FINANCING

THE LOAN/MORTGAGE SEQUENCE

1. Buyer applies to lender - Savings Associations, Mutual Savings Banks, Cooperative Banks, Commercial Banks (the ***Thrifts***); Mortgage Companies, Credit Unions, Life Insurance Companies; Sellers, Other Private Lenders
2. Lender requires: credit history (FICO score), income verification (non-discretionary payment obligations are factored into debt/income ratio, e.g., 28%/36%), record of cash for downpayment, property description/appraisal for ***collateral*** (security) for loan. Fair market value of property drives loan value (standard loan-to-value ratio in residential is 80% loan to 20% cash downpayment). Lender approves loan in ***letter of commitment*** to Buyer (borrower).
3. Lender gives **loan** to borrower. Borrower gives **Note** and **Mortgage** to lender (mortgagee) securing **Note**.
4. Borrower repays loan. Mortgagee returns Note and Mortgage to Borrower (mortgagor) with a Discharge of Debt instrument. Or borrower fails to pay off loan according to terms of Note, and lender has power to *foreclose*.

INSTRUMENTS OF FINANCING

The Note (also known as promissory or mortgage note)

1. The Note is the ***primary*** financing instrument (an I.O.U. (I owe you)), a personal obligation signed and dated by borrower (payor).
2. **Acceleration clause:** gives lender right to declare unpaid balance due in full because of default in payments: calling in Note; acceleration of maturity date. Penalty for late payment charged after 14 days.
3. **Prepayment penalty clause:** requires debtor to pay a penalty for paying all or part of debt substantially before maturity date (date of the last payment under the Note).

The Mortgage

1. A ***lien*** which can only exist as ***security*** for Note; it cannot exist by itself. Mortgagee (lender) has ***conditional title***; mortgagor (borrower) redeems title by paying off loan or sells with lien in place (no mortgagee permission needed for sale).
2. **Defeasance clause:** renders mortgage null and void upon discharge of debt (lender records D**ischarge** to give public notice of this event).
3. **Due-on-Sale (alienation/assumption) clause:** accelerates maturity date upon conveyance of property. Prevents mortgage take-over without lender's approval.
4. **Partial release:** lender releases part of collateral so builder may deliver clear title to buyer. Used in ***blanket*** mortgages.
5. **Power of sale:** clause empowering the mortgagee to sell the property because of failure of borrower to comply with terms of Note and Mortgage covenants.
6. **Mortgage covenants:** Borrower agrees to pay **P**rincipal/**I**nterest; not to commit waste/remove improvements; pay property **T**axes; keep property **I**nsurance; upon default, Mortgagee can inspect/appraise, take possession (mortgagee in possession).

FEDERAL HOUSING ADMINISTRATION (FHA)

- Established in 1934 for any qualified buyer.
- FHA ***insures*** lender if borrower defaults and there is deficiency after foreclosure.
- Insures generally the riskiest part of the loan.
- FHA caps dollar amount it will insure based on location of property within U.S.
- Loan comes from approved lender, NOT from FHA.
- FHA approves lender, property and credit of borrower, but allows lender to underwrite under the Direct Endorsement Program.
- No prepayment penalty by lender is allowed.
- Loans are for 1-4 family owner occupied homes (FHA 203 (b) Program) (some condo/coops included).
- Property may be sold by take-over financing. No due-on-sale clause allowed.
- Rate of loan interest is set by market conditions, NOT by FHA.
- FHA ***requires*** downpayment by borrower.
- The Federal Housing Act of 1934 introduced the fully amortized loan and low downpayments.

DEPARTMENT OF VETERANS AFFAIRS (VA)

- Established in 1944 for veterans. May be used repeatedly.
- VA ***guarantees*** lender if borrower defaults and there is deficiency after foreclosure.
- Guaranty is on the riskiest part of the loan.
- VA caps dollar amount it will guaranty.
- Loan comes from approved lender, NOT from VA.
- VA approves lender, the property and the credit of borrower.
- No prepayment penalty by lender is allowed.
- Loans are 1-4 family owner occupied homes (some condo/coops included).
- A non-veteran may assume a veteran's mortgage debt, but veteran remains liable in event of a foreclosure deficiency, unless previously ***released*** by lender and VA.
- Certificate of Reasonable Value (CRV) is issued by appraiser. If CRV is ***less*** than purchase price, buyer may withdraw from sale or make up difference in cash. Seller may also reduce price. Second mortgages not allowed at closing.
- Rate of loan interest is set by market conditions.
- 100% financing allowed by VA. This is the highest loan-to-value ratio possible.
- VA requires a funding or guarantee fee from the veteran.

PRIVATE MORTGAGE INSURANCE (PMI)

A method of protecting lender in conventional (non-FHA/VA backed loans) loans over 80% of selling price. Example: Loan is for $90,000 on $100,000 sale. This is $10,000 of debt exposure more than lender wishes. If the property is foreclosed and auctioned at $75,000, the lender's loss of $15,000 would be moderated by a $10,000 typical PMI policy provided by a private company. Thus, the lender's loss would be $5,000.

Buyer pays premiums usually monthly on this policy until there is a 20% spread between the debt and the value of the property. Sometimes referred to as **MGIC** financing. **NOTE:** Lender is insured, not the homeowner.

SECOND MORTGAGE

Buyer of $100,000 property borrows $80,000, needing $20,000 at closing. Suppose buyer has only $15,000. The $5,000 must come from another source.

At the passing, buyer gives seller $80,000 from lender (first mortgagee), $15,000 in cash and $5,000 from another lender. Borrower signs a Note for the first lender and gives the same lender a first mortgage lien on the property. Then borrower signs a second Note for the other lender, securing it with a second mortgage lien. This ***second*** mortgage is the junior lien.

In event of foreclosure, first mortgagee has claim on assets; next in priority is second mortgagee. Naturally, since risk is higher for second mortgagee, interest on that Note is usually higher and repayment period is usually shorter.

BALLOON MORTGAGE

A method of repaying a loan by making monthly payments of interest and some principal until maturity. On that last date the outstanding balance is due. This last payment is the "balloon." Payments of interest only with the principal due on the last payment is a ***straight mortgage***.

PURCHASE MONEY MORTGAGE (PMM)

Seller finances part or all of the sale of own property by receiving from the buyer a Note and a Mortgage.

CONSTRUCTION FINANCING

Developer/builder arranges financing from lender who releases loan in installments as building phases are completed. When building is complete, loan is paid off (taken out) by a new long-term lender or transforms into an amortized loan with first lender. The short-term lender may charge a higher rate of interest than the permanent mortgagee.

PACKAGE MORTGAGE

A package mortgage includes not only the real estate interest but items of personal property such as furniture and appliances. Chattel mortgage is secured by personal property only.

Advantages: one loan instead of several; one lender/one payment; longer payback; lower rate of interest; immediate use of amenities.

Disadvantages: equipment loses value before payments end.

OPEN-END MORTGAGE

This mortgage loan allows the borrower to obtain additional funds on the original loan terms or other terms. The additional borrowing cannot exceed the original loan amount. For example, if the original loan was for $80,000 and it had been repaid down to $60,000, the open-end mortgage provision would allow the loaning of $20,000. The loan amount would go back to the original loan of $80,000 at the current rate of interest or the original rate of interest. ***Equity Loan/(Home) Equity Line of Credit***

REVERSE (ANNUITY) MORTGAGE (RAM)

A method of freeing equity in the home of a home owner 62 or older and borrowing against a primary residence. A non-recourse loan (Lender may only foreclose, not sue on note for deficiency). Amount up to a certain limit loaned by lender against the equity. Loan and interest is repaid in full upon buyer no longer living in collateral (death, sale of property, or moving to nursing home). Can be used to buy a primary residence.

SECONDARY MORTGAGE MARKET

Refers to organizations which buy notes and mortgages from primary lenders, bundles them with other paper and sells it as an investment to investors. After selling the loan, the primary lender may receive service fees for collecting monthly mortgage payments. Certificate of no defense or estoppel certificate is a verification instrument signed by the parties confirming the debt owed (mortgagor permission not needed to sell paper).

Major Secondary Mortgage Organizations: Fannie Mae - Private but government regulated and sponsored. Specializes in conventional, VA and FHA loans; **Ginnie Mae -** Government entity specializing in FHA low income housing; **Freddie Mac -** Private, specializes in conventional mortgages.

TAKE-OVER MORTGAGES

New buyer takes over the debt of the seller. Buyer pays the seller the equity - the difference between the selling price and the assumed debt. Buyer receives a new deed and the right to redeem the original note and mortgage instruments upon paying the remaining indebtedness to lender. Title changes; original mortgage remains. Methods of taking over seller's lien:

Subject to - original mortgagor is always responsible for debt and is liable in event of deficiency after a foreclosure auction. Favors new buyer.

Assumption of - original mortgagor and new owner are ***both*** responsible in event of deficiency after foreclosure. Favors original mortgagor.

Novation - a new note is written between original lender and new buyer, original owner is released from indebtedness and is not liable for debt.

SHORT SALE

Home owner cannot make loan payments but outstanding debt is more than fair market value of the property. Owner lists property (with or without an agent), signs a purchase and sale agreement with a ready, willing and able buyer. Lender agrees to accept less than what is owed and forgives the remainder of the debt. Avoids foreclosure.

FORECLOSURE

A public auction through court oversight (judicial) or in accordance with legal requirements (statutory). Mortgagor's equity of redemption extinguishes. Mortgage changes from being a ***conditional*** title to being a fee simple. Lender gives good title to the highest bidder (which may be the lender itself) by signing and delivering a new deed. If the auction brings in more than debt and expenses, mortgagor receives excess money. If the auction does not bring enough, the borrower is liable for the deficiency. If no one bids enough to satisfy lender, lender bids on property and takes ownership and possession – bank owned or REO (real estate owned by the lender). Lender then sells like any other real estate transaction.

DIRECT REDUCTION LOAN

An amortized loan in which the monthly payments do not vary, but the amounts applied to interest and principal do. Interest is recalculated every month. Final monthly payment results in discharge of debt.

For a loan of $50,000 at 9% fixed annual rate of interest, what is this interest rate expressed in annualized dollars?

($4,500 = answer)
$50,000 X .09

With a loan repayment period is 25 years, the monthly payment of principal and interest $419.60. After the first payment is made, what is the outstanding loan balance?

($4,500)
$50,000 X .09

$4,500 ÷ by 12 = $375 first month interest

First payment	$419.60	$50,000.00
Lender's interest	- 375.00	- 44.60
	44.60	$49,955.40 [answer]

Using the data from the above problem, what is the outstanding amount owed to the lender after the second monthly payment has been made?

($4,495.99)
$49,955.40 X .09

$4,495.99 ÷ by 12 = $374.67 2nd month interest

Second payment	$419.60	$49,955.40
Lender's Interest	- 374.67	- 44.93
	44.93	$49,910.47 [answer]

POINTS

One point = one percent (.01) of the ***loan*** amount. A property sold for $100,000 with a lender loaning $80,000. The lender required the borrower to pay two points. How much were the points expressed in dollars? $80,000 X .02 = $1,600

DISCOUNT POINT

If a loan is to be sold to an investor, the interest rate on the note may be lower than the investor requires. Upfront discount points charged to the borrower would make up the difference and make the loan saleable. A borrower may ***buy down*** the loan rate by paying additional points.

CONVEYANCE SEQUENCE – TRANSFER AT CLOSING – PASSING OF PAPERS

- Lender lends some portion of the purchase price to buyer (borrower). Buyer gives lender a note to evidence debt and a mortgage to secure it. Seller's broker brings the deposit to closing. The loan, deposit and the rest of the downpayment brought by buyer make up the purchase price. The seller (as grantor) delivers the executed deed to the buyer (as grantee).
- Closing attorney hired by lender: secures municipal lien certificate; searches title at registry; discharges all liens (obtains pay-off/offset statement from seller's lender); records new instruments; distributes funds. All documents and checks are held by them in escrow pending release of all documents and payments simultaneously a moment before recording the first of document.
- S/he updates the title search to ensure mortgagee receives first priority lien. If no problems are found, s/he closes and records. Discharge of old mortgage, the new deed and the new mortgage are the main documents recorded. Recording tells the public there has been a transfer of title, acceptance by the buyer and notice the lender is the first lien holder.
- After recording, the attorney gives the Note to the lender, the commission to the broker, who then pays any co-broker or buyer's broker (each broker will share part of the commission with his/her salesperson) and any equity is distributed to seller. The actual recorded instruments are left at the registry for duplication; some time later originals will be sent to the appropriate parties: deed to buyer, mortgage discharge to seller and mortgage to lender.

PRORATION MODELS

EXPENSES PREPAID = CREDIT TO SELLER

Example: A seller prepaid annual property tax of $1,200 on January 1 for the entire year. Property is sold on July 15. How much must be returned to the seller as a credit?

Analysis: Count *time* owed the seller from the date of sale forward to the end of the period. For the exam, each month has 30 days and exam will say who gets the closing day (typically seller).

July 16 to July 30 = .5 months
Aug/Sep/Oct/Nov/Dec = 5 months
Total: 5.5 months prepaid
The monthly tax owed is $100 ($1,200 ÷ 12)
$100 x 5.5 = $550 credit to seller

If closing is on the 6^{th} day of a month, (6/30 = .20 (20%) is seller's responsibility, 80% is buyer's responsibility.

EXPENSES OWED IN ARREARS = DEBIT TO SELLER

Example: A seller property tax of $1,200 per annum was in *arrears* on sale date of July 15. Tax year began January 1. How much must be charged to the seller as a debit?

July 15 back to Jan 1 = 6.5 months in arrears
The monthly tax owed is $100 ($1,200 ÷ 12)
Answer: $100 x 6.5 = $650 debit to seller