cancel the lien and clear the title.

Trustee's Deed: If a borrower defaults on a DOT, the lender (beneficiary) presents conclusive evidence to the trustee that the borrower (trustor) has defaulted on the terms of the note, then instructs the trustee to sell the property. The resulting sale is known as a Trustee Sale. A notice of default is recorded on the public record.

After a prescribed waiting period (usually 90-120 days), the property is advertised in a public newspaper and in public places for a prescribed period of time. The property is then sold at a public auction, which is held in the county where the property is located. The new owner is given a trustee’s deed, which conveys all the rights, title, and interest that the original borrower had at the time he deeded the property to the trustee.

As in lien theory states, if auctioned property sells for more that all of the claims against it, the delinquent borrower receives the excess money. If the property sells for less than all the claims against it, the unpaid junior liens against the property are eliminated unless the buyer is the delinquent borrower (if the original borrower repurchases the property at auction, he remains liable for all junior liens).

Deficiency Judgment

In the event that a foreclosure/trustee sale does not produce enough money to cover the cost of foreclosure and pay off the entire debt, then the lender may file for a personal judgment against the maker of the note and/or against any additional parties responsible for repayment of the debt, such as endorsers or guarantors on the note, and any subsequent purchaser who "assumed" the mortgage. This personal judgment is known as a deficiency judgment.

Deed in Lieu of Foreclosure

When a delinquent borrower voluntarily deeds encumbered property to her lender, it is known as a deed in lieu of foreclosure, or a friendly foreclosure. Both parties must agree to this. A borrower may agree to a deed in lieu of foreclosure in order to avoid the expense and publicity of foreclosure proceedings, as well as the possibility of a deficiency judgment.

In return for the deed, the borrower receives a cancellation of the entire debt. A lender may agree to a deed in lieu of foreclosure in order to escape the expense and uncertainty of a judicial foreclosure and the resulting public auction. A voluntary deed also eliminates redemption periods. If the property is worth more than the debt, the lender must pay the defaulting borrower the difference. Also, junior liens are not eliminated— the lender assumes responsibility for them.

PROGRESS CHECK 6.2

1. If a property is auctioned due to a previous default and the property sells for more than the claims against it, who receives the excess money?
   A. The foreclosure agent
   B. The Lender
   C. The borrower
   D. The state

2. In which situation is the seller personally liable for any unpaid debt due to default?
   A. When a buyer assumes a mortgage
   B. In a "subject to" purchase agreement
   C. If a mortgage has a defeasance clause
   D. None of the above

3. Who is responsible to pay a deficiency judgement?
   A. The borrower
   B. The lender
   C. The foreclosure agent
   D. The state

4. In a title theory state, If a buyer purchases a property at a public auction what type of deed are they given?
   A. Sheriff's deed
   B. Quitclaim deed
   C. Bargain and sale deed
   D. Trustee's deed

MODULE 7
Financing and Credit Laws

Learning Objective:

- Understand Primary Financing and Credit Laws

Background

There are several federal laws that are intended to protect consumers who finance real estate.

Principal borrower protection laws include: the Truth in Lending Act (TILA), the Equal Credit Opportunity Act, the Real Estate Settlement Procedure Act (RESPA), and Fair Housing Act prohibitions against redlining (limiting loans in particular areas or neighborhoods).

Usury Laws
Some states have laws that establish maximum interest rates that a lender may charge. Rates in excess of these limits are called “usury.” Charging usurious interest rates (loan sharking) is not only a crime, it can also result in a void or voidable contract (depending upon state law).

TILA and Regulation Z

The Truth in Lending Act, or TILA, was passed in 1968 as part of the Consumer Credit Protection Act, and is implemented under the Federal Reserve Board's Regulation Z. TILA and Regulation Z do not establish interest rates or fees for credit.

Instead, TILA and Regulation Z specify that certain minimum information must be disclosed in a specified manner with a specified format. TILA and Regulation Z require that four main disclosures be made before a contractual relationship is created between a borrower and a lender as follows:

- the amount to be financed;
- the finance charge;
- the annual percentage rate (APR); and
- the total of all payments to be made over the term of the mortgage

Under TILA, the finance charge is the total of all costs the borrower must pay for obtaining credit. This includes items such as the interest amount, origination fee, loan servicing, finder's fee, and discount points.

The annual percentage rate (APR) is compiled by folding all of the finance charges into the interest rate. It is the relationship of the total finance charge to the total amount to be financed. It does not include items such as legal fees, appraisal fees, and credit reports. The total payment includes the number, amount in dollars, and timing of all payments due under the loan.

Advertising

TILA and Regulation Z strictly regulate real estate advertisements that include mortgage financing terms. General phrases such as "easy financing terms" or "excellent credit available" may be used without triggering full disclosure.

However, if any specific "trigger terms" are used in an advertisement, it must include five specific disclosures as follows:

- the cash price;
- the required down payment;
- the number, amounts, and due dates of all payments;
- the annual percentage rate; and
- the total of all payments to be made over the term of the mortgage

Trigger terms include the amount or percentage of a down payment, the amount of any installment or monthly payment, the number of payments, the period of payments, the finance charge, the interest rate (can only be used if APR is also given), and the use of the terms assume or assumable. However, the use of the terms FHA and VA in an advertisement are specifically exempted, and do not trigger any disclosures.

Exemptions

While TILA generally applies to mortgages and DOTs, it does not apply to all loans. For example, the following loans are exempt from TILA and Regulation Z:

- Loans for dwellings of more than four-family units;
- Loans of fewer than four installments;
- Loans for business, commercial, or agricultural purpose;

- Loans over a given threshold amount (adjusted annually for inflation).

Right of Rescission

TILA and Regulation Z include a three (3) day right to rescind for most consumer credit transactions. However, the right of rescission DOES NOT apply to initial mortgage or DOT transactions for principal dwellings.

For other consumer credit, this means that the borrower may cancel the loan after executing the loan contract. The three day period begins upon execution of the loan contract and continues until midnight of the third day.

Equal Credit Opportunity Act

The Federal Equal Credit Opportunity Act (ECOA) prohibits lenders and others who grant or arrange credit to consumers from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age (provided the applicant is of legal age), or dependence on public assistance. Lenders must inform credit applicants of the reasons for denial or termination of credit in writing within 30 days of application.

The ECOA protects consumers when they deal with any creditor who regularly extends credit, including banks, small loan and finance companies, retail and department stores, credit card companies, and credit unions. Anyone involved in granting credit, like a real estate broker who arranges financing, is covered by the law. Businesses applying for credit also are protected by the law.

Applying for Credit

When a consumer applies for credit, a covered lender cannot ask borrowers to disclose certain information. A lender must not discourage a borrower from applying for credit because of their sex, marital status, age, race, national origin, or because they receive public assistance income.

A lender must not ask a borrower to reveal their sex, race, national origin, or religion. However, a creditor may ask a borrower to voluntarily disclose this information (except for religion) if applying for a real estate loan since this information helps federal agencies enforce anti-discrimination laws. Borrowers may be asked about their residence or immigration status.

A lender must not ask a borrower whether they are widowed or divorced. When permitted to ask marital status, a creditor may only use the terms: married, unmarried, or separated. A lender must not ask about a borrower’s marital status if the borrower is applying for a separate, unsecured account.

A creditor may ask a borrower to provide this information if they live in “community property” states. Community property states include: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. A creditor in any state may ask for this information if a borrower applies for a joint account or one secured by property.

A lender must not request information about a borrower’s spouse, except when: their spouse is applying with them; a borrower’s spouse will be allowed to use the account; the borrower’s spouse is relying on their spouse’s income or on alimony or child support income from a former spouse; or if the borrower resides in a community property state.

A lender must not inquire about a borrower’s plans for having or raising children. A lender must not ask if a borrower receives alimony, child support, or separate maintenance payments, unless the borrower is first told that they do not have to provide this information if they will not rely on these payments to get credit. A creditor may ask if the borrower has to pay alimony, child support, or separate maintenance payments.

Borrower's Right

Borrowers have certain rights regarding their credit. A borrower may have credit in their birth name (Mary Smith), their first and their spouse’s last name (Mary Jones), or their first name and a combined last name (Mary Smith-Jones).

A borrower may get credit without a cosigner if they meet the creditor’s standards. A borrower may also have a cosigner other than their husband or wife, if one is necessary. A borrower may keep their own accounts after they change their name, marital status, reach a certain age, or retire, unless the creditor has evidence that the borrower is not willing or able to pay.

A borrower has the right to know whether their application was accepted or rejected within 30 days of filing a complete application. Borrowers have the right to know why their application was rejected.

The creditor must provide notice that informs the borrower either the specific reasons for their rejection or the borrower's right to learn the reasons if they ask within 60 days.

Acceptable reasons for rejection include: "Your income was low," or "You haven't been employed long enough." Unacceptable reasons for rejection are: "You didn't meet our minimum standards," or "You didn't receive enough points on our credit scoring system." Indefinite and vague reasons are illegal—the creditor must be specific.

A borrower has the right to find out why they were offered less favorable terms than they applied for, unless they accept the terms. A borrower also has the right to find out why their account was closed or why the terms of the account were made less favorable, unless the account was inactive or delinquent.

Evaluating Borrower Income

Lenders cannot refuse to consider public assistance income the same way as other income when evaluating a borrower's income. Lenders cannot discount income because of a borrower's sex or marital status when evaluating income.

Lenders cannot discount or refuse to consider income because it comes from part-time employment or pension, annuity, or retirement benefits programs. Lenders cannot refuse to consider regular alimony, child support, or separate maintenance payments. A creditor may ask a borrower to prove they have received this income consistently.

Extending Credit

The lender must not consider certain borrower characteristics in deciding whether to extend credit. A lender cannot consider a borrower's sex, marital status, race, national origin, or religion when deciding whether to extend credit.

A lender cannot consider whether a borrower has a telephone listing in their name when deciding whether to extend credit. However, a creditor may consider whether a borrower has a phone.

A lender cannot consider the race of people in the neighborhood where the borrower wants to purchase, refinance, or improve a house with borrowed money.

A lender cannot consider a borrower's age, unless: a borrower is under 18 years of age; the lender is using age to determine the meaning of other factors important to creditworthiness; or the lender is using age in a valid scoring system that favors applicants 62 years of age or older.

Real Estate Settlement Procedures Act (RESPA)

Background

The Real Estate Settlement Procedures Act (RESPA) is a federal law enacted in 1974 and amended in 1976. Its primary purpose is to ensure that buyers and sellers are fully informed of all settlement costs and to standardize real estate settlement practices.

The U.S. Department of Housing and Development (HUD) administers RESPA. RESPA applies to loans that involve federal money, loans that use federal insurance programs, and loans that might be sold on the secondary market to any federally backed agency. In effect, RESPA covers most institutional loans.

However, RESPA regulations apply only to first mortgage loan transactions for new residential homes. RESPA does not apply to: business purpose loans; temporary financing; loans to purchase vacant land; loan conversions; secondary market transfers; transactions financed solely by the seller; an assumption that does not require lender approval; a residential property consisting of more than four family units; or cash sales. RESPA requires that borrowers receive disclosures at various times and identifies certain prohibited acts.

RESPA Requirements

RESPA does not set prices for settlement services. Instead, RESPA imposes obligations on settlement agents (those who conduct real estate closings), which are intended to alleviate buyer confusion over the real estate closing process and costs.

Within 3 days of the loan application, a lender must provide the following: Special Information Booklet, Homeownership Counseling References, Loan Estimate, and Mortgage Servicing Statement. These documents are meant to ensure that the borrowers understand what they're agreeing to before taking on a loan.

EXAMPLE: *Special Information Booklet gives general advice about homeownership, explains closing costs and procedures, and talks about shopping for the best mortgage. The Loan Estimate explains the charges that a borrower will likely have to pay at settlement.*

The lender is required to provide other disclosures to the borrower (before, during, and after settlement).

EXAMPLE: *At least 3 days before settlement, the lender must provide a Closing Disclosure. This itemizes the actual charges that the borrower will have to pay (a final version of the earlier loan estimates).*

Loan servicers must also provide an Escrow Account Statement within 45 days after settlement, an annual escrow statement once a year thereafter, and a servicing transfer statement if they sell or assign the loan to another loan servicer.

RESPA Prohibitions

RESPA prohibits kickbacks or any unearned fee.

EXAMPLE: *Lenders may not receive a fee from an insurance company for referrals. While lenders can recommend a particular company, they cannot collect a fee for doing so. RESPA also prohibits the seller from requiring a buyer to purchase title insurance from a particular title company.*

Finally, RESPA prohibits the lender from collecting excessive reserve amounts for property tax and insurance payments. Lenders may only collect the buyer's share of taxes and insurance accrued prior to settlement, plus a two-month reserve that must be placed in an escrow account.

PROGRESS CHECK 7

1. Which of the following do RESPA rules apply to?
   A. A buyer pays writes a check for the total sales price
   B. A block of 5 townhouses
   C. The seller offers to provide financing to the buyer
   D. A private residence with buyers using a VA loan to finance

2. Which of the following would trigger TILA disclosures?
   A. "Excellent credit available"
   B. "Only 180 monthly payments"
   C. "Low Down Payment"
   D. "Easy financing terms”

3. The purpose of ___________ is to protect consumers when they apply for credit.
   A. The FHA
   B. RESPA
   C. TILA
   D. The ECOA

4. Within _____ days a borrower must receive a Special Information Booklet, according to RESPA.
   A. 3
   B. 5
   C. 7
   D. 14