11 Financing

Chapter Overview *Often a real estate transaction hinges on a buyer's ability to obtain financing. This chapter provides key information on mortgage loans and qualifying for a loan.*

Important Terminology

acceleration clause
adjustable rate loan
amortization
assumable loan
balloon loan
balloon payment
bridge loan
certificate of eligibility
certificate of reasonable value
conventional loan
credit score
creditor
deed in lieu of foreclosure
defeasance clause
deficiency judgment
discount point
Federal Housing Administration
finance rate
fixed rate loan
foreclosure
government financing
judicial foreclosure
land contract
lien theory
loan-to-value ratio
mortgagee
mortgagor
non-conforming loans
origination fee
prepayment penalty
primary market
private mortgage insurance
promissory note
purchase money mortgage
Real Estate Settlement and Procedures Act
reverse mortgage
right of redemption
Rural Housing
satisfaction of mortgage
secondary market
strict foreclosure
triggering term
Truth in Lending Act
vendee
vendor
Veterans Administration

A LICENSEE'S ROLE

Financing plays an important role in the typical real estate transaction. Licensees do not have to find financing for buyers and buyers should consult with potential financing sources early in the purchase process to determine a buyer's needs and access to financing. Licensees do need to understand the financing process and its effect on a transaction.

MORTGAGE LAW

A mortgage is a voluntary lien on real estate. The borrower or **mortgagor** pledges the real property to the lender or **mortgagee** as collateral for the debt. Mortgage law is state specific and Wisconsin law regulates mortgage contract terms and the rights of mortgagors and mortgagees.

There are several different types of mortgage law. Wisconsin recognizes **lien theory**, where the mortgage creates a lien on the real estate that is pledged as loan collateral. The borrower obtains legal title at closing from the seller and the lender obtains a lien right from the borrower. If the mortgagor defaults, the mortgagee must go through judicial foreclosure proceedings to obtain legal title to the property.

FORECLOSURE

Foreclosure is a state-specific legal process by which a property that a buyer pledged as security for a debt is sold to satisfy the debt. Foreclosure procedure is state law and the process will vary from state to state. A foreclosure transfers a property's title to a party that purchases the property at a foreclosure sale. The purchaser may be the lender who issued the loan or it could be a third party. A lender may foreclose a mortgage to secure repayment of the buyer's debt, to prevent deterioration in the value of the property, to obtain occupancy and possession of the property, to obtain title to the property, to terminate all rights, or to obtain a deficiency judgment. The title that the purchaser receives is clear of all liens.

A lender may choose to work with a buyer in default before pursuing foreclosure. Pursuing foreclosure could result in unrecoverable fees and costs, significant time commitments, adverse publicity, property deterioration, and potential environmental liability.

Stages of Foreclosure in Wisconsin

1. A borrower defaults on a loan.
2. The lender files a summons and complaint, which begins the foreclosure lawsuit.
3. A court reaches a judgment determining the total amount the defaulting borrower owes to the lender.
4. The court establishes the redemption period. The redemption period is period during which a borrower can pay the judgement amount and retain the property. Minimum redemption periods depend on the type of property subject to the foreclosure action and whether the lender is seeking a deficiency judgment.
5. The sheriff conducts a public sale of the property.
6. A judge confirms the sheriff's sale and the new owner receives title to the property.

Judicial foreclosure is when a mortgagee files suit asking a court to sell the property to satisfy the mortgage debt. The highest bidder at the public sale purchases the property. If the sale results in a purchase price over what the borrower owes on the foreclosure judgment, the excess goes to the borrower. If there is a deficiency and the property does not sell for as much as the borrower owes to the lender, the lender may ask a court for a **deficiency judgment** against the borrower for the deficient amount.

In Wisconsin, a court awards a defaulting borrower a **right of redemption**. A right of redemption is the time during which a borrower can pay the lender in full, stop the foreclosure proceeding, and keep possession of the property. The borrower can live on the property during the redemption period. Redemption periods vary depending on the property, the terms of the mortgage contract, and the foreclosure judgement. If the property is an owner-occupied one-to-four family residence, a farm, a church or other charitable organization, the redemption period is at least one year and a court can award a longer redemption period. However, if a lender agrees to waive a deficiency judgment, the minimum redemption period is six months.

Strict Foreclosure

Strict foreclosure refers to a process that a seller under a land contract can use to reclaim the property if a buyer defaults. There is not a sheriff's sale. A seller still seeks court assistance to achieve strict foreclosure and return of the property. In the strict foreclosure process, the redemption period may be as short as seven business days.

Deed in Lieu of Foreclosure

A **deed in lieu of foreclosure** is the process by which a borrower deeds property back to a lender in full or partial settlement of the debt. Parties may refer to the deed in lieu of foreclosure process as "friendly foreclosure" because it permits a defaulting borrower to avoid the actual foreclosure process despite the default. If a lender agrees to a deed in lieu of foreclosure, the defaulting borrower may avoid the public exposure of financial difficulties brought by the public notices and advertisements of a foreclosure sale and may avoid the severe credit consequences of a foreclosure. A lender will usually only agree to a deed in lieu of foreclosure if the buyer's title is free and clear of all encumbrances.

SOME FACTS ABOUT MORTGAGES

A mortgage contract is made up of two parts, the mortgage, which creates the lien and the **promissory note**, which is the borrower's promise to repay the loan. The promissory note serves as evidence of the debt, outlines the terms of repayment, and is negotiable because the note holder can transfer the note to another party. Lenders often sell notes to other lenders, investors, or the secondary market to raise capital for issuing new loans. Lenders bundle several loans together in a package and sell the packages to other parties. Lenders then have capital to issue new loans and the purchasers of the loan package benefit from the repayment of interest on the loans.

ABC National Bank issues $2,000,000 in loans. They package $1,800,000 together and sell the debt to a third party. ABC now has $1,800,000 in capital to issue new loans and they earn interest on the retained debt of $200,000. The third-party purchaser earns income from the interest on the $1,800,000 loan package.

A borrower must understand the terms of a mortgage contract. Lenders should review mortgage documents with a borrower.

The terms of a borrower's loan might include a **prepayment penalty**. Prepayment penalties are charges a lender imposes on a borrower who pays off a mortgage early. Prepayment penalties are not the same as prepayment premiums. A prepayment premium is a monthly fee in addition to a prepayment penalty that a lender charges a borrower. The financing contingency found in most of the Wisconsin offers to purchase states that the loan the buyer is trying to secure cannot include a prepayment premium.

A lender can charge a prepayment penalty to a borrower. If a borrower pays a mortgage debt off ahead of the scheduled repayment, the lender charges a penalty. The penalty covers some of the loss a lender incurs in lost interest income due to the buyer's early repayment. Lenders often charge prepayment penalties for only a portion of a loan term. For example, a lender may only impose prepayment penalties on borrowers who pay off a loan in the first year of the lending contract. After a borrower makes payments for more than one year, the lender waives the penalty and the buyer is not subject to a penalty for early payment of the loan. Lenders may also waive a penalty if the borrower refinances a debt with the lender or takes out a new loan with the lender.

A mortgage contract will usually contain a **defeasance clause.** A defeasance clause requires a lender to remove the lender's lien from a borrower's property when the borrower repays the loan. A lender removes the lien by recording a **satisfaction of mortgage** in the public records.

A mortgage agreement may also contain an **acceleration clause**. An acceleration clause gives a lender the right to accelerate the entire balance due if a borrower defaults on the terms of the loan agreement. The acceleration clause is what gives a lender a right to start foreclosure proceedings against a borrower. If a borrower defaults on a mortgage, the lender's acceleration clause means that the borrower now owes the entire amount of the mortgage rather than the monthly payment due. The lender can then sue the borrower for the money judgement in the amount of the mortgage and legal expenses. The lender then asks the court to order a sheriff's sale of the property to satisfy the money judgement against the borrower.

Some mortgages are **assumable loans**. If a loan is assumable, a buyer can assume a seller's mortgage loan. The buyer acquires title to the seller's property and agrees to become personally liable for the terms and conditions of the existing mortgage. A buyer may choose to assume a seller's existing loan if current interest rates are higher than the interest rate on the seller's mortgage. Whether a mortgage contract permits another party to assume the loan will depend on the terms of the loan agreement. Most mortgage agreements contain a "due on sale" clause, which requires a borrower to repay a loan in full before the borrower can transfer title to the property. If a mortgage contains a due on sale clause, another party cannot assume the terms of that mortgage.

To obtain a loan, a buyer will pay financing charges. An **origination fee** is finance charge that a lender charges a buyer to cover the costs of issuing the loan. Origination fees vary depending on the lender. A **discount point** is a financing charge a buyer pays to buy down an interest rate. A lender charges a borrower discount points before originating the loan. For test purposes, a buyer will pay 1% of the principal loan amount for every discount point the buyer purchases. Actual charges for points may vary depending on the lender. A buyer may benefit from purchasing points because a lower interest rate will mean lower monthly payments and potential tax benefits. Before purchasing points, however, a buyer needs to consider the cost of the points compared to the savings the buyer expects from the lower interest rate. In some cases, a buyer may benefit more by putting money towards a down payment rather than purchasing points.

A buyer needs to borrower $100,000. The borrower consults with a lender and the lender presents two options.

1) A 30-year loan with an 8% interest rate. The borrower's monthly principal and interest payments will be approximately $733.00.
2) A 30-year loan with a 7.75% interest rate if the borrower purchases two discount points. The lender charges 1% of the principal loan amount for each point. The borrower will pay $1000 per point if the borrower chooses this loan. The points lower the interest rate from 8% to 7.75%. The borrowers monthly principal and interest payments will be $717.00. The borrower will save about $16 per month if the buyer chooses this loan.

The borrower needs to determine how long the buyer plans to live in the property to realize a benefit from purchasing the discount points up front rather than paying interest over the life of the loan. At a monthly savings of $16.00, the borrower needs to remain in the property for at least 10 years to recover the $2,000 that the borrower paid for the discount points. The average homeowner lives in a property less than six years.

Mortgage loans payments are based on **amortization** of the loan. An **amortized** loan is paid off over time. A property owner may say, "I have a 30-year loan," which means the loan is amortized over 30 years. A borrower makes regular payments of a constant amount and the lender calculates each payment on the remaining loan balance, the initial payments consist mostly of interest. With each payment, the principal loan balance decreases. More of each subsequent payment pays down the principal. In a fully amortized loan, the last payment pays off the loan.

A lender originates an amortized **fixed rate loan**, which means the interest rate does not change over the life of the loan, or an **adjustable rate loan**, which has a fluctuating interest rate. The initial interest rate on an adjustable rate mortgage (ARM) is usually lower than the rate on a fixed rate mortgage. ARM rates are attached to an index such as a one-year treasury bill.

Features of an adjustable rate mortgage may include:

1. Adjustment intervals of one month, six months, three years, or five years;
2. Rate caps for each rate change or rate caps establishing the highest rate that a lender can charge over the life of the loan.
3. Payment caps limiting the amount payments can increase in any given year.
4. Teaser rates for the initial rate period. For example, 5% for the first six months after which the rate is 7.25%.
5. A convertible feature specifying the circumstances under which a borrower may convert the ARM into another mortgage, such as a fixed rate mortgage.

OTHER TYPES OF LOANS

A **balloon loan** is a short-term loan with payments amortized over a period longer than the term of the loan. For example, a balloon loan may have payments based on a 30-year amortization but the actual term of the loan is five years. A borrower's final payment is a **balloon payment.** A balloon payment is larger than other payments and satisfies the debt in full. The interest rate on a balloon loan is often lower than the rate for a conventional fixed or adjustable rate loan, which makes it attractive to borrowers. Balloon loans benefit lenders because borrowers often refinance before the balloon payment is due and the lender earns fees originating and financing the new loan.

A **reverse mortgage** is a Housing and Urban Development (HUD) loan program that allows older homeowners to withdraw equity from their homes in the form of monthly payments from a private lender to the homeowner. Reverse mortgages are only available for homeowners age 62 and older and the property must be the homeowner's principal place of residence. The homeowner retains title to the property. The borrower must repay the loan if the borrower sells the home, moves out of the home, breaches the mortgage terms, or dies, in which case the borrower's estate repays the loan.

A **bridge loan** is a residential financing arrangement in which the buyer obtains a second mortgage on the buyer's unsold home to pay for a down payment on a new home. A buyer might apply for a bridge loan when a buyer wants to close on a new property but has not yet sold the buyer's existing property. Because the buyer has not sold the existing property, the buyer does not have the funds to make a down payment on the new property. A buyer pulls equity out of an existing home before it is sold to purchase a new home. Bridge loans are common in real estate transactions because many buyers do not have the funds to purchase a new home before selling the current home.

SOURCES OF FINANCING

There are four common financing sources for buyers who need to finance a real estate transaction: seller financing; conventional financing; nonconforming loans; and government loan programs. Each form of financing has different eligibility guidelines, interest rates, and terms. Buyers who plan on financing a transaction with a loan from a lending institution should meet with a lender early in the home-buying process. Most transactions will depend on a buyer's ability to finance the purchase. Licensees are not responsible for finding financing for a buyer but should encourage buyers to meet with lenders to explore eligibility for available financing.

Seller Financing

When a seller finances a transaction, the lending arrangement is between the seller and the buyer, not the buyer and a conventional lender. Two common forms of seller financing are the land contract and a purchase money mortgage.

A **land contract** is seller-financing where a buyer/**vendee** makes installment payments for the purchase price of the property to a seller/**vendor** over the term of the contract. This is also known as an installment contract or a contract for deed. Land contracts can be short term where a buyer makes payments to the seller over the course of five years. The payment amounts are amortized over thirty years and a buyer typically owes a balloon payment for the final payment. With this arrangement, a buyer may seek conventional financing before the final payment and convert the seller-financed transaction to one financed with conventional lending. Land contracts can also be long term where a buyer makes identical monthly payments over a term of years.

A land contract differs from other financing arrangements because legal title does not pass to the buyer during the term of the contract but passes at the conclusion of the contract when the seller is paid in full. When the parties execute the contract, the buyer obtains equitable title and the seller retains legal title. Equitable title is the right to obtain absolute ownership to a property when legal title is held in another's name. A party does not have to record a land contract for the contract to be valid but to protect against third party claims, parties should record land contracts. Attorneys, brokers, and parties to a transaction can draft land contracts.

Advantages of a land contract for the seller:

1. Permits the seller to offer financing for a buyer who is not be eligible for conventional financing.
2. Possible tax advantages for the seller if the seller can defer taxes owed as a result of the sale.
3. A seller may be able to negotiate a sale that might not otherwise be possible.
4. The seller retains legal title and equity in the property.
5. The seller may be able to invest a portion of the monthly payments from the buyer and earn interest on the buyer's payments.
6. Land contracts may be subject to strict foreclosure, which can be a faster process than other foreclosure actions.
7. Potential financial advantages to a seller because the buyer pays interest to the seller rather than to a lender.

   For example, a seller and a buyer execute a $100,000 60-month land contract with an interest rate of 9%. The buyer's payments are amortized over 30 years with a final balloon payment. As of the buyer's 59th payment, the buyer has paid the seller $44,160 in interest and $4,110 in principal. The buyer owes the seller a balloon payment of $95,881 for the 60th payment. The buyer pays the seller a total of $144,160 over the course of the 60-month contract.

Disadvantages of a land contract for the seller:

1. A seller runs the risk of getting the property back if the buyer defaults and the property may be in poor condition.
2. If a buyer defaults on the contract, the seller incurs the costs of any legal action necessary to seek payment, start foreclosure, or enforce the contract.
3. If a buyer walks away from the property, the seller must pay legal fees to seek foreclosure and a suit to quiet title.
4. A seller is still bound to the property.

Advantages of a Land Contract for the Buyer

1. The buyer may be able to finance a purchase even if the buyer is not eligible for conventional financing.
2. The buyer may be able to finance a property for more than the amount a lender was willing to lend to the buyer.
3. The buyer will establish a credit history over the term of the land contract.
4. The buyer gains equity in the property.
5. The buyer may be able to buy with smaller down payment.
6. The buyer may be able to buy with lower monthly payments or a lower interest rate.

Disadvantages of a Land Contract for the Buyer

1. The buyer does not get legal title or the title is unmarketable.
2. The buyer risks that the seller will not use the buyer's payment to pay any existing mortgages.
3. The buyer does not have full equity in the property until title is transferred.
4. Land contracts are subject to strict foreclosure for which there can be a very limited redemption period.
5. The seller retains an interest in the buyer's property.
6. When the final payment is due, the seller may be missing, bankrupt, or dead.

A **purchase money mortgage** is seller-financing where a seller provides a loan to the buyer for a portion of the purchase price. The seller holds a mortgage from the buyer, which is usually a second mortgage to the lender-held first mortgage. A buyer may use a purchase money mortgage to make up the difference between the buyer's down payment and the amount of the lender-held first mortgage. Parties may refer to this form of seller financing as "the seller taking back a second." The buyer receives legal title at closing.

A lender gives a loan to a buyer for 75% of the selling price. The buyer has a 15% down payment. The seller finances the remaining 10% by granting the buyer a purchase money mortgage.

Conventional Financing

Conventional financing refers to financing between a borrower and a private lender where the lender requires 80% loan-to-value ratio and a borrower has 20% of the purchase price for the down payment. A **conventional loan** is secured by the real estate and the promissory note is secured by the borrower's ability to pay. The lender uses the appraisal of the property and the borrower's credit worthiness to estimate the risk of lending.

Generally a lender will require a borrower to have 20% of the purchase price for a down payment on the property but borrowers with a down payment that is less than 20% of the purchase price may be eligible if the borrower purchases **private mortgage insurance**. Private mortgage insurance insures the top 20% of the loan. This means that the borrower pays an insurance premium that covers the lender's risk in lending to a borrower with a down payment that is less than 20% of the purchase price of the property.

A borrower wants to purchase a property for $100,000. The borrower has only $5,000 for a down payment. The borrower wants a loan for the other 95% of the purchase price. The lender will issue the loan if the borrower purchase private mortgage insurance on $15,000 of the total loan that, coupled with the buyer's actual down payment of $5,000, would be equal to the conventional down payment of 20% of the purchase price. The lender takes the risk that the property will sell for at least $80,000 if the borrower defaults.

PMI has separate underwriting guidelines. When a lender requests private mortgage insurance, the lender will submit the borrower's loan application, credit report, and appraisal to the insurance provider. A borrower normally pays a fee for the first year's insurance premium at closing. A borrower also pays a monthly fee while the insurance is in place. For loans originated after April 1998, the borrower request that the lender remove the insurance when the borrower has 25% equity in the property. The lender does not automatically remove PMI but must notify the borrower that the borrower has 25% equity in the property. The borrower must request removal of the insurance.

Nonconforming Loans

Nonconforming loan is a broad term that refers to any loan that does not conform to the strict guidelines of conventional loans, such as a 20% down payment. Borrowers who do not qualify for conventional loans can look to nonconforming loans to finance a transaction. Ineligibility for conventional loans can be due to lack of credit history, insufficient down payment, or inadequate debt-to-income ratio. The terms of nonconforming loans vary dramatically based on the lender and the individual applicant.

Government Financing

If a borrower is eligible for **government financing**, the government insures or guarantees the funds that the lender is issuing to the borrower. If a borrower is unable to repay a loan, the government insurance compensates for the loss the lender incurs from the borrower's default. Because of the government insurance, lenders are more liberal when considering a borrower's eligibility because the lender's risk is reduced. Government financing program eligibility guidelines and the funding process vary with the program and licensees should direct buyers with government financing questions to participating lenders.

Federal Housing Administration Loans

As a result of the housing and lending crises brought on by the Great Depression, in 1934 the federal government created the **Federal Housing Administration** (FHA) to provide mortgage insurance to private lenders to induce lenders to lend to borrowers who might not be eligible for conventional financing. The borrower's ineligibility for conventional financing often stems from an insufficient 20% down payment, which does not prohibit eligibility for an FHA loan.

<u>FHA Loan Features</u>

1. The Department of Housing and Urban Development (HUD) operates the FHA loan program.
2. The FHA does not issue loans to borrowers but <u>insures</u> loans made by private lending institutions. The insurance protects the lender against potential loss if the borrower defaults on the loan.
3. A lender can charge an insurance premium at closing. The borrower will pay a mortgage insurance premium (MIP) on the outstanding debt as part of the monthly payment. Once a borrower has 22% equity in the home, the borrower does not have to continue to carry the insurance. The FHA may refund premiums when the house is sold or the loan is refinanced.
4. Before issuing insurance on a loan, the FHA will require an appraisal that includes a basic survey of the physical aspects of the home. The appraiser must disclose defects to the buyer. The FHA will generally require a buyer to repair defects prior to closing. An FHA appraisal may be more strict than other appraisals. For example if an appraisal noted chipping or peeling paint in target housing, the FHA might require a buyer to repair this before closing due to the lead-based paint concern. If the borrower is receiving an FHA loan, a separate home inspection contingency must be included. The licensee needs to be aware of this fact to avoid later complications.

5. The maximum loan amount is based upon the appraisal or the purchase price, whichever is less. If the purchase price exceeds the FHA-appraised value, the buyer may pay the difference in cash as part of the down payment. In addition, the FHA sets maximum loan amounts for various parts of the country. As of July 2014, the FHA mortgage limits in Wisconsin for single-family homes statewide range from approximately $271,050 to $410,000. To learn more about a specific community's mortgage limit, please visit www.hud.gov and search Wisconsin.
6. FHA interest rates are set by the open market.
7. Buyer credit ratings are generally more flexible in that the FHA allows gifts to be used as down payments and a buyer can carry more debt than with conventional financing.
8. A FHA lender can charge points. Payment of fees, points, and charges are negotiable between buyer and seller, although they are usually paid by the buyer.
9. FHA regulations set standards for type and construction of buildings. The cost of repairs required by the appraiser may be negotiated between the buyer and seller.
10. FHA allows up to 100% of the closing costs to be financed with the loan.
11. FHA lends on condominiums if a certain ratio of owner-occupied units to tenant-occupied units exists. Lenders who work with FHA loans have a list of the FHA-approved condominium developments in specific areas.

Veterans Administration Loans

Veterans Administration loans are a product of the GI Bill of Rights, which Congress enacted in 1944. One of the features of this program is to provide returning veterans with low-interest loans for the purchase or construction of homes, mobile homes or condominiums. The advantage of the VA loan is the *guarantee feature* that promises lenders that in the event of a deficiency from a foreclosure 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.

VA Loan Features

1. The applicant must be a veteran and must be eligible based on the veteran's service record.
2. The VA must issue a **Certificate of Eligibility**, which sets the maximum loan guarantee amount to which the veteran is entitled.
3. Veterans and non-veterans can assume VA loans. If a non-veteran assumes the loan, the veteran is liable for the contract unless the VA releases the veteran from the lending contract. A veteran may not be eligible for future VA lending until the non-veteran repays the assumed loan amount. If another veteran assumes the loan, the veteran can use the veteran's own eligibility for the loan, which would permit future eligibility for the other veteran. Whether the VA allows another borrower to assume a VA loan will depend on the origination terms of the loan.
4. A borrower will pay origination fees and can negotiate responsibility for closing costs with the seller.
5. A VA appraiser conducts an appraisal and issues a **Certificate of Reasonable Value** (CRV) for the property stating the current market value based on the appraisal. If the purchase price is greater than the amount on the CRV, the veteran can pay the difference in cash. The VA appraiser may condition the CRV on repairs to the property that a purchaser must complete before closing.
6. The private lender and the open mortgage market determine the loan's interest rate.
7. Unremarried spouses of veterans that died of a service-related injury or illness as well as unremarried spouses of veterans missing in action may be eligible.
8. The loan must be for the veteran's primary residence.
9. The VA guarantees an amount of the loan but does not set limits on the amount of the loan. A veteran may borrow up to four times of the guarantee amount and may not need a down payment.

United States Department of Agriculture (USDA) Rural Development Loans

The USDA's Rural Development program is a federal lending program under the Department of Agriculture. Rural Development offers assistance to aid low-income and moderate-income rural residents purchase, construct, repair, or relocate a dwelling and related facilities. A borrower must qualify financially and if a borrower's income increases above eligibility limits, the borrower will have to refinance the purchase through a different source.

Rural Housing provides two categories of loans.

1. <u>USDA Rural Housing Guaranteed Loans</u>: The private lender issues and services a 30-year loan and the USDA guarantees 90% of the loan in the case of borrower default. Under the terms of the program, an individual may borrow up to 100% of the appraised value of the home, which eliminates the need for a down payment. Applicants for loans may have an income up to 115% of the median income for the area. Applicants must not have access to adequate housing but must be able to afford the mortgage payments, including taxes and insurance, and have reasonable credit histories.
2. <u>USDA Rural Housing Direct Loans</u>: The USDA issues the loan directly to the borrower. Most eligible borrowers must have income below 80% of the median income level for the community. To be eligible, an applicant must be without access to adequate housing and be able to afford the mortgage payments including taxes and insurance. Eligible borrowers can use the loans to purchase a home, build, repair, renovate or relocate a home, or to purchase and prepare construction sites for new construction.

THE PRIMARY MARKET VERSUS THE SECONDARY MARKET

Loans originate in the **primary market**. The primary market is made up of banks, savings and loans, insurance companies, mortgage banking companies, credit unions, and mortgage brokers. Participants in the primary mortgage market may retain the loans they originate or sell the loans. Primary mortgage market participants sell loans to raise capital for future lending. For example, a lender has issued $1,000,000 in loans. The lender may keep $100,000 of the debt and sell $900,000 of the debt to the secondary mortgage market. The lender now has $900,000 to issue new loans and still earns interest on the $100,000 of retained debt. Lenders also profit through finance charges such as discount points and origination fees, recurring income such as interest earned on loans, and services fees for processing payments, paying real estate taxes and insurance, and providing tax information to the IRS.

The **secondary market** is the market for sales of existing mortgages. Participants in the secondary mortgage market invest in existing mortgages as liquid assets. An investor in the secondary mortgage market purchases pools of mortgages from the primary market and the participants in the primary mortgage market use the invested capital to originate additional loans. If demand for secondary market mortgages falls, the amount of money available for primary market loan origination also falls, which may increase interest rates. If demand for secondary market mortgages increase, primary market participants will have more access to capital for originating loans and interest rates may decrease.

The secondary market also standardizes loan requirements. All lenders selling loans on the secondary market must use standardized forms such as appraisal reports and closing statements as well as have their borrowers meet other standardized criteria.

The federal government has an active role in the secondary mortgage market operating through three major entities: the Federal National Mortgage Association (Fannie Mae, FNMA); the Government National Mortgage Association (Ginnie Mae, GNMA); and the Federal Home Loan Mortgage Corporation (Freddie Mac, FHLMC). Ginnie Mae, Fannie Mae, and Freddie Mac provide financial services and products for low-income, moderate-income, and middle-income families that want to buy homes.

Secondary Market Underwriting Guidelines

The following factors are taken into consideration when determining a borrower's qualifications for a loan.

1. Credit score: A **credit score** is a statistical method of assessing the credit risk of a loan applicant. Credit scores range from 300 to 850 and a lender usually considers an applicant with a higher score as less of a risk. A less risky applicant will receive loans with lower interest rates and may need less of a down payment than a riskier applicant.
2. Credit payment history: Underwriters generally will review the last seven years of an applicant's credit history, focusing on the following indicators or creditworthiness.
   a) Mortgage and rent: an applicant's history should reflect no 30-day late rent or mortgage payments in the last 12 months.
   b) Car payments: An applicant's history should reflect no 60-day late payments.
   c) Credit cards: An applicant's history should reflect no 60-day late payments.
   d) Bankruptcy: Lenders generally require a period of years from an applicant's bankruptcy discharge date before the applicant is eligible for lending. The time between the discharge date and eligibility depends on the source of the loan. Applicants with past bankruptcies should consult a lender for current lending requirements.
   e) Foreclosure: Lenders generally require a period of years from an applicant's foreclosure date before the applicant is eligible for lending. The time between the discharge date and eligibility depends on the source of the loan. Applicants with past foreclosures should consult a lender for current lending requirements.
3. Income: An applicant's income must be sufficient to repay both the loan and any recurring debts such as car payments, charge cards, other loans, or spousal support. A lender considers income if the applicant establishes consistent working patterns producing the income and there is a reasonable expectation that the income will continue. Generally, a lender will verify at least a two-year job history and the lender will verify any income the applicant reported. A lender will consider part-time wages and overtime wages, pensions, retirement benefits, and wages from seasonal or secondary employment if an applicant can establish sufficient history and reliability for the income. If an applicant's sole income is from commissions, a lender will generally verify the income from the applicant's past two years' tax returns. If part of an applicant's income is from commissions, a lender might only require W-2 forms and a verification of employment. A lender may require additional documentation for self-employed applicants such as tax returns, current profit and loss statements, a current balance sheet, and a business credit report.
4. Debt-to-income ratio: Underwriters use an applicant's debt-to-income ratio to determine whether a borrower can qualify for a mortgage. The ratio is a measurement of a borrower's ability to repay a mortgage debt based on the borrower's income.

5. Down payment: Lenders want to see a "sourced and seasoned" down payment. A lender will need to verify the funds belong to the applicant and that the applicant has held the funds in an institution for at least three months. Funds that the applicant saved under a mattress or withdrew as a credit card cash advance are not "sourced and seasoned." Each loan program requires a different down payment amount and lenders will help applicants determine this amount.

The relationship between the loan amount, the down payment, and the value of a property is the **loan-to-value ratio.**

Fannie Mae requires a 95% loan-to-value ratio. For a property with a purchase price of $120,000, a buyer can receive a loan for $114,000, which is 95% of the purchase price. ($120,000 x .95 = $114,000). The difference between the loan amount and the purchase price is what a buyer must provide as a down payment, which in this case is $6,000. ($120,000 - $114,000 = $6,000).

Mortgage Fraud

Licensees need to be aware of situations that might constitute mortgage fraud and avoid these transactions. Mortgage fraud occurs when a person misrepresents or omits information on a loan application with the intent to secure lending that a lender would not extend based on an a truthful application. Parties may commit mortgage fraud by preparing two offers, one representing the actual terms of the transaction and another prepared for the lender to induce the lender to extend more credit than a party needs to complete the transaction. Parties can also commit mortgage fraud by inflating a sales price or by misrepresenting the value of personal property a party is including in the a property's purchase price.

Any party in a real estate transaction including a seller, buyer, real estate broker or salesperson, mortgage broker or banker, appraiser, and loan originator who has knowledge of or participates in misrepresenting facts to a lender can be guilty of mortgage fraud.

Examples of Mortgage Fraud

1. A buyer asks a broker to rewrite an offer to present to a lender stating the purchase price of a property at the $79,000 appraised value rather than the actual $72,000 offer price. The buyer wants to obtain the additional financing and will keep $5,000 and split the remaining $2,000 with the broker and the seller as a "thank-you" for assisting in the transaction.
2. A buyer offered $75,000 and asked the seller to pay $3,000 toward the buyer's closing costs. The seller countered for $79,900. The mortgage broker says that the underwriter will not lend if the seller is paying closing costs and there is a price adjustment in a counter-offer. The mortgage broker wants the real estate broker to rewrite the offer to show a $79,900 sales price and backdate the new offer to the date of acceptance in the original offer.
3. A licensee prepares an amendment that provides for a $10,000 roof repair credit and provides the amendment to the lender. The lender asks the title company not to put the credit on the closing statement.

Real estate licensees cannot draft or use any document that the licensee knows falsely portrays an interest in real estate. If a licensee believes that any party is committing or attempting to commit fraud in a transaction, the licensee should adhere to the following guidelines.

1. Prepare offers accurately and inclusively reflecting true purchase prices and dates. If a party asks a licensee to prepare a new offer, the licensee should state that the new offer supersedes and replaces the original offer and identify the original offer by date and purchase price and include a statement that the offering party is withdrawing and cancelling the original offer.

2. If a transaction participant asks a licensee to prepare a document containing inaccurate information, a licensee should ask for the request in writing.
3. If a licensee is aware that a party is misrepresenting information that could be the basis of mortgage fraud, the licensee should issue a letter warning the parties, the lender, and other participants of the potential fraud and urge them to consult with their attorneys to correct the misrepresented information. If the parties do not correct the misrepresentation, the licensee should cease participation in the transaction.
4. Report apparent fraud to the Department of Financial Institutions or other appropriate agencies. Provide extensive detail and copies of relevant documents.

CALCULATING A BUYER'S MORTGAGE PAYMENT

To complete a financing contingency in an offer to purchase, a licensee must know how to calculate a monthly mortgage payment. A borrower's mortgage payment depends on the amount borrowed, the finance charges, and the amortization schedule. To calculate a mortgage payment, refer to the amortization chart located in the back of this book. Find the term of the loan and the interest rate to determine the factor for calculating the mortgage payment.

<u>Using the Amortization Chart</u>

A person borrows $100,000, to be repaid over 30 years at 8.5% interest. Use the amortization chart to find the factor for 30 years at 8.5% interest. The factor is 7.69. The chart used in this book shows interest rates from 7% to 17%. When taking the state licensing exam, test takers will have an amortization chart for calculating mortgage payments.

<u>Calculating the Mortgage Payment</u>

$$\textbf{Mortgage Payment} = \frac{\textbf{Amount Borrowed x Factor}}{\textbf{1000}}$$

To calculate a monthly mortgage payment for a $100,000 loan at 11% interest over a 30-year term, first find the factor using the loan term of 30 years and the interest rate of 11%. The factor is 9.52. Then multiply $100,000 by 9.52 and divide the product by 1000. The monthly mortgage payment is $952.00.

$$\$952.00 = \frac{\$100{,}000 \times 9.52}{1000}$$

FINANCING LEGISLATION

The Consumer Credit Protection Act, Truth in Lending Act, and Regulation Z

The Consumer Credit Protection Act is composed of several sections regulating consumer credit. Title I of the Act is the **Truth in Lending Act** (TILA). TILA requires creditors to disclose to consumers the true cost of obtaining credit and allows consumers to compare credit costs and terms of a loan. Regulation Z is the section of the federal administrative code that implements the provisions of TILA. For credit to fall under Regulation Z requirements, it must involve a finance charge or be payable in more than four installments by written agreement. If credit is regulated by Regulation Z, disclosure must include the financing charges, the annual percentage rate, the total amount financed, and the total number of payments. **Finance charges** are the costs a consumer will pay directly or indirectly for obtaining credit. Finance charges include interest, loan origination fees, discount points, and service fees. Real estate expenses that a consumer pays regardless of whether credit is extended such as fees for legal services, deed preparation, surveys, or credit reports are not finance charges.

The Truth in Lending Act assumes that the more credit a borrower can obtain, the less protection that consumer needs. Regulation Z applies to all consumer loans for $25,000 or less that are for personal, family, household, or agricultural purposes. Regulation Z also applies to residential loans that are secured by a dwelling, new mortgage loans, refinanced loans, or consolidated loans. Regulation Z does not apply to business or commercial loans, consumer credit transactions over $25,000 not secured by a dwelling, or loans made to an artificial entity, such as a corporation.

For example, Regulation Z applies to a car loan for $10,000, an agricultural loan for $20,000 and a first mortgage loan of $130,000. Regulation Z does not apply to a car loan for $30,000, an agricultural loan for $50,000, and a business loan for $5,000.

All creditors must comply with Regulation Z. A **creditor** is defined as a party who arranges for or extends credit more than 25 times in the preceding calendar year or more than five times in the preceding calendar year if the transaction is secured by a dwelling.

The following are examples of a creditor:

1. A financial institution such as a bank, credit union or insurance company.
2. A contractor performing work and taking lien rights.
3. A property owner selling properties under a land contract.

Regulation Z regulates credit advertising. If an advertisement contains a **triggering term**, the advertisement must also disclose the full terms of the offered financing. The goal is to ensure that a consumer has all the important terms of a credit plan, not just the most attractive ones.

Examples of triggering terms:

1. The amount of the down payment, expressed as either a percentage or dollar amount (10% down, $1,000 down);
2. The amount of any payment, expressed as either a percentage or dollar amount (less than $600, $210.95 per month);
3. The number of payments or the period of repayment (up to four years to pay, 48 months to pay); and
4. The amount of any finance charge (financing costs less than $300 per year).

Some statements about credit terms are too general to trigger additional disclosures. Examples of terms that do not trigger the required disclosures include:

1. No down payment;
2. Easy monthly payments;
3. Pay weekly; or
4. Terms to fit your budget.

A licensee's advertisement stating the down payment amount for a locally available mortgage does not violate Regulation Z.

Real Estate Settlement and Procedures Act (RESPA)

The purpose of **Real Estate Settlement and Procedures Act** (RESPA) is to ensure that borrowers in mortgage loan transactions have knowledge of all settlement costs. RESPA applies to all federally-related first mortgages on residential one-to-four family properties.

RESPA requires that:

1. A lender must provide a good-faith estimate of all closing costs at the time the borrower applies for the loan or within three business days of the borrowers application.
2. Settlement service providers such as lenders, attorneys, and title insurance companies cannot pay other settlement service providers for referrals.
3. A lender must use the HUD Uniform Settlement Closing Statement and allow the applicant to inspect the statement the day before closing.
4. RESPA is administered by HUD.

RESPA forbids paying someone for the mere referral of business. Settlement service providers cannot give gifts or fees to individuals for the referral of business to the settlement service provider. For example, it is a violation of RESPA if a mortgage brokerage firm pays a real estate broker $200 for every loan made to a consumer who the real estate broker referred.

Under RESPA, a person cannot give or receive fees or kickbacks for referral of settlement services, or give or receive a split or percentage of settlement charges other than for services actually provided. Paying or receiving a fee or a "thing of value" for the referral of business related to a mortgage loan settlement without rendering a service is illegal under RESPA. Receiving compensation for referring a buyer or borrower to a settlement service provider is prohibited and a settlement service provider cannot split or pay a settlement charge unless the settlement service provider actually provided services in exchange for the payment.

RESPA defines real estate settlement services. Settlement services include any services related to: (1) the origination, processing, or funding of a federally-related mortgage loan; (2) mortgage broker services such as counseling, taking applications, obtaining verifications and appraisals, and lender-borrower communications; (3) title company services; (4) an attorney's legal services; (5) closing document preparation; (6) credit reports and appraisals; (7) property inspections; (8) conducting the settlement; (9) mortgage insurance; (10) hazard, flood or casualty insurance, and homeowner warranties; (11) mortgage life, disability or similar insurance; (12) real property taxes and assessments; and (13) real estate brokers and agents.

RESPA prohibits any agreement or understanding that a party will give a thing of value in exchange for a settlement service referral. The parties do not need to have a written or verbal agreement. Parties can establish an agreement by practice, pattern, or course of conduct. Licensees must abide by RESPA rules and if a licensee is concerned about a potential RESPA violation, the licensee should speak to the employing broker and consult an attorney if necessary.