Modern Real Estate Practice in Illinois, 6th Edition

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Chapter 16: Real Estate Financing: Practice

Learning Objectives

After reading this chapter, students should be able to:

- Identify the types of institutions in the primary and secondary mortgage markets.
- Describe the various types of financing techniques available to real estate purchasers, and the role of government financing regulations.
- Explain the requirements and qualifications for conventional, FHA, and VA loan programs.
- Distinguish among the different types of financing techniques.
- Define the following key terms: adjustable-rate mortgage; amortized loans; balloon payment; blanket loan; buy down; certificate of eligibility; Community Reinvestment Act; computerized loan origination; construction loan; conventional loans; Equal Credit Opportunity Act; entitlement; Fannie Mae; Farm Credit System; Farm Service Agency; Farmer Mac; Freddie Mac; Federal Deposit Insurance Corporation; Federal Open Market Committee; Federal Reserve System; FHA loan; Ginnie Mae; growing-equity mortgage; home equity loan; Homeowners Protection Act of 1998; loan-to-value ratios; Office of Thrift Supervision; open-end loan; package loan; primary mortgage market; private mortgage insurance; purchase-money mortgage; RESPA; Regulation Z; reverse-annuity mortgage; sale-leaseback; secondary mortgage market; straight loan; Truth-in-Lending Act; VA loan; Veterans Millennium Health Care and Benefits Act of 1999; wraparound loan.

Why Learn About Real Estate Financing Practice?

Like the previous chapter, this one goes directly to the heart of your client's real estate transaction. Having an understanding of current financing techniques and sources of financing can help you direct buyers to the mortgage loans that will help them reach their real estate goals. Most real estate transactions require some sort of financing. Few people have the cash in hand necessary to buy a house or another large property. Also, as economic conditions change, the forces of supply and demand reshape the real estate market. Both of these factors have combined to create a complex and rapidly evolving mortgage market. One of the greatest challenges today's real estate licensees face is how to maintain a working knowledge of all the financing techniques available. If you understand these issues, the actors involved in the mortgage market and the mortgage options available to your clients, you will provide a valuable, attractive service to the public.

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Suggested Items to Bring to Class

1. Newspaper, Internet, and periodical articles about the current activities of HUD, FHA, VA, Fannie Mae, and GNMA.
2. Copies of the federal real estate loan disclosure statements, both blank and completed with a sample transaction's information.

Lecture Outline

I. Introduction to the Real Estate Financing Market

A. The Federal Reserve System

- The Federal Reserve System ("The Fed") divides the country into 12 federal reserve districts, each served by a federal reserve bank. All nationally chartered banks must join and purchase stock in district reserve banks.

1. Reserve requirements

The Fed requires that each member bank keep a certain amount of assets on hand as reserve funds unavailable for loans or any other use. This protects customer deposits and provides a means of manipulating the flow of cash in the money market.

- When the money available for lending decreases, interest rates rise.
- By decreasing reserve requirements, the amount of money circulated in the marketplace rises, causing interest rates to drop.

2. Discount rate: the discount rate is the rate charged by the Federal Reserve when it lends money to its member banks.

- The prime rate is strongly influenced by the Fed's discount rate.

B. The Primary Mortgage Market

Made up of the lenders that originate mortgage loans. For a lender, a loan must generate enough income to be attractive as an investment.

- Thrifts, savings associations, and commercial banks
- Insurance companies
- Credit unions
- Pension funds
- Endowment funds
- Investment group financing
- Mortgage banking companies

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- Mortgage brokers

C. The Secondary Mortgage Market

Here, loans are bought and sold after they have been funded.

1. **Fannie Mae or FNMA** (formerly the Federal National Mortgage Association): a quasi-governmental agency organized as a privately owned corporation that provides a secondary market for mortgage loans
    - Fannie Mae buys a block or pool of mortgages from a lender in exchange for mortgage-backed securities.
2. **Ginnie Mae** (formerly Government National Mortgage Association): a division of HUD organized as a corporation without capital stock
    - Administers special-assistance programs and guarantees MBSs using FHA and VA loans as collateral.
3. **Freddie Mac (FHLMC)** (formerly Federal Home Loan Mortgage Corporation)
    - Provides a secondary market for the sale conventional loans

II. Financing Techniques

A. Straight Loans

Divides the loan into two amounts (principal and interest), to be paid off separately. Ordinarily, only interest is paid during the term of the loan; the principal is paid at the end of the transaction.

B. Amortized Loans

The loan payment is divided into two parts: one for interest payment, and one for a reduction in principle. If it is fully amortized, the entire debt is paid at the end of the term; if it is a partially amortized loan, there will be a principal balance remaining on the loan. This is sometimes called a balloon payment.

- Each payment is applied first to the interest owed; the balance is applied to the principal amount.

C. Adjustable-Rate Mortgages (ARMs)

A loan originated at one rate of interest that fluctuates up or down during the loan term based on some objective economic indicator

- Rate caps limit the amount the interest rate may change.
- Payment caps set a maximum amount for payments.
- Adjustment periods establish how often the rate may be changed.

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D. Balloon Payment Loan

When the periodic payments are not enough to fully amortize the loan by the time the final payment is due, the final payment is larger than the others.

E. Growing-Equity Mortgage (GEM)

Uses a fixed interest rate, but payments of principal are increased according to an index or a schedule.

- GEM is most frequently used when the borrower's income is expected to keep pace with the increasing loan payments.

F. Reverse-Annuity Mortgage (RAM)

Loan in which the lender makes regular monthly payments to the borrower, based on the equity the homeowner has invested in the property.

- Allows senior citizens on fixed incomes to draw on the equity they have built up in their homes without having to sell.

G. Nonrecourse Loan

This loan is sometimes called a no-recourse loan and allows the borrower to escape personal responsibility on the loan. The lender's only remedy is to take over the property.

III. LOAN PROGRAMS

LTV is the ratio of the loan or debt to the value of the property: the lower the ratio, the higher the down payment, which minimizes the lender's risk. An 80% LTV means a down payment of 20%.

A. Conventional Loans

Viewed as the most secure loans because their LTV ratios are lowest, usually 80% of the value of the property or less, with a down payment of at least 20%.

B. Private Mortgage Insurance (PMI)

If a lender is giving a loan for greater than 80% of value, they will require the borrower to secure insurance from a private mortgage insurance company as additional security to insure the lender against borrower default.

- PMI protects a certain percentage of a loan, usually 25% to 30%, against default.

C. FHA-Insured Loans

FHA operates under HUD and has primary responsibility for administering the government home loan insurance program.

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- Title II, Section 203(b), fixed-interest rate loans for 10- to 30- year loans on one- to four-family residences -- most popular FHA program.
- Certain technical requirements must be met before FHA will insure a loan:

1. **Prepayment privileges**
2. **Assumption rules**
3. **Discount points**

   The lender of an FHA-insured loan may charge discount points in addition to a loan origination fee. The payment of the points is to be negotiated between the parties.

D. VA-Guaranteed Loans

The Department of Veterans Affairs (VA) is authorized to guarantee loans to purchase or construct homes for eligible veterans who meet certain time-in-service criteria and their spouses.

- The VA does not normally lend money; it guarantees loans made by lending institutions approved by the agency.

1. **Certificate of eligibility** states the maximum guarantee to which the veteran is entitled.
2. **Certificate of reasonable value (CRV)** states the property's current market value based on a VA-approved appraisal and places a ceiling on the amount of a VA loan allowed for the property.
   - If the purchase price exceeds the CRV, the veteran may pay the difference.
3. **Reasonable discount points** may be charged, and either the veteran or the seller may pay them.
4. **Prepayment privileges**

   The borrower can prepay the debt at any time without penalty.
5. **Assumption rules**

   VA loans made before March 1, 1988, are freely assumable (with an assumption processing fee). For loans made on or after March 1, 1988, the VA must approve the buyer and assumption agreement.

E. Agricultural Loan Programs

1. **Farm Service Agency (FSA)**

   Formerly Farmers Home Administration
   - A federal agency of the Department of Agriculture that offers programs to help low- and moderate-income families

purchase or operate family farms or purchase or improve single-family homes in rural areas

2. **Farm Credit System**
    - Provides loans to farmers, ranchers, rural homeowners, agricultural cooperatives, rural utility systems and agribusinesses
3. **Farmer Mac**
    - Another government-based enterprise that operates similarly to Fannie Mae and Freddie Mac, in the context of agriculture.

IV. Other Financing Techniques

A. Purchase-Money Mortgage

A note and mortgage created at the time of the purchase to make the sale possible. It can be a first or second mortgage.

B. Package Loan

Includes personal property as security for the loan in addition to the actual real estate

C. Blanket Loan

Covers more than one parcel or lot; usually includes a partial release clause that permits the borrower to release any one lot or parcel from the lien by repaying a certain amount of the loan

D. Wraparound Loan

Enables a borrower with an existing mortgage to obtain additional financing from a second lender without paying off the first loan

E. Open-End Loan

Secures a note plus any future advances of funds

- The interest rate on the initial amount borrowed is fixed, but interest on future advances may be charged at the market rate then in effect.

F. Construction Loan (Interim Financing)

The lender commits to the full amount of the loan but disburses the funds in payments (draws) during construction for work that has been completed since the previous payment.

G. Sale-and-Leaseback

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The land and building are sold to an investor, and then leased back by the investor to the seller, who continues to conduct business on the property as a tenant.

H. Buy down

A lump sum is paid in cash to the lender at the closing that offsets (and so reduces) the interest rate and monthly payments, typically by 1 to 2 percent over the first one to three years of the loan term. In a permanent buy down, a larger upfront payment reduces the effective interest rate for the life of the loan

I. Home Equity Loan

Using the equity buildup in a home to finance purchases is an alternative to refinancing. The original mortgage loan remains in place; the home equity loan is junior to the original lien.

- With the home equity line of credit (HELOC), the lender extends a line of credit that the borrower can use whenever he or she wants.

V. Financing Legislation

A. Truth-in-Lending Act and Regulation Z

Regulation Z, promulgated pursuant to the Truth-in-Lending Act, requires credit institutions to inform borrowers of all finance charges and the true interest rate before a transaction is completed.

- Regulation Z applies when a residence secures a credit transaction; a consumer must be fully informed of the provisions of the law.

1. Creditor

- Any person who extends consumer credit more than 25 times each year or more than 5 times each year if the transactions involve dwellings as security
- The credit must be subject to a finance charge or payable in more than four installments by written agreement.

2. Three-day right of rescission

A borrower has three days in which to rescind the transaction by merely notifying the lender.

- This right does not apply to residential purchase-money or first mortgage.

3. Advertising

The annual percentage rate (APR) must be stated.

- Specific credit terms, such as down payment, monthly payment, dollar amount of the finance charge, or term of

the loan, may not be advertised unless the advertisement includes specific information.

4. **Penalties**

Regulation Z provides a range of penalties for noncompliance, including fines and imprisonment.

B. Equal Credit Opportunity Act (ECOA)

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, or dependence on public assistance.

- Lenders and other creditors must inform all rejected credit applicants of the principal reasons for the denial or termination of credit in writing, within 30 days.
- Borrowers are entitled to a copy of the appraisal report if the borrower paid for it.

C. Community Reinvestment Act (CRA)

Under the CRA, financial institutions are expected to meet the deposit and credit needs of their communities, participate and invest in local community development and rehabilitation projects, and participate in loan programs for housing, small businesses, and small farms.

- To ensure compliance, financial institutions are periodically reviewed by one of four federal financial supervisory agencies.

D. Real Estate Settlement Procedures Act (RESPA)

RESPA is designed to ensure that buyer and seller are both fully informed of all settlement costs. The law requires that a HUD-1 standard closing statement be used showing all expenses related to the closing.

VI. Computerized Loan Origination (CLO) and Automated Underwriting

A CLO is an electronic network for handling loan applications through remote computer terminals linked to several lenders' computers.

- Under federal regulations, licensees may assist applicants in answering the on-screen questions and in understanding the services offered.
- The broker in whose office the terminal is located may earn fees of up to one-half point of the loan amount.
- Consumers must be informed that other lenders are available.

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Discussion Questions

1. What are the advantages of purchasing a home with an FHA-insured loan? What are the disadvantages?
2. What are the advantages of purchasing a home with a VA-guaranteed loan? What are the disadvantages?
3. What are the advantages of purchasing a home with a conventional loan? What are the disadvantages?
4. How would the real estate lending industry function if the secondary mortgage market did not exist? What improvements to the workings of the secondary market would you suggest?

Classroom Exercises

1. Obtain information from the regional HUD office and your municipality about the lesser known FHA-insured loan programs and have your students research and report on them, assigning each student one specific program.
2. Review with your students provisions of the Truth-in-Lending Act (Regulation Z) by thoroughly going over copies of the federal real estate loan disclosure statements.
3. Have your students bring copies of the real estate sections from your local newspapers; these should include both classified advertisements and display advertisements. Have them check to determine whether the disclosures required by the Truth-in-Lending Act (Regulation Z) are being met. Discuss some of the differences in financing terms and arrangements that would lead a potential borrower to think he or she was getting the "best deal" on a loan when, in fact, the annual percentage rate would be higher. (A good example is the inexpensive interest rate quoted with high discount points and expensive loan charges.)
4. Arrange to have a representative from a local mortgage company or a real estate broker speak with your class about various FHA, VA, and conventional loan programs. Have him or her address the differences in the requirements between conventional loans that will be sold in the secondary mortgage market and those that will be warehoused by the originating lender. Ask him or her to explain the qualifications borrowers must meet to obtain a mortgage loan, including minimum income amounts, maximum debt ratios and loan processing procedures.
5. Have your students practice qualifying someone for a loan.

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