California Community Colleges
Instructor’s Guide

Real Estate Finance
PREFACE

Publication of the California Community Colleges Real Estate Finance Instructor's Guide and Student Study Guide has been funded by a grant from the California Department of Real Estate.

ACKNOWLEDGEMENTS

The 2002 revision author wishes to acknowledge the contributions of the following authors and reviewers:

Dr. Robert J. Bond
Ted M. Ford
Stanley S. Reyburn, DBA
Allan Nuttall

The author also wants to thank George Bairey and Paul Vantress, former Directors of the California Community Colleges Real Estate Education Center, for their assistance.

Frederick C. Henning
Disclaimer

This guide is designed to apprise students of recent developments in the industry. The guide contains material deemed reliable as of date of publication. Students are cautioned not to fowl conclusions pertaining to legal and/or tax matters from course material without obtaining appropriate legal and/or tax advice. Course information should be evaluated in light of previous, pending and current information on the subject matter.

###
interest rates are at an all time low, we are in the interest frenzy, as •

ownership has taken advantage of favor market conditions. According to the report, "sales are of the •

Attendance is up, up in the real estate program. It is the Coca Cola •

•JuSt got a new service call for their new customers. As the •

class about real estate education: for real estate agents who need to enhance the •

faxes to view properties that only do successful salesmen •

taperecord with them as they travel, but computers, printers, are necessary. Anything else that will enhance their mobile offices •

•

today •

activity from is total menu of services offered. Real estate professionals •

tify their existence or slow fade away •

and sales activities, such as in the lean on the escrow •

or will not enter the real estate •

whether the banking industry or will not enter the real estate •

Alternative (NA) •

P. IS Seartediggiliehattle agust 01:8:SerViCes 2:ierrez:i: foreiendetif •

becoming commonplace. •

An American Slusse: the Internet haters use it to find homes faster. A significant portion of buyer and borrower prospects: •

areaStr the Internet. BEFORE contacting the agent for sales •

has assume •

Note. •

the loan application. •

process. •

At the very core: if FIC •

to take the positive •

market.
Big changes have occurred in Conforming Conventional, FHA, DVA, and Cal-Vet financing, and a significant portion of it just this year, 2002. Changes in qualifying guidelines as-well as increasing loan limits have that become the norm. This is a reality.

However, with all that we are experiencing as a part of the real estate profession, real estate is still an exciting profession: one that is a challenging one that is what makes it great, isn’t it?

Fred Henniirs.

Overland Investments
Post Office Box 1243
Glendortex, California 91740-
This GUIDE includes:

1. A Preview of each lesson, providing in one short paragraph, what the lesson covers.
2. Performance Objectives for each of the fifteen lessons.
3. Practice quizzes consisting of twenty multiple choice questions for each lesson. The INSTRUCTOR GUIDE contains answers to all of the multiple choice questions contained in the STUDENT STUDY GUIDE. The letter a, b, c, or d representing the correct answer is in **bold** print and *underlined* in the INSTRUCTOR GUIDE, but not in the STUDENT GUIDE.
4. THE INSTRUCTOR GUIDE also contains a MID-TERM EXAMINATION of 100 questions and answers covering the first seven lessons and a FINAL EXAMINATION of 100 questions and answers covering lessons 8-15.

This Guide is just that, a GUIDE, written in a condensed, outlined format and is not designed to replace standard textbooks needed to gain in-depth knowledge of an increasingly complex subject. Ideally, this Guide should be used to supplement, and not to supplant, textbooks on the subject of California Real Estate Finance as well as assisting instructors in the preparation of lesson plans. Additionally, it is meant to aid students in gaining a better knowledge of the subject of Real Estate Finance.
## TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>LESSON</th>
<th>TOPIC</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>One</td>
<td>Why Real Estate Finance?</td>
<td>1-1</td>
</tr>
<tr>
<td></td>
<td>Financing Steps; Qualities, Creation of Money; Monetary and Fiscal Policies; Interest Rate Fluctuations; Financing Instruments, Special Clauses; California Mortgage Market Characteristics</td>
<td></td>
</tr>
<tr>
<td>Two</td>
<td>Who Are the Institutional Lenders?</td>
<td>2-1</td>
</tr>
<tr>
<td></td>
<td>Characteristics &amp; Trends Of Fiduciaries; FIRREA; FHFB; SAIF; OTS</td>
<td></td>
</tr>
<tr>
<td>Three</td>
<td>Who are the Non-Institutional Lenders?</td>
<td>3-1</td>
</tr>
<tr>
<td></td>
<td>Contrast Institutional vs. Non-Institutional Lenders; Characteristics of Non-Institutional Lenders; Purpose &amp; Provisions of the Mortgage Loan Broker Law; Interest Rate Tax Deductibility</td>
<td></td>
</tr>
<tr>
<td>Four</td>
<td>Alternative Mortgage Instruments: What Are They?</td>
<td>4-1</td>
</tr>
<tr>
<td></td>
<td>Five Basic Types Of AMIs; ARMs; GPMs; ROMs; SAMs; Negative Amortization; Borrowing Short and Lending Long</td>
<td></td>
</tr>
<tr>
<td>Five</td>
<td>What Are Conventional Loans?</td>
<td>5-1</td>
</tr>
<tr>
<td></td>
<td>Definition; Advantages; Disadvantages; Lender Selection Process; Lender Policies, Calculation of Fees, Prepayment Penalties, and Loan-To-Value Ratios</td>
<td></td>
</tr>
<tr>
<td>Six</td>
<td>What Are Government-Backed Loans?</td>
<td>6-1</td>
</tr>
<tr>
<td></td>
<td>Characteristics of FHA and DVA Loans; Differences Between FHA and DVA Loans; Cal-Vet Eligibility Requirements &amp; Advantages and Disadvantages</td>
<td></td>
</tr>
<tr>
<td>Seven</td>
<td>How Do Points, Discounts Operate In The Secondary Market?</td>
<td>7-1</td>
</tr>
<tr>
<td></td>
<td>Differentiate Between Points and Discounts; Relationship between Price and Yield; Use of Points; Secondary Mortgage Market Defined; Functions of Fannie Mae, Freddie Mac, and Ginnie Mae; Role of Investment Bankers in Secondary Market</td>
<td></td>
</tr>
<tr>
<td>Eight</td>
<td>What Role Does Qualifying the Property Play In Loan Underwriting?</td>
<td>8-1</td>
</tr>
<tr>
<td></td>
<td>What is Meant by Qualifying the Property; Three Approaches to Value; Influence of Fannie Mae and Freddie Mac on Property Standards; Marketability Defined; Impact on Real Estate Financing Process of Savings and Loan Bailout Bill; How Licensees and Assist Appraisers</td>
<td></td>
</tr>
<tr>
<td>Nine</td>
<td>What Role Does Qualifying the Borrower Play In Loan Underwriting?</td>
<td>9-1</td>
</tr>
<tr>
<td></td>
<td>Reasons to Scrutinize Loan Applicants; The Cs of Credit; Creditworthiness of Prospective Borrowers; Evaluating the Stability and Durability of Income; Evaluating the Quantity and Quality of Borrower Assets; Income and Expense Requirements of the Various Government Loan Programs; Roles of Fannie Mae and Freddie Mac in Qualification Process</td>
<td></td>
</tr>
<tr>
<td>LESSON</td>
<td>TOPIC</td>
<td>PAGE</td>
</tr>
<tr>
<td>--------</td>
<td>----------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>Ten</td>
<td>How Does Processing, Underwriting, Funding, Closing, and Servicing Loans Take Place?</td>
<td>10-1</td>
</tr>
<tr>
<td></td>
<td>Information Sought by Lenders on Loan Application; Equal Credit Opportunity Act; Verifications of Deposit and Employment; Steps in Final Loan Approval; RESPA; Truth In Lending and APR; Prepayment Privileges and Penalties</td>
<td></td>
</tr>
<tr>
<td>Eleven</td>
<td>How Do Foreclosures and Other Lending Problems Fit Into Real Estate Finance?</td>
<td>11-1</td>
</tr>
<tr>
<td></td>
<td>Trust Deed Collateral Provisions; Foreclosure Proceedings; Power of Sale and Deed in Lieu of Foreclosure; Assignment of Rents Clause Protections; Minimizing or Mitigating Foreclosure Losses; PMI and Foreclosures; Community Reinvestment Act and the Collection of Confidential Data</td>
<td></td>
</tr>
<tr>
<td>Twelve</td>
<td>Who Are The Major Players In Construction Financing?</td>
<td>12-1</td>
</tr>
<tr>
<td></td>
<td>Basic Principles of Construction Lending; Construction Lending Technical Vocabulary; Sources of Construction Loans; Take-Out vs. Interim Loans; Items of Construction Loan Costs; Filing Steps in Mechanics's Lien; Construction Loans: Self-Contained, Self-Servicing Loans</td>
<td></td>
</tr>
<tr>
<td>Thirteen</td>
<td>How Can I Simplify Mathematics of Real Estate Finance?</td>
<td>13-1</td>
</tr>
<tr>
<td></td>
<td>Straight Note vs. Amortized Note; Use of formula: I=PRT; Calculating Mortgage Payments and Mortgage Balances; Use of Amortization Tables; Computing Effective Yields; Refinancing Decisions; How to Use the HP-12C to Simplify Real Estate Math</td>
<td></td>
</tr>
<tr>
<td>Fourteen</td>
<td>What Are Some Creative Financing Approaches?</td>
<td>14-1</td>
</tr>
<tr>
<td></td>
<td>Traditional vs. Creative Financing; Alternative vs. Creative Financing; Creative Financing Techniques; Junior Financing; Installment Sales: Advantages and Disadvantages; Exchanging Techniques; Major Provisions of the Seller Carryback Financing Disclosure</td>
<td></td>
</tr>
<tr>
<td>Fifteen</td>
<td>How Does One Finance Small Investment Properties?</td>
<td>15-1</td>
</tr>
<tr>
<td></td>
<td>Differences in Financing Single Family, Commercial, and Industrial Properties; Interest Rates, Points and Terms: Why Do They Vary According to Property Type; Tax Shelter Opportunities; Essential Financial Information in Listing An Apartment Project; Comparative Advantages and Disadvantages of Investments in Various Property Types</td>
<td></td>
</tr>
</tbody>
</table>
LESSON ONE
WHY REAL ESTATE FINANCE?

PREVIEW:
This lesson supplies a overview of real estate financing, examining its importance in the marketing of real estate. We describe the nature of money, how it is created, the Federal Reserve Board's role in manipulating the supply and cost of money, and how money flows into the mortgage market to help finance real property. The six-step financing process is tracked from the application to closing and servicing of the loan. We conclude with discussion of some of the more important instruments used in financing real estate, together with a few of the special clauses found in them.

PERFORMANCE OBJECTIVES:
At the conclusion of this lesson, you should be able to:

1. Explain why financing is important to the successful marketing of real property.
2. Trace the steps involved in real estate financing.
3. Describe some of the qualities of money.
4. Differentiate between "monetary policy" and "fiscal policy".
5. Outline the mechanics for the "creation" of money by the banking system.
7. List and describe the instruments required in financing real estate.
8. Cite three of the many special clauses found in basic financing instruments.
9. List 4 characteristics peculiar to the California mortgage market.

I. WHY IS FINANCING IMPORTANT TO THE REAL ESTATE BUSINESS?

A. Access to money and credit is fundamental to most real estate transactions. Without financing, the sale of real estate would come to a virtual standstill. The successful sale of real property involves a sequence of events that is more or less patterned as follows:
1. Owner decides to sell and decides to employ a real estate agent to find a qualified buyer. Such an arrangement is reduced to writing through a document called a "listing agreement", of which there are a wide variety of forms to accomplish its basic objective: employment of an agent to sell the owner-principal's property.

2. Agent advertises and prospects for qualified buyers.

3. Upon finding a "ready, willing, and able" buyer, an offer to purchase is executed by buyers, typically through a combination Real Estate Purchase Contract and Receipt for Deposit or similar titled instrument.

4. Seller accepts the offer or makes a counteroffer, to which counteroffers may go back and forth. Negotiations continue until terms and conditions are acceptable to both parties.

5. After mutual acceptance has been reached, escrow is opened, and a search of title ownership and status is ordered.

6. Agent assists the buyer in finding acceptable financing under terms of the purchase contract.

7. Prospective lender orders an appraisal in order to qualify the property, which is an integral part of underwriting real property loans.

8. A credit report is ordered by the prospective lender from one of the many credit-gathering firms, such as Equifax, Trans Union, and Experian. These three are data banks that supply credit information to subscribing credit agencies.

9. Analysis of the applicant's credit history is made in order to qualify the buyer-borrower.

10. After the appraisal, credit check, title search and other documentation is obtained, the underwriting lender either approves or rejects the loan application. If approved, funds and necessary documents are forwarded to the escrow holder. (If disapproved, applicants should seek other lenders who may accept their loan requests.)

11. After all of the terms and conditions of the sale and purchase agreement have been fulfilled, including the escrow instructions, loan documentation and other lender requirements, title is transferred from seller to buyer through escrow. After title transfers at time of recordation of deed, funds are disbursed.
12. Itemized closing statements and title insurance policy are issued after escrow closes.

13. Changes are occurring in the Escrow field in California.
   a. Recently, the role of the independent escrow company has been diminishing in Southern California with many former independent operators (as regulated by the Corporations Commissioner) being absorbed as escrow divisions of title companies.
   b. More and more real estate brokerage firms engaged primarily in listing and sales operations are including escrows as a part of their services, cutting further into the independent escrow business.

B. Demand. Historically, the population growth rate in California has exceeded the national average. This has created a strong demand for mortgage money to help finance housing, agriculture, and business needs of the state.

C. Other reasons. Even people who have sufficient funds rarely pay all cash for real estate because income tax deductions and investment yields favor the use of borrowed funds. The principle of LEVERAGE applies here.

II. WHAT IS THE RELATIONSHIP OF MONEY AND THE MORTGAGE MARKET?

A. What is money? Money is viewed as anything that people will accept in exchange for goods and services. Its value lies primarily in our confidence that other people will accept money in exchange for their goods and services. It is more than just coins and paper currency. Symbolic meanings and functions of money include:

   1. Medium of exchange
   2. Standard of value
   3. Storehouse of purchasing power
   4. Printed (engraved) promise to pay
   5. Summation of wealth
   6. Representation of goods and services
   7. Credit
   8. Debits

B. How is Money Earned?
   We earn money in one of four ways:

   1. Wages, fees, and commissions, in exchange for labor and

4. Rents, in exchange for use of real or personal property.

C How is Money Accumulated?

Money accumulates in a variety of ways. The principal method is through savings, which is spending less than what is earned. There are many savings and investment choices available to savers. Where those savings will ultimately accumulate will be dependent on needs, degree of risk, and personal preference.

D How is Money Created?

Money is created in three ways:

1. By the U.S. Treasury, through coins that are minted and the paper currency that is printed.

2. Within the commercial banking system, under what is referred to as fractional reserve banking. A single deposit can grow to many times its face value as it travels, less any government reserve requirements, from bank to bank. An illustration below illustrates the situation.

<table>
<thead>
<tr>
<th>Depository</th>
<th>Deposit</th>
<th>Reserve Requirement</th>
<th>Loanable Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$500.00</td>
<td>$100.00</td>
<td>$400.00</td>
</tr>
<tr>
<td>B</td>
<td>$400.00</td>
<td>$ 80.00</td>
<td>$320.00</td>
</tr>
<tr>
<td>C</td>
<td>$320.00</td>
<td>$ 64.00</td>
<td>$256.00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$976.00</td>
<td>$244.00</td>
<td></td>
</tr>
</tbody>
</table>

$500.00 was deposited in Bank A. It was loaned out, less any government reserve requirements. That loan of $400.00 was used to buy a good or service. The seller deposited the funds in his bank, Bank B. That institution loaned out the deposit, less any reserve requirements. That loan was used to purchase a good or service. The seller deposited the funds in his bank, Bank C. Bank C loaned out the funds, less any reserve requirements. The original deposit in Bank A of $500.00 has now grown to $976.00!

3. Demand Deposits (checking accounts).

III. WHAT IS THE FEDERAL RESERVE SYSTEM, AND WHY DOES IT EXIST?

A. Referred to as "the Fed", the Federal Reserve System is charged with maintaining sound credit conditions in order to:

(1) help counteract inflation and deflation
(2) encourage high employment
B. Banker's Bank. The Fed is the "banker's bank", consisting of 12 federal reserve districts. Each district is served by a federal reserve bank, coordinated and directed by a seven member board of governors appointed by the President. Benefits of membership include borrowing privileges, sharing in reams of information published by the Fed, and insurance of all checking and savings accounts up to $100,000 each. The 12 District, serving California, Nevada, and Arizona is located in San Francisco, California.

B Monetary policy. The Fed's ability to control the supply and cost of money is referred to as "monetary policy". Monetary control is necessary to reduce or increase the effective demand for goods and services by increasing or decreasing the money stock or its velocity. The principal ways in which the Fed exerts its influence on the supply of money are through reserve requirements, open market operations, and discount rates.

1. Reserve Requirements. All member banks must set aside reserve funds in order to protect depositors. Adjusting these reserves up or down allows the Fed to manipulate the amount of money in circulation.

Example 1. If the reserve requirement is 10%, banks need to set aside $10 in reserves for every $100 of deposits. Any money beyond the required reserves may be loaned out, in this case, at a ratio of 10 to 1. (Simply divide 1 by the percentage required to be set aside to arrive at the multiplier.) Banks are then able to create excess reserves in their portfolios.

Example 2. If the Fed doubled the reserves required to be set aside from, say, 10% to 20%, the Fed would effectively decrease the amount of loanable funds by a substantial margin. Instead of setting aside $10 per $100 of deposits, banks would need to place $20 out of every $100 of deposits into reserves.

Example 3. If existing 20% reserves are cut back to 10% by Fed directive, the amount of bank's lending activity is suddenly increased, in this case, doubling the amount before Fed action was taken.
Summary. The higher the reserve ratio, the less money that can be invested in loans and other banking opportunities. Conversely, the lower the reserve requirements, the larger the amount of capital that is made available for real estate and other lending activities.

2. Open Market Activities. The Fed's open market activities involve buying and selling government securities, under the direction of the Federal Open Market Committee (FOMC).

a. Purchasing securities. When the Fed buys government securities, they increase the reserves by putting money into the marketplace held in sellers' banks. Cash is paid to the sellers, who in turn deposit it into their bank accounts. With the additional funds, the bank is able to extend more credit, that is, create more money. This translates into more real estate activity.

b. Selling securities. When the Fed sells government securities, the opposite takes place. Reserves in buyers' banks decrease. Cash is paid to the Fed by the buyers, who pay for the securities with funds withdrawn from their banks. With the banking system holding less cash, less credit is available for real estate and other activities.

c. Relationship to reserve requirements. Actions taken by the Federal Open Market Committee in the buying and selling of government securities have the same consequences as the Fed's increasing or decreasing the reserve requirements for member banks.

3. Discount Rates. To avoid having their reserves dip below the required minimum, banks may borrow from the Fed. The rate charged by the Fed is called the "discount rate".

a. Increases. The impact of changing discount rates by the Fed on real estate financing can be enormous. The higher the Fed's discount rate charged to banks, the higher the rate of interest charged by the bank to the real estate borrower. Hence, buyers may simply postpone the purchase of a home with the hope that "interest rates will soon come down".

b. Decreases. The reverse of the cycle is also true. The lower the discount rate, the lower the rate of interest charged by banks to borrowers. A greater demand for loans usually follows, resulting in increased real estate activities.
4. Statements of the Federal Reserve Chairman.
   a. Official monetary policy statements.
   b. Other public statements.

IV. THE UNITED STATES TREASURY

A. Fiscal policy. Congress and the President, through the U.S. Treasury, act as the nation's fiscal agent, managing the federal government's debt. The government's printing and coining of money plus its spending and taxing policies are referred to collectively as fiscal policy, in contrast to the monetary policy of the Fed.

1. Impact on real estate financing. How much the federal government spends, and how much it takes in through taxation, affects all levels of financing. For example, if the U.S. Treasury decides to issue long-term debt instruments to help finance government spending, less money is available for mortgages. The impact is similar to the Fed's increasing the reserve requirement. Fewer homes would be constructed or purchased because of the reduction in available capital. On the other hand, if the government decided to curtail or reduce spending, more money is available for the capital markets, including the financing of real estate.

2. Peripheral activities. The Treasury is more than just the supplier of funds for federal spending. It has long been involved in the initial funding of new programs designed to bolster our economy. For example, it helped establish Fannie Mae, the Federal Land Bank system, and other agencies that continue to affect the financing of real estate.

3. Fannie Mae and Freddie Mac have the right to call on treasury funds, if needed. However, they have never had to request these funds.

V. WHAT DETERMINES THE COST OF MORTGAGE MONEY?

A. Supply and demand for funds is the major factor affecting the cost of money for real estate loans. Others include:

1. Local factors, such as employment, population, government spending, level of development in the community, and even climatic conditions.

2. National factors, including actions taken by the Federal Reserve Board, the U.S. Treasury, inflation and business cycles.
3. International factors, such as an unfavorable trade balance, strength of the American dollar, securities markets abroad, and political changes.

4. Institutional factors. Lending institutions must take into account the following in setting the price for borrowing money:

   a. Deposit cost. This refers to the cost of attracting depositors to the financial institution. The higher the rate paid on savings accounts, the larger the lending cost to the institution.

   b. Borrowing costs. All lenders from time to time tap the bond and other financial markets for needed capital. Underwriting costs and interest expenses are in turn passed on to real estate consumers.

   c. Sales costs. Promotional costs of all types are included here, including advertising, loan solicitors, and so on.

   d. Administration. There are overhead and administrative costs in any business. Rent, utilities, management maintenance, and other expenses must be absorbed in establishing the cost of money.

   e. Reserves. As pointed out earlier, reserves must be set aside by commercial banks and other institutional lenders. This represents an opportunity cost, measured by the price of money that must sit idle and unproductive.

   f. Profit. As with any enterprise, lenders are in the business of earning a profit for their stockholders and for themselves. A reasonable profit is viewed as a necessary "expense" in conducting business.

B. Why do Interest Rates Fluctuate?

{SHOW T 1-8}  
(INSTRUCTOR: You MAY WANT TO INTRODUCE THE SECTION LABELED "MARKETS DIARY" FOUND IN PART THREE (MONEY AND INVESTING) OF THE WALL STREET JOURNAL. EXPLAIN HOW THE DATA RELATES TO INTEREST RATES GENERALLY. KEEP THE GRAPHS UNTIL END OF THE COURSE IN ORDER TO COMPARE TO WHAT HAD HAPPENED OVER THE COURSE OF THE SEMESTER.)
Many things cause interest rates to fluctuate up and down. Underlying all rate fluctuations for real estate loans are supply and demand for credit over the long-term. After all, credit is bought and sold like any other commodity. When borrowers compete in the credit markets, the price of borrowed money is driven upward. Specific forces influencing changes in interest rates include:

1. **Supply.** As incomes increase, the money stock also increases, fueling economic expansion. If demand for loans does not keep pace, interest rates trend downward.

2. **Demand.** A strong demand for credit pushes rates upward. Even as the money supply continues to grow, the economy becomes overheated, and competing borrowers bid up prices. As prices climb, lenders naturally demand higher returns to offset reduced purchasing power of their money.

3. **Excessive government spending.** As deficit spending increases, so does inflation, thus causing higher rates.

4. **Large government borrowings.** As the federal government increases its spending faster than its collection of tax revenues, it heightens competition in the capital markets to raise money. Such competition invariably raises interest rates.

5. **Inflation.** Inflation is an inevitable consequence of increasing government (and others) spending and borrowing, causing increases in interest rates even with increases in the money supply. As the money supply swells, so do expectations of rapid inflation, thus causing lenders to demand higher rates of return to compensate for the reduced purchasing power of the dollar. (Inflation may be viewed as "spending too much for that which we think we need").


   a. **Tight money** refers to restrictive monetary policies of the Fed in its attempt to combat inflation by reducing the money supply. Any action to reduce the supply will ordinarily cause interest rates to rise, unless of course the demand for funds correspondingly reduces. But where demand remains the same or increases, competition for the restricted supply of money climbs. Money invariably leaves thrift institutions for "greener pastures", where higher returns are paid for funds. (This is
referred to as *disintermediation*.}
b. Easy money refers to a relatively loose money policy of the Fed, which attempts to combat recession by easing the supply of money in circulation. As money supply increases, employment increases, leading to increased income and savings. As money builds up, interest rates trend downward. Real estate activities usually increase under easy money condition.

7. Political and bureaucratic actions, policies, and regulations.

(INSTRUCTOR: THIS MAY BE AN OPPORTUNE TIME TO INTRODUCE THE TOPIC OF "AFFORDABILITY INDEX" DISCUSSED IN LESSON TWO)

VI. WHAT IS THE RELATIONSHIP OF SHORT-TERM, INTERMEDIATE-TERM AND LONG-TERM RATES TO REAL ESTATE MARKETS? Interest rates are greatly influenced by the length of the loan:

1. Short-term rates. Credit that is extended for a term of less than one year is defined as short-term. Examples: U.S. Treasury Bills, Certificates of deposit, Installment Loans, and Commercial Paper, which are corporate promissory notes (IOUs). Financiers refer to short-term credit as the money market. Within this market rates vary from the lowest "prime" rate, which is the rate charged for the most credit-worthy borrower, to the higher rates charged for marginal debtors.

a. Liquidity. Short-term interest rates are normally lower than long-term rates. Lenders believe that risks rise with the length of maturity. Thus, a premium is charged on longer term loans. After all, most savers desire to hold their money in a highly liquid state, to withdraw within several days if needed. This means a pile-up of short-term funds for short-term lending. Such a surplus of demand for short-term assets (savings) leads to lower rates for short-term borrowings. This pattern is also found in real estate loans: as the length of loan extends, so also does the effective rate increase.

2. Intermediate rates. Money loaned for periods between 1 to 10 years is part of the intermediate financial market. Examples include treasury certificates and treasury notes.

3. Long-term rates. Extension of credit in excess of 10 years is often referred to as the capital market. This is the market that deals in real estate loans. Other examples include government bonds and corporate bonds.
1. Long-term interest rates tend to go up when the market expects more long-term inflation. Short-term interest rates tend to go down when the market expects long-term inflation. Thus, if the Treasury dips into the long-term market for $X billion, long-term interest rates tend to rise, while shorter term rates tend to fall. Borrowers then must seek their financing in the short-term money market (adjustable rate mortgages). Eventually long-term rates fall back, and borrowers return to the long-term capital market (fixed-rate mortgages).

2. The federal government is the largest user of credit and commands a prime position in the money and capital markets. It has relatively unlimited resources in the market as a competitor with private sector investors.

3. The 10-year treasury note has been substituted as an index for trends in long-term fixed-rate mortgage financing due to the Treasury's decision in 2001 to discontinue the issuance of the former bellwether 30-year notes.

(INSTRUCTOR: ALTHOUGH PRICE AND YIELD ARE DETAILED IN LESSON 7, THE DIFFERENCE BETWEEN PRICE AND YIELD IN THE BOND MARKET COULD AT LEAST BE INTRODUCED HERE, SINCE BOND RATES ARE A GOOD BAROMETER FOR LONG-TERM INTEREST RATES.)

VII. WHAT IS THE SIX-STEP FINANCING PROCESS?

{Show T 1-11}

A. Application. The loan process begins with the application blank filled in by the borrower or lender's agent or loan officer. The form includes information on the applicant's financial condition, including amount and consistency of income, along with outstanding debts and expenses. The application also requests information concerning the property, including location, age, size of lot and improvements thereon. If the application is for a construction loan, details concerning the proposed improvements are required. A complete, thorough and honest application provides all the essentials for a good loan.

B. Processing. After the completed application form is provided to the lender, the lender verifies all information included in the application along with the order of a credit report and property appraisal.
C. **Underwriting.** The processed package is reviewed to determine if the borrower and the property appear to meet the lender's standards. If acceptable, the lender presents the proposed financing terms to the borrower. Applicants may accept, reject, or attempt to negotiate with the lender to obtain more favorable terms. Good credit of the borrower is essential; late payments and repositions may cause applicants to be declined.

C **Funding.** After agreement is reached, loan documents are drawn, disclosure forms prepared, and instructions for the escrow and title insurance company are issued. Lenders establish their own processing patterns in accordance with their own policies and procedures.

1 **Hazardous substances.** Increasing numbers of disclosures are being required before loans can be processed and sale finalized. Toxic wastes directly impact lending practices, since lenders are frequently joined in lawsuits involving later discovery of such hazards. For residential properties containing one to four units, the Civil Code (Section 1102.6) requires sellers to disclose whether they are aware of "any substances, materials or products on the property that may be an environmental hazard". These include asbestos, formaldehyde, radon gas, lead-based paint, fuel or chemical storage tanks, and contaminated soil or water.

2. **All loan papers and the transferring of title.**
Practices vary within the state in the handling of the escrow. In Southern California, many transactions are handled through the use of independent escrows, who coordinate with the lender and the title company. But in much of Northern California, the usual procedure is for the lender to send all papers to a title company that handles signing of the papers and the escrow.

E. **Closing.** Lender funds are sent to the title company, who handled the transfer of title and payoffs of any existing loans. An overages, once the title is transferred, are sent to escrow for distribution.

F. **Servicing.** This refers to loan collections and records keeping. It includes necessary follow-up to assure that the property is maintained; that insurance, taxes, and other obligations are paid; and that delinquency is prevented in order to reduce possibility of foreclosure. Stated differently, servicing is the function that monitors the obligations of the borrower as set forth in the instrument of obligation, the note, and the instrument which secures it, the deed of trust. Most lenders do their own servicing, while others pay independent mortgage companies fees for handling the
VIII. WHAT ARE THE MOST COMMON INSTRUMENTS USED IN FINANCING REAL ESTATE?

{Show T 113}

A. Promissory Notes. A promissory note is a promise: the first four words typically read "I/we promise to pay:, followed by "on or before" a given date. If this promise is not met, foreclosure may follow. The promissory note is the basic, underlying financing instrument, the primary evidence of a debt, outlining terms of repayment and due dates. The two basic types are the installment note and the straight note.

1. Installment Note. By far the most common form of promissory note, this requires periodic payments that include both principal and interest. The periodic reduction of principal is referred to as amortization, hence the loan is said to be an "amortized loan."

Variations of the amortized loan include:

a. Fully Amortized Note. Under this form, the loan is periodically liquidated through equal, or level payments that include principal and interest. The payments are arranged in such a way that the final installment pays off the loan completely. Unless a financial calculator is used (see Lesson 13), payment charts such as illustrated in T 1-10 are used.

b. Partially Amortized Note. Under this plan the periodic installments cover the interest plus only a portion of the principal, not enough to cover the amortization on a fully self-liquidating basis. Hence a lump sum payment, called a "balloon", is due at maturity. For example, a loan may be structured using a 30 year repayment term, but require the entire unpaid balance paid off in a much shorter time, such as 15 years.

c. Amortized Loan, Interest Extra. This is also referred to as a "principal plus interest" loan scheme, in contrast to the "principal and interest" plan outlined in (a) and (b). Each month a fixed amount is paid to reduce the principal. To this figure is added interest computed on the unpaid balance. It's used in seller carry-backs, where the buyer-borrower's income is at a high level today, but is expected to decline due to retirement, etc. The calculation is illustrated in Lesson 13.
d. Variable-Rate Note. Here the interest rate is periodically adjusted, up or down, according to a particular index used by the lender. Many variations of this method of financing exist. They may be constructed to fully, partially, or negatively amortize. This type of loan program will be detailed in Lesson 4.

1. Straight Note. This promise to pay is also referred to as an "interest only" note, where the borrower agrees to pay the interest in periodic installments and to pay the entire principal in a lump sum on the due date. On rare occasions the interest may simply compound and get paid off with the principal at maturity, its "due date". When compounded interest is used this way, it is called a one-pay note.

a. Calculating Interest. Interest on a straight note is computed by using the simple interest formula:

\[ \text{Interest} = \text{Principal} \times \text{Rate} \times \text{Time} \]

OR

\[ I = P \times R \times T \]

Example:
To find the interest paid on a $100,000 note at 12%, paid at the end of the year:

\[ I = \$100,000 \times .12 \times 1 = \$12,000 \]

Here interest was figured on an annual basis. To calculate monthly interest, you have 3 choices:

(1) Substitute 1/12 for the T (time) factor:
\[ I = \$100,000 \times .12 \times 1/12 \]
\[ I = \$1,000 \text{ (for one month)} \]

(2) Divide the R (rate) by 12:
\[ I = \$100,000 \times .12/12 \]
\[ I = \$1,000 \text{ (for one month)} \]

(3) Divide the amount of annual interest by 12:
\[ I = \$100,000 \times .12 \times 1 \text{ (for one year)} \]
\[ I = \$12,000 \text{ (for one year)} \]
\[ I = \$12,000 / 12 \text{ (for one month)} \]
\[ I = \$1,000 \text{ (for one month)} \]

We'll do some further calculations for these in Lesson 13.

b. Straight notes are commonplace with seller financing, particularly with second trust deeds.
B. Deed Of Trust.

To assure that promissory notes will be paid when due, lenders require security. An instrument called deed of trust, or simply trust deed, is used to accomplish this. Characteristics of a trust deed include:

1. Three-party instrument. The borrower is called a trustor. The lender is called beneficiary. A neutral party who stands between these two, and holds bare legal title in trust, is termed trustee.

2. Title. Under the terms of the deed of trust, trustor conveys legal title to the trustee, who retains title until the note is repaid. Once the debt is fully paid, the beneficiary orders the trustee to convey title back to the trustor through an instrument called Deed of Reconveyance. (It may be noted that since California is a so-called "lien theory" state, the transfer of title to the trustee is subject to the equitable title of the borrower.

3. Duty of trustee. The trustee is given the trust deed "with power of sale." If the debt is not paid in conformance with the deed of trust, the beneficiary can order the trustee to conduct a "trustee's sale." The proceeds raised through such sale are used to pay off the loan.

4. Redemption. Once the trustee's sale has been held in accordance with the law, the borrower loses all rights to redeem the property.

C. Mortgage. On rare occasions a California lender may use a mortgage instrument as security for the loan, as is common in many other states.

1. Parties. This is a two-party instrument involving the lender, called mortgagee, and the borrower, called mortgagor.

2. Title. Under terms of the mortgage contract, title to the property is retained by the mortgagor.
3. Foreclosure. To foreclose on a mortgage, the mortgagee must go through a court (judicial foreclosure). The court issues a decree of foreclosure and the property is offered for sale at public auction. It is possible for the Mortgagors to redeem foreclosed property within one year after the public auction.

4. Preference. Trust deeds are favored in California over the mortgage due to the relative speed, lower costs with which a trust deed may be foreclosed and the absence of the redemption process.

D. Installment Sales Contract. Popularly referred to as a "land contract" or "contract of sale," this financing device is an agreement between buyer and seller where the buyer is given possession and use of property in exchange for regular installment payments. Its chief characteristics include:

1. Parties. Like the mortgage instrument, only 2 parties are involved: the seller who is formally referred to as the vendor, and the buyer who is called the vendee.

2. Possession. In the conventional sale a grant deed is issued by seller and title transferred to buyer. A grant deed is not issued in the land contract, but physical possession is transferred to the vendees.

3. Title. Legal title to the property remains with the vendor until an agreed amount has been paid, at which point vendor conveys a grant deed to the vendee. Meanwhile vendees hold only equitable title to the property, which is equal to the down payment and equity buildup.
4. **Equity.** In effect, the vendor acts as the lender, carrying back "paper" for the difference between the sales price and down payment, or remaining equity. However, it is possible that there is an existing trust deed that is to remain as a lien against the property, payable by vendor-trustor to the beneficiary from the proceeds received under the land contract.

5. **Default.** One of the claimed benefits of the installment sales contract is the ease with which the vendor could eliminate a buyer's interest in case of default. However, changes in California law increasingly protect the rights of the vendee. Vendor must spend considerable time, effort, and money to oust defaulting vendees. Consumer protection groups have also been growing, offering increased protection to vendees against forfeiture or other harsh or inequitable results.

6. The only significant lending source that uses a land contract as a security instrument is the State of California Department of Veterans Affairs (Cal-Vet).

E. **Lease.** While this is actually an alternative to purchasing real property, leasing does have several earmarks of a financing scheme.

1. **Possession.** Leasing provides lessee or tenant with use, possession and control as if the property had been purchased with sellers carrying back paper. The major difference is that in the case of a lease, the lessor or landlord financed the full amount of equity, since there is no down payment as such.

2. **Estates.** Lease contracts create what is known as a "leasehold estate" that may be used by lessee as security for a loan. Should lessee default on a loan, the lender would foreclose and take over lessee's right of possession under the lease agreement.

3. **Lessor borrowings.** A lease can also be used as collateral for financing for lessors as well. Lessors may borrow money and pledge lease payments to secure the loan repayment.

   {A variation of the lease, called Sale-Leaseback, is discussed and illustrated in Lesson 14.}
X. SIGNIFICANT CLAUSES FOUND IN REAL ESTATE INSTRUMENTS

A. In addition to repayment terms, real estate financing instruments typically contain one or more special clauses or conditions to which the borrower and lender agree, including:

1. Acceleration Clause. This gives the lender the right to call all sums due and payable upon the happening of any one of certain enumerated events, such as failure to meet monthly payments, non-payment of property taxes, willful destruction of the property.

2. Due on Sale Clause. Also referred to as an alienation clause, this is a specific type of acceleration clause that gives the lender the right to call the loan if the borrower sells or transfers the property.

   a. Due on Further Encumbrance. Another form of alienation clause which is granted by borrower, precipitated by incurring further debt on the borrower's part.

3. Prepayment Penalty Clause. Allows lender to charge borrowers a penalty in the event the loan is repaid before the due date. The typical penalty is from three to six months' interest on the outstanding balance. State law prescribes that during the first five years of a loan on an owner-occupied dwelling lenders may not charge more than six months' interest on the portion of the prepayment which exceeds 20% of the original principal amount of the loan. This means that borrowers may pay their regular payment plus 20% of the original principal each year, thus paying off the entire note in less than 5 years without penalty.

4. Lock-in Clause. Restricts prepayment of a loan in advance of its due date. Commonly used by life insurance companies.

5. Open-end Clause. Allows additional advances on a loan, as will be explored in detail in Lesson 12.

B. Understanding Other Clauses. Many other provisions are contained in financing instruments, as can be seen by a detailed reading of any note and trust deed. Borrowers should carefully read all documents to make certain that they understand what these clauses mean. This will help maintain harmony between lender and borrower during the life of the loan.
Federal disclosure regulations require all terms be explained, and that copies of all docs be given to borrowers upon signing.

XI. THE CALIFORNIA MORTGAGE MARKET

A. California's mortgage market has characteristics peculiar to this state because of:

1. High demand. Because of the large amount of construction and other real estate activities, California has traditionally been mortgage money "hungry."

2. Population. California is the most populous state and continues to attract emigrants from other areas of the nation as well as world-wide.

3. Financial institutions. California contains the largest number of banks and thrift institutions that want to be "where the action is", where the greatest demand for real estate loans exist.

4. Loan correspondents. California draws many experienced and diversified mortgage loan correspondents representing out-of-state life insurance companies and other institutional lenders.

5. Title companies. The first title insurance company in the world was incorporated in a small office opposite Philadelphia's Independence Hall in 1876. California has carried that operation to a high level as it continues to grow in volume. Independent Escrow companies are also widespread in this State.

6. Use of trust deeds. The deed of trust is used almost exclusively for securing real estate loans, rather than the mortgage instrument.

7. Active secondary markets. Loans are extensively sold to out-of-state purchaser-investors. These include mutual savings banks, largely nonexistent in California but which infuse large amounts of capital through purchases in the secondary market. The largest secondary markets which would include securitized loans would be placements by Wall Street, Ginnie Mae, Freddie Mac, Fannie Mae, and the Residential Funding Corporation (RFC).
LESSON ONE MULTIPLE CHOICE QUESTIONS

Directions: Underline the letter representing the correct answer.

1. Buyers typically purchase real property through:
   (a) sellers carrying back the note after a modest down payment
   (b) paying part cash and financing the balance
   (c) 100% financing
   (d) use of a Land Contract

2. One-pay notes are:
   (a) self-amortizing
   (b) fully-amortizing
   (c) straight notes
   (d) variable payments

3. The six steps of the real estate financing process occur in which order?
   (a) Application, processing, underwriting, servicing, funding, closing
   (b) Underwriting, processing, servicing, closing, application, funding
   (c) Application, servicing, underwriting, processing, closing, funding
   (d) Application, processing, underwriting, funding, closing, servicing

4. Preliminary preparation of loan documents, disclosure forms, and escrow instruction is referred to as:
   (a) loan servicing
   (b) loan analysis
   (c) loan closing
   (d) loan processing

5. Consummation of a real estate transaction typically follows a set procedure. Which of the following would be the last step?
   (a) transferring title
   (b) executing the deposit receipt
   (c) funds and documents forwarded to escrow
   (d) credit analysis of the borrower is made

6. The interest rate charged by the Federal Reserve bank to borrowing member banks is called the:
   (a) prime rate
   (b) discount rate
   (c) federal reserve rate
   (d) annual percentage rate
7. In order to restrict credit, that is, reduce the amount of money in circulation, the Federal Reserve board might:
   (a) raise reserve requirements
   (b) buy government securities
   (c) reduce discount rates
   (d) do any of the above

8. A buyer gives the seller a straight note for $12,000 at an interest rate of 9%, with installments to be paid monthly. What is the buyer's monthly payment?
   (a) $95
   (b) $950
   (c) $114
   (d) $1140

9. Using the same information from question 8, how much interest would the buyer pay over a 4-year period?
   (a) $1,140
   (b) $4,560
   (c) $5,700
   (d) $6,840

10. The extension of long-term credit, in excess of 10 years, is referred to as the:
    (a) capital market
    (b) money market
    (c) corporate market
    (d) unrestricted credit market

11. An example of short-term financing is evidenced by a(n):
    (a) municipal bond maturing in 2000
    (b) a 15-year trust deed
    (c) a one-year certificate of deposit
    (d) a 20-year industrial bond issued 5 years ago

12. In a trust deed the lender is called the:
    (a) trustor
    (b) trustee
    (c) beneficiary
    (d) vendor

13. In California the most popular instrument for securing a real estate loan is the:
    (a) promissory note
    (b) mortgage
    (c) trust deed
    (d) land contract
14. Under a trust deed who holds bare legal title to the property?
   (a) beneficiary
   (b) trustee
   (c) Trustor
   (d) None of the foregoing

15. Under a mortgage instrument, the lender is called:
   (a) mortgagor
   (b) mortgagee
   (c) beneficiary
   (d) trustor

16. A contract of sale is also referred to as a:
   (a) principal plus interest note
   (b) interest only transaction
   (c) principal and interest note
   (d) installment sale contract

17. Under what type of sale would the buyer be called vendee and the seller a vendor?
   (a) Installment sales contract
   (b) Land contract
   (c) Contract of sale
   (d) Any of the above

18. The fiscal policies established by Congress and the President are controlled by:
   (a) the Fed
   (b) the U.S. Treasury
   (c) commercial banks
   (d) savings and loan associations

19. A provision in a note that allows a lender to call the loan in event borrower sells the property securing the loan is described as:
   (a) an acceleration clause
   (b) a prepayment clause
   (c) an alienation clause
   (d) a subordination clause

20. The Fed would double the reserve requirement ratio from 10% to 20% if it wanted the money supply to:
   (a) increase
   (b) decrease
   (c) remain the same
   (d) compete with tax revenues
INFLUENCING MONEY SUPPLY

1. RESERVE REQUIREMENTS
2. OPEN MARKET ACTIVITIES
3. DISCOUNT RATES
4. FED CHAIRMAN PUBLIC POLICY STATEMENTS
CAUSES OF FLUCTUATIONS IN INTEREST RATES

1. SUPPLY
2. DEMAND
3. EXCESSIVE GOVERNMENT SPENDING
4. LARGE GOVERNMENT BORROWINGS
5. INFLATION
6. FED
7. POLITICAL,
BUREAUCRATIC
FINANCING PROCESS

6. SERVICING
5. CLOSING
4. FUNDING
3. UNDERWRITING
2. PROCESSING
1. APPLICATION
PROMISSORY NOTES

- PROMISSORY NOTE
- STRAIGHT NOTE
- INSTALLMENT NOTE
  a. FULLY AMORTIZED
  b. PARTIALLY AMORTIZED (BALLOON PAYMENT)
DEED OF TRUST

LENDER- BENEFICIARY
- BORROWER - TRUSTOR
- THIRD PAWN - TRUSTEE
SPECIAL CLAUSES FOUND IN REAL ESTATE INSTRUMENTS

- ACCELERATION CLAUSE
- 'ALIENATION CLAUSE
- PREPAYMENT CLAUSE
THE CALIFORNIA MORTGAGE MARKET

1. HIGH DEMAND
2. POPULATION GROWTH
3. FINANCIAL INSTITUTIONS
4. "LOAN CORRESPONDENTS"
5. TITLE COMPANIES
6. DEED OF TRUST
7. ACTIVE SECONDARY MARKET
PREVIEW:
In this unit we explore the characteristics of the three principal institutional lenders: savings and loan associations, commercial banks, and life insurance companies. Lending powers and policies of each of these will be discussed and contrasted. Agencies that regulate financial institutions are probed.

PERFORMANCE OBJECTIVES:
At the conclusion of this lesson, you should be able to:

1. List five characteristics of institutional lenders.
2. Cite some trends anticipated for institutional lenders.
3. Explain the activities of the Financial Institutions Reform, Recovery, and Enforcement Act.
4. Differentiate between the Federal Housing Financing Board (FHFB) and the Savings Association Insurance Fund (SAIF).
6. Explain the activities of the Office of Thrift Supervision (OTS), successor to the Federal Home Loan Bank Board.

I. WHAT IS AN INSTITUTIONAL LENDER?
Any depository that pools the money of depositors and clients, and in turn invests these funds into trust deeds and mortgages. These institutions include savings and loan associations, commercial banks, life insurance companies, mutual savings banks, pension and retirement funds, and credit unions.

II. WHAT TYPES OF INSTITUTIONAL LENDERS ARE THERE?

1. Savings and Loan Associations. A savings and loan accepts savings from depositors and invests these savings principally in real estate trust deeds and mortgages.
a. S&Ls account for the largest number of existing home 
loans. With the S&L crisis their percentage of loans 
has slipped below that of mortgage companies.

b. They were structured as either a mutual or a stock 
institution, but most have converted to stock 
companies.

   i. In a mutual savings and loan, depositors and 
borrowers are given shares in return for 
deposits of money.

   ii. A stock association, by contrast, issues shares 
of stock, representing shares of ownership of 
the association.

c. Are either state-chartered or federally-chartered.

d. Lending limits are generally restricted to 
properties located within the state.

e. Make high percentage of loan-to-value loans.

f. Medium to long-term loans are permitted with 
maturities of from 35 to 40 years.

g. Interest rates have usually been the highest among 
institutional lenders, but bank rates are now higher

h. Take greater risks when qualifying borrowers. 
(Witness the large number of S&Ls that have gone 
during the 1980s!)

   i. The bulk of real estate loans are made on 
conventional, single family dwellings.

j. Package loans that combine construction and long-
term or "take out" financing are common, though 
construction loan activity is much more restrictive 
under the 1989 Federal "bail out" bill.

k. Permitted to make collateral loans secured by 
borrowers' savings accounts, savings certificates, 
bonds, existing secured notes, and certain other 
forms of liquid assets.

l. Prepayment penalties are sometimes employed except 
for loans sold to Fannie Mae and Freddie Mac 
(discussed in Lesson 7).
a. Prefer short term loans to businesses and industry, but are aggressively entering the home loan market.

b. Usually stock corporations operating under a license or charter from either the federal or state government.

c. Require strong collateral and like a favorable relationship between bank and borrower.

d. Interest rates are fairly competitive with other lenders.

e. Have historically preferred properties that are to secure the loans to be located in proximity of the bank's branches.

f. Actively seek home improvement loans.

g. Aggressively pursue home equity loans, particularly because of the restrictions placed on interest deductions (discussed in Lesson 5)

h. Due to securitization and the secondary market, commercial banks now serve as the primary institutional originating source for single family (1-4 unit) residential loans.

3. Life Insurance Companies. Specialize in the insuring of lives of individuals in exchange for specified premium payments.

a. Prefer to lend money on large scale projects, as larger scale project. The interests of this type lender lies with an investment's stability and safety. Such ventures include:

i. Shopping malls.
ii. Office buildings.
iii. Factories.
iv. Housing subdivisions.
v. Large scale multi-family housing, preferably new construction.

b. Loan-to-value ratios tend to be on the conservative side, generally in the 66 2/3 to 75 percentage range for conventional financing.
c. Long pay-back terms, usually 30 year amortization periods, but relatively short due dates.

d. Interest rates are the lowest among institutional lenders.

e. Prepayment penalties, if any, are the lowest among the institutional lenders.

f. There are no geographic limitations relative to the home or regional office.

g. Construction loans are seldom made. Instead, life insurance companies will make "take out" loans. These are loans paid after the structure has been completed according to plans and specifications.

h. In California "loan correspondents" such as mortgage companies are widely used as agents for insurance companies. Mortgage companies also function independently, obtaining funds through lines of credit as well as their own reserves. Funded and closed loans are usually sold in the Secondary market, the money of which is used to repay any borrowed funds.

4. Mutual Savings Banks. Operate much like S&Ls. None exist in California, but they play a major role in furnishing capital for residential loans through the secondary market.

a. Located in the northeast part of the country.

b. Purchase large blocks of VA and FHA loans along with conventional mortgages from California lenders, operating largely through correspondents.

5. Credit Unions. The majority of loans made by Credit Unions are consumer loans, but increasingly the larger ones are providing residential financing.

6. Pension and Retirement Funds. These funds are one of the latest sources of financing for real estate. Financing is provided through the use of Mortgage Bankers and Mortgage Brokers.
II. Regulatory Agencies.

A massive change in the regulatory structure at the federal level was instituted as a result of the massive number of thrift institutions that failed in the 1980s. A whole new alphabet soup of acronyms has replaced many of the old, beginning with the law itself, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, which in turn led to the creation of many new federal agencies:

A. Office of Thrift Supervision (OTS)
   1. An arm of the U.S. Treasury.
   2. OTS was created by FIRREA to replace the Federal Home Loan Bank Board as the chief regulator of all savings associations whose deposits are federally-insured.

B. Savings Association Insurance Fund (SAIF)
   1. Created by FIRREA to replace the Federal Savings and Loan Insurance Corporation (FSLIC) that became insolvent by 1988.
   2. SAIF collects insurance premiums on checking and savings deposits from all federally-insured savings associations as well as State subscribing Savings Associations.
   3. Administered by the familiar FDIC (Federal Deposit Insurance Corporation), but SAIF insurance premiums are kept separate from premiums paid by commercial banks who subscribed to the Bank Insurance Fund (BIF).
   4. The management arm of the FDIC is officially titled the Deposit Insurance Fund (DIF). Like its FSLIC predecessor, it insures accounts up to $100,000 each.

C. Federal Housing Finance Board (FHFB).
   1. Overseas mortgage lending by the 12 regional Federal Home Loan Banks. (This regulatory function was previously performed by the FHLBB.)
   2. Federal Home Loan Banks are the backup source of thrift industry funds.
   3. The FHFB is also responsible for providing statistical data to the housing industry.
   4. A composite of fixed and adjustable interest rates are compiled by the FHFB.
D. Federal Deposit Insurance Corporation (FDIC)

1. Formerly an independent agency that provided federal deposit insurance for individual accounts in commercial banks. The amount of coverage was $100,000 per account.

2. Now under the Treasury Department, assigned by FIRREA to managed the SAIF (for Savings and Loan Associations) and BIF (for Commercial Banks). Both funds are under the Deposit Insurance Fund (DIF).

3. Insures deposits of up to $100,000 per individual account for both Savings and Loan Associations and Commercial Banks.

4. Also assigned by FIRREA to manage the defunct RTC (Resolution Trust Corporation), which processed and disposed of the assets of failed Savings and Loan Associations. The RTC was dissolved in 1995.

E. Federal Reserve Bank Board

1. Overseas the Federal Reserve System.

2. Regulates activities of commercial banks and non-member banks that operate subsidiaries through a bank holding company.

3. Regulates the flow of money and credit (as discussed in Lesson 2).

F. Freddie Mac (formerly the Federal Home Loan Mortgage Corporation or FHLMC).

Involved in the secondary mortgage market (discussed in Lesson 7)

In addition to the federal agencies outlined above, here are the chief state-regulatory agencies impacting on real estate lenders:

G. California Savings and Loan Commissioner.

Supervises all state-chartered S&Ls.

H. California Department of Banking

1. Regulates state-chartered banks.

2. Banks whose deposits are insured are also subject to rules and regulations of OTS and FDIC.
I. Government National Mortgage Association (GNMA), otherwise known as Ginnie Mae, and Fannie Mae - Secondary Market Sources (as discussed in Lesson 7).

III. WHAT IS THE AFFORDABILITY INDEX?

A. Origination. No discussion of money and the mortgage market would be complete without a brief discussion of the term, affordability index, coined by the National Association of Realtors (NAR).

B. Question: Suppose NAR announced that "the affordability index had increased last month from 106 to 110", what does this mean?

Answer: The index measures the relationship of median family income, median house prices and mortgage interest rates. An index of 100 means that families earning the median income have 100% of the income necessary to purchase median-priced homes.

"Median family income" means that half the families in the U.S. earn more than the median family income, and half earn less. "Median house prices" means that half the existing single-family dwellings sell for more than the median price and half sell for less.

The higher the index the better. More buyers will qualify for housing and for mortgage loans, because:

1. Purchasing power is enhanced as incomes increase
2. More discretionary income is available as house prices decline
3. Discretionary income is enhanced as interest rates decrease.

C. Example. Suppose median income nationwide is $36,000, median priced homes are priced at $100,000, fixed interest rates are at 9%, and the affordability index is quoted at 110 (up from 106 in the previous month). What does this mean for home buyers? Licensees?

The number tells us that the average buyer had 110% of the income required to qualify for a conventional loan of 80% LTV for homes priced at $100,000, and based upon the prevailing 9% interest rate.
D. **Summary.**

*Increases* in affordability index is due to 3 factors:

1. Increase in incomes.
2. Decline in housing prices.
3. Drop in interest rates.

* Decreases in affordability index is due to the same three factors, but inversely:

1. Decreased incomes.
2. Increased housing prices.

Of course you can have any combination of the above, so that if interest rates drop less than increases in income, the affordability index could actually decline.

As the affordability index plunges to below 75, more interest is sparked in the use of creative financing schemes, as we'll discuss in Lesson Fourteen.
LESSON TWO MULTIPLE-CHOICE QUESTIONS

Directions: Underline the letter representing the correct answer.

1. A decrease in the affordability index is most likely due to:
   (a) increased incomes
   (b) decreased housing prices
   (c) reduced interest rates
   (d) decreased incomes

2. Life insurance companies make real estate loans mainly for:
   (a) homes
   (b) apartments
   (c) large commercial ventures
   (d) all of the above

3. If the Office of Thrift Supervision declares a thrift institution to be insolvent, it will assign the thrift to the
   (a) Resolution Trust Corporation
   (b) Savings Association Insurance Fund
   (c) Federal Deposit Insurance Corporation
   (d) Federal Home Loan Mortgage Corporation

4. If the monthly interest rate is 1.5%, what is the annual interest rate?
   (a) 0.13%
   (b) 13.00%
   (c) 15.00%
   (d) 18.00%

5. The eroding value in the purchasing power of the dollar, which usually tends towards higher prices for real estate, is termed:
   (a) stagflation
   (b) devaluation
   (c) deflation
   (d) inflation

6. Which of the following characterize loans made by commercial banks?
   (a) Short-terms
   (b) strong collateral
   (c) Prefer home-equity loans
   (d) all of the above
7. You borrow $50,000 through an interest extra note payable at 10% interest per annum, and with annual principal payments of $2,000. How much interest will you owe during the fourth year?
   (a) $ 5,000  
   (b) $ 4,200  
   (c) $ 5,600  
   (d) $ 2,000

8. The agency responsible for managing the nation's "instruments of credit policy" is the:
   (a) United States Treasury  
   (b) Federal Reserve Board  
   (c) Office of Thrift Supervision  
   (d) Federal National Mortgage association

9. Saving and checking accounts, vital to the real estate market, are currently insured for up to:
   (a) $ 40,000  
   (b) $ 50,000  
   (c) $ 100,000  
   (d) none of these is correct

10. The chief regulatory agency for thrift institutions is the:
    (a) Federal Housing Finance Board  
    (b) Office of Thrift Supervision  
    (c) Resolution Trust Corporation  
    (d) Federal Reserve Bank Board

11. If the Fed wanted to increase the supply of money in an effort to stimulate real estate activities, would:
    (a) raise discount rates  
    (b) purchase government securities  
    (c) increase reserve requirements  
    (d) establish a higher prime lending rate

12. Historically, which institutional lenders have made the most home loans?
    (a) Savings and loan associations  
    (b) Commercial banks  
    (c) Life insurance companies  
    (d) REITs

13. When the Fed sells government securities, it is attempting to accomplish the following with the money supply:
    (a) tighten  
    (b) ease  
    (c) stabilize  
    (d) de-stabilize
14. The right of a lender to call a loan upon the happening of specific events is called:
   (a) an acceleration clause
   (b) a prepayment clause
   (c) an alienation clause
   (d) a subordination clause

15. When investors sell government securities to the Fed, the money supply will:
   (a) decrease
   (b) increase
   (c) not be effected
   (d) none of the above is correct

16. Which of the following factors affect the cost of money?
   (a) International factors
   (b) National factors
   (c) Locational factors
   (d) all of the above

17. The Fed has control over:
   (a) fiscal policy
   (b) monetary policy
   (c) taxing policy
   (d) spending policy

18. Which of the following is NOT considered a characteristic of money?
   (a) Medium of exchange
   (b) Store of value
   (c) Profitability
   (d) Standard of value

19. U.S. Treasury has control over:
   (a) spending money
   (b) collecting money
   (c) both spending and collecting money
   (d) neither spending nor collecting money

20. As reserve requirements are increased, banks are able to lend:
   (a) less money
   (b) more money
   (c) more money only if they have assets to back the loans
   (d) none of the above
INSTITUTIONAL LENDERS

I. SAVINGS AND LOAN ASSOCIATIONS
2. COMMERCIAL BANKS
3. INSURANCE COMPANIES
4. MUTUAL SAVINGS BANKS
5. CREDIT UNIONS
6. PENSION AND RETIREMENT FUNDS
REGULATORY AGENCIES
GOVERNING INSTITUTIONAL LENDERS

A. OFFICE OF THRIFT SUPERVISION (OTS)
B. SAVINGS ASSOCIATION INSURANCE FUND (SAIF)
C. FEDERAL HOUSING FINANCE BOARD (FHFB)
D. FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)
E. FEDERAL RESERVE BANK BOARD
F. FREDDIE MAC (FORMERLY FEDERAL HOME LOAN MORTGAGE CORP. - FHLMC)
G. CALIFORNIA SAVINGS AND LOAN COMMISSIONER
H. CALIFORNIA DEPARTMENT OF BANKING
LESSON THREE
WHO ARE NON-INSTITUTIONAL LENDERS?

PREVIEW:
In this unit we explore the characteristics of various non-institutional lenders: individuals, sellers, mortgage brokers, REITs, pension and trust funds, endowment funds, credit unions. Lending practices and policies of each is compared. Limitations placed upon licensees through the Mortgage Loan Brokers Law is analyzed. Because of the importance of income taxes on borrowing, we conclude with a broad outline of deductions for interest payments on both fixed and variable mortgages.

PERFORMANCE OBJECTIVES:
At the conclusion of this lesson, you should be able to:
1. Contrast non-institutional with institutional lenders.
2. List five characteristics of non-institutional lenders.
3. Explain the purpose of the Mortgage Loan Brokers Law.
4. Explain the provisions of the Mortgage Loan Brokers Law.
5. Determine under what conditions interest payments are deductible on a homeowner's income tax return.

I. WHAT IS A NON-INSTITUTIONAL LENDER?

Any individual or organization that lends money, with the exception of banks, savings and loans associations, mutual savings banks, life insurance companies, credit unions, and pension and retirement funds are referred to as non-institutionals.

A. How do non-institutional lenders differ from institutional or private lenders?

1. Non-institutional lenders are not as tightly regulated and supervised by federal and state agencies as institutional lenders.

2. Non-institutionals are usually informal in structure and organization, while institutional lenders are very formal, from organizational structure to lending policies and procedures.
3. Institutional lenders receive deposits from others. Hence, they are referred to as depository institutions. In turn, they lend these deposits to others. As such, they act as intermediaries, pooling the funds of others.

4. Non-institutional lenders invest their own funds directly into real estate loans, rather than through a financial intermediary.

II. TYPES OF NON-INSTITUTIONAL LENDERS

A. Private (or individual) lenders constitute the largest group of non-institutional lenders. They include:

1. Direct lenders, who lend money directly to borrowers because they want higher returns than are paid on savings and other accounts. Direct lenders perform their own appraisals, inspections, and collections.

2. Indirect lenders, who invest their money through mortgage loan brokers because of the conveniences and services offered through brokers.

3. Sellers very often become lenders by "carrying back paper" for the difference between the sales price and the down payment.

4. Others, shown below, but let's first examine some characteristics of individual lenders.

B. Characteristics of Individual Lenders

1. Often inexperienced and therefore make subjective decisions when determining where and on what properties to lend.

2. Maximum interest rate is usually charged.

3. Usually heavy involvement in junior financing.

4. Prime loans and construction financing are virtually nonexistent.

5. Most loans are relatively small in size, secured by single-family dwellings.

6. The majority of loans are made within the geographic area of the lender.

7. Loans are of relatively short duration.

8. Risks are greater, but the potential rewards are also
greater.

C. Mortgage Companies Characteristics Include:

1. Restricted in their lending activities to the same regulations that govern those they represent, their principals as well as the regulations governing the institutions they sell their originated loans to. Such institutions include Fannie Mae and Freddie Mac.

2. In California, mortgage companies must be licensed as real estate brokers by the Department of Real Estate (DRE) or the California Department of Corporations.

3. Subject to the restrictions of the Real Property Loan Law.

4. Frequently act as loan correspondents.

5. Mortgage Bankers have the loanable funds. They perform the entire loan process (Retail Mortgage Banking) or all but the first two steps in the process (loan application and processing). In the latter instance, they are referred to as Wholesale Mortgage Bankers. The first two steps are performed by Mortgage Brokers.

D. Real Estate Investment Trusts Characteristics Include:

1. The Real Estate Investment Trust, or "REIT", is the "mutual fund" of the real estate business because of its large size and pooling arrangement.

2. The most significant outlet for their pooled funds is in construction and development loans, such as housing tract development, financing of income-producing properties, and for large home loans.

3. Invest in a diversified portfolio of real estate and mortgages.

4. Must be at least 100 investors who combine or pool their resources.

5. Due to tax considerations, REITs are required to distribute 90% of their annual income to shareholders.

E. Endowment Funds.

1. Endowed colleges and universities, hospitals, and charitable institutions operate similar to pension funds.
2. Many deal with banks and mortgage companies in financing commercial and industrial properties.

F. Sellers.

1. Provide financing to cash strapped or sub-credit buyers.
2. Financing is predominately junior, straight note, short-term financing.

III. WHAT IS THE MORTGAGE BROKERS LAW?

Individuals dealing through a mortgage loan broker are protected under the provisions of Article 7, Section 3 of the Real Estate Law (embodied in the Business and Professions Code, sections 10240 through 10248). This law is also referred to as the "Real Property Loan Law", and by the name, "Necessitous Borrowers Act".

A. What is the Purpose of the Real Property Loan Law?

1. To protect borrowers of relatively small loan amounts which secured their homes.

2. Requires that prospective borrowers be furnished with complete information concerning the loan through a Mortgage Loan Disclosure Statement by the broker before borrowers become obligated to go through with the loan.

B. Mortgage Loan Disclosure Statement

1. Contents. Contains information about reasonably estimated costs, expenses, and commissions to be paid by the applicant for a loan.

2. Data. Informs borrowers of the approximate net amount of the loan after commissions, costs, expenses, and payoffs on existing loans against the property.

   a. What are the exceptions to the law?

      i. Loans secured by first trust deeds when the principal amount is $30,000 or more.

      ii. Loans secured by junior loans where the principal amount is for $20,000 or more.

      iii. Transactions where no real estate licensee is acting as a broker.

      iv. Sellers, vendors and principals are exempt from the Mortgage Brokers Law.
b. What are the maximum commissions that may be charged?

**[SHOW T 3-5A]**

Mortgage loan brokers are limited in the amount of commissions that they may charge as follows:

<table>
<thead>
<tr>
<th>Type of Loan</th>
<th>&lt; 2 years</th>
<th>2 years but 3+ years</th>
<th>Fees Negotiable for loans of</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st T.D.</td>
<td>5%</td>
<td>5%</td>
<td>10% $30,000+</td>
</tr>
<tr>
<td>Junior T.D.</td>
<td>5%</td>
<td>10%</td>
<td>15% $20,000+</td>
</tr>
</tbody>
</table>

**c. What are other allowable costs and expenses?**

**[SHOW T 3-5B]**

In addition to commission limits, brokers are limited on the amount that may be charged for other costs and expenses. These include fees for appraisal, escrow, title insurance, notary, recording and credit investigation. These may not exceed 5% of the loan amount. However, if 5% of the loan is less than $390, the broker may charge up to that amount providing the charges do not exceed actual costs and expenses. But in no event may borrowers be charged more than $700.

Brokers may charge as much as the borrower is willing to pay on first loans of $30,000 and over, or for junior loans of $20,000 and over. Thus it is possible for borrowers to net less cash from a loan that exceeds the legal limits than would be the case where the loan amount is within the statutory limits. Brokers must disclose such facts to borrowers or face disciplinary action. Competition ordinarily keeps down the costs and expenses.

**d. What provisions are there for balloon payments?**

The term "balloon payment" is used in real estate law to describe any payment that is more than twice the amount of the smallest installment. Balloon payments are prohibited if the:

i. term of loan is for six years or less, and

ii. loan is secured by the borrower's residence.
e. What provisions apply to insurance requirements?

i. Borrowers are not required to purchase credit, life, or disability insurance as a condition for obtaining a loan. An exception would be if a Cal-Vet loan is obtained. Cal-Vet may have required insurances, including those for life and disability.

ii. Lenders may, however, insist upon fire and hazard insurance on the property to protect the security until the loan has been repaid.

iii. Brokers may act as agents for insurers in selling fire and hazard insurance if licensed as a fire and casualty agent. However, borrowers may purchase the coverage through any source.

f. What other provisions apply?

i. Mortgage brokers are prohibited from charging loan servicing or collection fees to be paid by the borrower.

ii. Late charges may not exceed $5 or 10% of the principal and interest portions of installment payment, whichever is greater. However, but borrowers are permitted a grace period of ten to fifteen days (depending on the contractual agreement with the lender) from the due date of any payment, during which time no late charges can be made.

iii. In the event of early repayment of the loan, no prepayment penalty can be charged for loans over seven years. During the first seven years, borrowers on owner-occupied dwellings are allowed to pay up to 20% of the remaining principal balance of the loan during any twelve-month period without penalty. Only the remaining balance may be subject to a maximum penalty of six months' unearned interest.

IV. WHAT CONSTITUTES USURY?

Usury is charging more interest than the law allows. In California, loans secured by real property may not exceed the greater of 10% or 5% above the Federal Reserve Bank discount rate. If the greater of these percentages is exceeded, it would be considered usurious. Not exempt from this law are individuals loaning cold hard cash as opposed to those advancing credit (such as sellers). Those exempt from this law include the following:
A. All institutional lenders

B. Real estate brokers
C. Sellers who carry back loans secured by the properties they are selling
D. Personal property brokers
E. Credit unions
F. Industrial loan companies
G. Pawn brokers.

V. RELATIONSHIP OF INTEREST PAYMENTS AND INCOME TAX DEDUCTIONS

The subject of interest deductions for income tax purposes is quite complex and confusing, compared to the simple and straight-forward approach that existed before the 1986 Tax Reform Act (TRA). Depreciation rules, passive losses, and interest deductions were changed by this act. Agents have a duty to disclose property tax consequences. Further, agents should counsel the parties to obtain advice from qualified tax consultants when making decisions.

A. Classifying interest expenses. How interest payments are deducted depends upon the type of interest paid by individual taxpayers into one of the following:

1. Investment
2. Trade or Business
3. Personal
   a. Consumer
   b. Qualified residence
      i. Acquisition mortgage
      ii. Home equity mortgage

Only interest paid on loans for qualified residences concern us here, since the other categories go beyond the scope of this course.

B. Qualified Residence Interest is deductible for-
acquisition mortgages of up to specified limits, the amount depending upon when the residence was acquired.

1. Qualified means a principal or secondary residence. It may be a house, condominium, townhouse, mobile home, boat—essentially anything that provides basic living
accommodations.

2. Acquisition mortgage is one in which the proceeds are used to acquire, build, or substantially improve a qualified residence.

C. Interest paid on real estate loans is tax deductible, dependent on the time the loans were acquired.

1. The interest paid on real estate loans originated prior to 10/13/87 is fully tax deductible.

2. The interest paid on refinanced real estate loans originated prior to 10/13/87 is fully tax deductible.

3. The interest paid on real estate loans involving home acquisition debt (to purchase, construct, or substantially improve) taken out after 10/13/87 is tax deductible up to $1,000,000 (including any debt acquired prior to 10/13/87 and still outstanding). This includes the borrower's primary residence plus one additional residence.

Example. Jane purchased her primary residence which she occupied on January 2, 1987. She used a purchase money deed of trust in the amount of $750,000. In 1990, she purchased a vacation home, again using a purchase money deed of trust in the amount of $350,000. How much interest can she deduct? Jane can deduct all of the interest on the $750,000 primary residence loan. However, she is limited to an interest deduction on only $250,000 of the $350,000 loan on the second residence. The amount over the $1,000,000 in combined loans is not qualified residence interest.

4. The interest paid on home equity debt (other than to purchase, construct, or substantially improve) is tax deductible up to $100,000. This is over and above the acquisition debt.

Example 1. James purchased a home eighteen years ago for $70,000. The original loan has been fully repaid. The property is now worth $170,000. Last month, James took out a $125,000 home equity loan, using $15,000 of it to purchase an automobile and the balance, $110,000, for investments of a non-real estate nature. How much interest can James deduct? Interest on only the first $100,000 of the loan is tax deductible in accordance with the maximum home equity rule.

Example 2. Assume the above facts, except that James uses the balance of $110,000 to improve his residence. How much interest can James deduct? In this example, interest on the $125,000 is fully tax deductible. The
$1,000,000 ceiling was not reached insofar as the $110,000 is concerned. The remaining $15,000 of the loan would be applied to the $100,000 maximum home equity rule.

D. Points. Whether referred to as points, discounts, discount points, loan fees, or loan origination fees, how much of it is deductible and over what time period is determined by how the buyer-borrower utilizes the funds.

1. If the loan proceeds are used to purchase, build or substantially improve a qualified residence, the cost is deductible in full. (It would be advisable, however, to pay for the charge separately, and not have it deducted from proceeds of the loan.)

2. If proceeds are used other than to buy, build or substantially improve, the points must be amortized over the life of the loan.

3. If loan costs are financed into the loan rather than paid up-front in cash, such costs are deductible for income tax purposes over the life of the loan.

Example. You refinance your home in order to take advantage of a lower interest rate. The new loan is for 30 years, and a $3,000 origination fee is charged. You may deduct 1/30th of the $3,000, or $100 per year. If you pay off the loan early, or sell, you can deduct the balance then at that time.

E. Negative Amortization.

As we'll see in the next lesson, any loan featuring negative amortization has, by definition, interest payments deferred to one or more future pre-determined time periods. Since no interest is paid until then, no deductions can be taken for interest that would have been paid had the negative feature not been part of the loan. Once positive amortization begins, interest paid is then deductible, the amount of interest is calculated by the formula, Interest = Principal x Rate x Time.
1. The law governing activities of loan brokers is called the:
   (a) Real Estate Law
   (b) Real Property Loan Law
   (c) Mortgage Loan Disclosure Law
   (d) Real Property Securities Act

2. A depository that pools the money of depositors and policyholders and typically invests these funds into real estate mortgages is called a(n):
   (a) syndication
   (b) institutional lender
   (c) non-institutional lender
   (d) trust fund

3. Private lenders invest money only:
   (a) other people's
   (b) their own
   (c) institutional
   (d) insured

4. A loan broker lends $9,000 for 4 years at 12% on a third trust deed. The maximum commission the broker may charge for this transaction is:
   (a) $ 450
   (b) $ 900
   (c) $ 1350
   (d) none of the above

5. Which of the following are characteristics of individual lenders?
   (a) Large loans secured by homes
   (b) Minimal interest rates are charged
   (c) Relatively unstructured
   (d) Strong collateral required

6. A real estate investment trust (REIT) must have a minimum of
   (a) 50 investors
   (b) 75 investors
   (c) 100 investors
   (d) 1000 investors

7. Popularly called the "mutual fund" of the real estate business are:
   (a) pension funds
   (b) credit unions
   (c) syndications
   (d) real estate investment trusts
8. The largest category of non-institutional lenders are:
   (a) Commercial banks
   (b) Life insurance companies
   (c) Lenders
   (d) Pension funds

9. A loan broker lends $35,000 as a second trust deed due and payable in 3 years. The maximum commission that the broker can charge is limited to:
   (a) 5%
   (b) 10%
   (c) 15%
   (d) none of the above

10. Private lenders are most likely to invest their money:
    (a) into a fund that is lent for real estate
    (b) only through REITs
    (c) directly into real estate
    (d) mainly on speculative properties

11. A broker makes a fourth trust deed loan on a single family rental house. The loan amount is for $7,000 at 15% interest only, all due and payable in 4 years. She charges a $700 commission and fees of $350. What provisions of the mortgage broker law did she violate?
    (a) Excessive commissions
    (b) Maturity period for the balloon payment
    (c) The trust deed position, since it is too risky
    (d) No violation is evident

12. Which of the following is NOT an institutional lender:
    (a) Real Estate Investment Trust
    (b) Commercial bank
    (c) Life insurance company
    (d) Savings and loan association

13. Credit unions have traditionally dealt with:
    (a) short-term loans
    (b) long-term loans
    (c) commercial loans
    (d) construction loans

14. Exempt from usury are the following:
    (a) Licensed real estate brokers
    (b) Credit unions
    (c) institutional lenders
    (d) each of the above

15. The most significant outlet for the pooled funds of REITs is in construction and development loans, such as:
    (a) housing tract development
    (b) financing of income producing properties
    (c) large home loans
    (d) all of the above are uses of the pooled funds
16. Balloon payments are prohibited if the:
   (a) term of the loan is for six years or less
   (b) loan is secured by the borrower's residence
   (c) both of the above must apply
   (d) none of the above is true

17. California's mortgage broker law prescribes that the maximum penalty which may be charged for paying off a loan before maturity may not exceed six months' interest. This restriction on the lender applies to what type of property?
   (a) Owner-occupied residential properties
   (b) Single-family rental properties
   (c) Farm land
   (d) Commercial properties

18. You borrow $1,000,000 on a first trust deed, plus another $250,000 secured by a second trust deed to purchase your dream home. The maximum interest deductions that you can write off on your federal income tax return is limited to:
   (a) $1,000,000
   (b) $1,100,000
   (c) $1,250,000
   (d) none of the above

19. Among institutional lenders, the rates charged by commercial banks are usually considered:
   (a) low
   (b) competitive
   (c) high
   (d) fixed

20. Loan brokers may charge as much as for other costs and expenses for a junior loan of $20,000.
   (a) $ 195
   (b) $ 350
   (c) 5%
   (d) whatever the traffic will bear
# Maximum Commissions

<table>
<thead>
<tr>
<th>Type of Loan</th>
<th>Less Than 2 Years</th>
<th>2 Years But Less Than 3</th>
<th>3 Years And Over</th>
<th>Exempt Transactions</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Trust Deeds</td>
<td>5%</td>
<td>5%</td>
<td>10%</td>
<td>Loans of 530,000 and over</td>
</tr>
<tr>
<td>Junior Trust Deeds</td>
<td>5%</td>
<td>10%</td>
<td>15%</td>
<td>Loans of $10,000 and over</td>
</tr>
</tbody>
</table>
# Maximum Charges for Other Costs and Expenses

<table>
<thead>
<tr>
<th>Loan Amount</th>
<th>Under $7,601</th>
<th>35,901 to 13,999</th>
<th>$1,000 to $29,999</th>
<th>First Loans of $20,000 &amp; Over</th>
<th>Junior Loans of $10,000 &amp; Over</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum Charges</td>
<td>SS90</td>
<td>5% of Loan</td>
<td>$171.30</td>
<td>No Legal Limitations</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The charges do not exceed actual costs and expenses.
LESSON FOUR
ALTERNATIVE MORTGAGE INSTRUMENTS:
WHAT ARE THEY?

PREVIEW:
This lesson introduces the subject of mortgage interest rates that are neither fixed nor level, but vary up and down during the life of the loan. Characteristics of nine basic types of alternative mortgages are explained, along with an understanding of the term "negative amortization".

PERFORMANCE OBJECTIVES:
At the conclusion of this lesson, you should be able to:

1. List and define five basic types of alternative mortgage instruments.

2. Give three reasons for using adjustable rate mortgages.

3. Identify the common purpose behind the GPM, ROM, and SAM.

4. Explain the meaning and use of negative amortization.

5. Explain what is meant by lenders "borrowing short and lending long".

WHAT IS AN ADJUSTABLE RATE MORTGAGE (ARM)?

A. Adjustable = Variable. Any loan secured by real estate where the note interest rate may move up or down, depending upon market conditions, is an adjustable. It may also be referred to as an Adjustable Mortgage Loan (AML) or a variable mortgage or variable rate, the once familiar VIR (variable interest rate) that preceded the ARM.

B. Types of Adjustable or Variable Rate Plans. There are a wide range of mortgages where rates or payment schedules can be adjusted or varied. They read like an alphabet soup: ARM (adjustable rate mortgage), AML (adjustable mortgage loan), ROM (rollover mortgage), GPARM (graduated-adjustable rate mortgage), Two-Step, etc. Some loan programs have characteristics associated with ARMs, such as the Graduated Payment Mortgage (GPM). Private lenders are free to offer whatever is agreeable between themselves and borrowers. Institutional lenders are not given the same carte blanche authority, but may experiment to a substantial degree with novel plans. Hence there is no uniformity and predictability as with fixed-rate loans. A
prime objective of lenders is to structure loans to sell to the secondary market at some point, hence the reason for what appears to be uniformity.

Due to spatial constraints, we can at best present only a broad outline, providing general principles to guide you through the maze called "adjustables". The variations, combinations and permutations seem endless because changes and adjustments could occur in many ways:

1. The interest rate may be tied to any number of approved indices. However, the index selected must be beyond the control of the lender to manipulate. Thus, lenders may not use their own cost of funds or cost of doing business as the index selection. Additionally, the index must be readily verifiable by the borrower.

2. Amount of payment.

3. Outstanding principal loan balance. This includes negative amortization.

4. Term of loan.

5. Maximum loan-to-value ratios.

6. Any combination of the foregoing variables.

C. Cal-Vet. As described in Lesson Six, variable rates have been around for a very long time, illustrated by the California Department of Veterans Affairs that has used adjustable rates for its Cal-Vet home and farm loan programs almost since its inception in 1921. The Cal-Vet Loan Program was intended to benefit World War I veterans.

II. WHY USE ADJUSTABLE / VARIABLE INTEREST RATES?

A. Changes etc. When rapid changes occur in the level of interest and inflation rates, coupled with reduced availability of money, a variety of lending problems arise. Result: the traditional fixed-rate, fixed-term, level-payment, fully-amortized loans no longer satisfies either borrower or lender.

B. Quandary. Being able to vary interest rates to the market helps to solve the lender's dilemma of having to borrow money for short periods of time while lending out for much longer periods - referred to as "borrowing short and lending long".
C. General Features.

1. Notification. Borrowers are notified at least 60 days, but no later than 45 days prior to any change in the contract interest rate.

2. Indexing. Institutional lenders adjust interest rates based upon one of the many indices to which rates may be tied, such as the "cost of money" index issued by the Federal Home Loan Bank in San Francisco, California referred to as the 11 District Cost of Funds). Interest rates rise or fall in accordance with the rise and fall of the index selected. The index that is used is two months in arrears due to the time required in its compilation.

3. Rate Changes.

   a. Up. In the event of an increase in interest rate under an adjustable rate loan, borrowers may be given the option to either increase their monthly payments with the term of the loan remaining the same, or to pay off the loan in full, without penalty unless the loan documents so provide.

   b. Down. When the index shows a decline, the borrower's payments reduce.

   c. Caps. An annual cap is shown in the loan document. This is the maximum that the rate can rise in any one year, usually 1-2%. Additionally there is a cap over the life of the loan, called a "lifetime interest rate cap", typically no more than 5-6%. The monthly payment may also be subject to a cap.

   d. Deferred Interest. A significant number of variable and adjustable payment plans contain provisions for negative amortization. This method of amortization results in an increase rather than a decrease in the loan balance as monthly payments are made.

III. WHAT IS NEGATIVE AMORTIZATION?

A. Definition. The traditional real estate loan repayment schedule consists of two parts: principal and interest. As installments are received they are first applied to the interest portion, and the balance to principal.

When payments are equal only to the interest, it is an "interest-only" or "straight note". But when payments are less than the interest portion, the difference is added to the existing loan amount, thus increasing the principal balance. This phenomenon is called negative amortization, or "deferred interest".
B. When Is It Used? Negative amortization is found in virtually all forms of graduated payment mortgages and other types of mortgage instruments outlined in here and in Lesson Fourteen. Conceptually sound, in practice there are two significant pitfalls:

1. Property owners may be unable to meet the larger payments at the pre-agreed times due to decline in income, debt problems, disability and so forth.

2. Property value may not keep up with the increase in the mortgage balance, so that at time of re-sale the outstanding loan may be greater than the net selling price.

C. Example. You borrow $100,000 at 12% with payments of $800 per month. The first month's interest should be 1% x $100,000 or $1,000, but since you are paying only $800, you are short $200 on the interest portion. This $200 is added to the existing loan amount of $100,000, resulting in a new balance of $100,200 after the first month's installment.

IV. ADJUSTABLE RATE MORTGAGES (ARM).

A. Purpose. To assist home buyers, especially first-timers, in qualifying for a home loan through lower payments in the beginning. ARM is not precisely defined, but is generally used to describe any loan in which the interest rate, or the payments, or both interest rate and the payments, change.

B. Characteristics.

1. Allows lender to make changes in the interest rate at periodic intervals, tied to a mutually-agreed upon index negotiated between lender and borrower.

2. To protect borrowers, the Federal Reserve Board requires lenders to provide extensive information to borrowers, including an example of how payments on a loan would have changed based on actual historical data on the index applied.

3. Notification must be given borrowers annually showing the index rate, the interest rate applied, the adjusted payments, and loan balance at time of adjustment.

4. The earliest version offered by institutional lenders was called a Variable Rate Mortgage (VRM) or Variable Interest Rate (VIR), but had been scrapped in favor of the ARM because lenders felt the VRM was too restrictive in the areas of interest changes and lifetime caps.
(INSTRUCTOR: THIS WOULD BE A GOOD TIME TO DISCUSS THE HISTORICAL RECORD OF ARMS, AVAILABLE THROUGH SOURCES SUCH AS THE MORTGAGE BANKERS ASSOCIATION)

C. What Are Some Advantages of ARMs to the Borrower?

1. The initial rate is usually lower when compared to fixed rate loans.

2. Loan charges are usually less than those of fixed-rate loans.

3. It is easier to qualify for home loans because of initially lower payments.

4. When rates decline, there is no need to refinance.

5. Usually more attractive terms, such as lower origination charges, no prepayment penalties, and assumption rights.

D. What Are Some Disadvantages of ARMs to the Borrower?

1. The rate of growth in property value may not keep up with the rate of increase in the interest rate.

2. The risk of rising interest rates is borne by the borrower.

3. Buyer's income may not increase at the same rate as the increase in loan payments.

4. Excessively high payments may cause default.

5. Possibility of negative amortization which can use up the equity.

V. WHAT IS A RENEGOTIABLE RATE MORTGAGE (RRM)?

A. Purpose. Allows lenders to make loans for specified short terms, typically 5 years, at fixed rates.

B. Characteristics.

1. Guaranteed renewable and may be adjusted up or down by 1% for each year the loan was at fixed rate, up to a maximum of 5% over the life of the mortgage, and for up to one-third the original term of loan.

2. Benefits both borrower and lender. Lenders can match their source of funds (deposits) to their use of funds (loans) more effectively.
3. Often referred to as a "Rollover" mortgage, or ROM, since the loan periodically rolls into a new 5-year loan.

C. It is a standard loan option in Canada, where it is referred to as the Canadian Rollover. But unlike its U.S. counterpart, the Canadian model has no guarantee of renewal.

VI. WHAT IS A GRADUATED PAYMENT MORTGAGE (GPM)?

A. Purpose. Allows borrowers to tailor monthly mortgage payments to expected increases in future income. It is a loan option designed for the young family, although any qualifying borrower can use it.

B. Characteristics.

1. Payments start at lower levels, increasing (graduating) by a predetermined percentage to a predetermined point which is identified in years (5 or 10 years).

2. Borrowers may select from various plans whose payments may increase by 21/2%, 5%, or 71/2% per month over 5 to 10 years before leveling off to higher but fixed monthly payments for the remaining term of the loan.

3. Enables borrowers with smaller incomes to qualify for loans where they may not otherwise if they used the standard fixed rate loan.

4. Especially attractive for first-time buyers or for anyone whose current income has not caught up with their potential loan repayment ability through increased incomes.

5. Very popularly used with the FHA 245 program, discussed in Lesson Six.

6. It is a fully amortized loan program.

7. The borrower is aware of all future changes in the payment and loan balance BEFORE agreeing to the GPM loan.

VII. WHAT IS A GRADUATED PAYMENT ADJUSTABLE RATE MORTGAGE (GPARM)?

A. Purpose. Provides for partially defined payments of principal at start of loan, increasing in future years.
B. Characteristics

1. Like the GPM, this loan is designed to assist borrowers whose future incomes are expected to grow with time.

2. Differs from the GPM where rate is fixed, and only the payments change (graduate). GPARM's rate is variable, so that both interest rate and monthly installments fluctuate.

3. Due to its volatility, it no longer enjoys much acceptance.

VIII. WHAT IS A BALLOON PAYMENT MORTGAGE (BPM)?

A. Purpose. This type is more beneficial to lenders who want to recover the loan faster. Borrowers may profit through negotiating lower interest rate, etc.

B. Characteristics.

1. Also called a "straight" or "term" loan.

2. Usually a one-to-five year loan, but with up to 40-year amortization.

3. Balance is due at the end of a pre-agreed period, usually 15 years, subject to negotiation.

4. There is no guarantee of renewal.

5. Although the interest rate is usually fixed, it may be a variable rate balloon.

IX. WHAT IS A SHARED APPRECIATION MORTGAGE (SAM)?

A. Purpose. To offer long-term, fully-amortized loan with below-market interest rates, but with lender participating in the appreciation of the property.

B. Characteristics.

1. Another form of "shared equity mortgage" used for years in commercial and income-producing property, and sometimes used to finance homes during periods of tight money or excessively high interest rates.

2. Assists buyers who cannot qualify for a loan at market rate, or who are interested in obtaining what is essentially a subsidized rate as a trade-off for lender participating in the growth.
X. WHAT IS A TWO-STEP MORTGAGE?

A. Purpose. To allow home buyers to qualify based on lower interest rate and therefore lower payments.

B. Characteristics.

1. A fixed rate of interest is charged for the initial period, usually 5 or 7 years, that is lower than standard 30-year fixed-rate loans.

2. Amortization is based on 30-year payment schedules.

3. An automatic conversion follows the initial period, which may be another fixed rate at the then prevailing rate. It could be adjustable but with a lifetime interest ceiling set at the time of the loan, at no additional cost. The conversion feature assures borrower that the otherwise large balloon due in 5 or 7 years will come from the same lender, only at a different rate.

4. Because they qualify for purchase by Fannie Mae in the secondary market (Lesson 7), loan amounts vary according to the limits set by Fannie Mae ($300,700 in 2002).

5. Though subject to change, FNMA regulations require a minimum down payment of 10%; a new rate at the end of 5 or 7 years adjusted on the basis of a 10-year Treasury Bond Index, subject to an interest cap of 6 points above the initial rate; no additional fees; and the new rate must remain unchanged for the remaining 25 or 23 years, respectively.

XI. WHAT IS A REVERSE ANNUITY MORTGAGE (RAM)?

A. Purpose. Enables retired or nearly-retired homeowners to use the equity in their homes while living there.

B. Characteristics.

1. The lender pays the home owner a fixed annuity based upon a percentage of loan to home's market value and the homeowner's age according to insurance actuarial tables.

2. Eligibility is based on amount of equity in the home rather than applicant's income.

3. Unlike the traditional home equity loan borrowers may opt for payments in the form of an annuity, lump-sum, combination annuity-lump-sum, or a
line of credit.

4. Repayment of the loan is made at the time of sale or death, whichever comes first.

5. Does not affect Social Security or Medicare benefits, since RAM's don't figure in as income receipts. The borrower is simply borrowing his or her home equity.

{INSTRUCTOR: IF YOU HAVE A CLASS OF LIVELY ELDERLY STUDENTS OR LICENSEES WHO DEAL WITH OLDER CLIENTS, DETAILED INFORMATION CAN BE REQUESTED FROM "THE NATIONAL CENTER FOR HOME EQUITY CONVERSION, 348 WEST MAIN STREET, MARSHALL, MN 56258"}
LESSON FOUR MULTIPLE-CHOICE QUESTIONS

Directions: Underline the letter representing the correct answer.

1. An interest rate that is subject to change, as market rates of interest fluctuate, is popularly titled:
   (a) fluctuating
   (b) adjustable
   (c) changeable
   (d) irregular

2. Which of the following concerning a Graduated Payment Adjustable Rate Mortgage loan is correct?
   (a) As the index increases, payments can also be increased.
   (b) When the index increases, lender and borrower may arrange to have the term of the loan extended.
   (c) Both a and b are correct.
   (d) Neither a nor b is correct.

3. In a Reverse Annuity Mortgage:
   (a) the loan is due in 30 years
   (b) the loan is fully funded at the time of origination
   (c) borrowers are paid an annuity, among their options
   (d) the loan has a 5% cap

4. Savings and loan associations that issue adjustable rate loans typically peg their rates to the following impartial index:
   (a) cost of money
   (b) cost of living
   (c) prime rate
   (d) long-term certificates of deposit

5. The variable interest rate has been used for over a half century by:
   (a) federally-chartered savings and loan associations
   (b) FHA
   (c) state-chartered banks
   (d) Cal-Vet

6. This method of amortization results in an increase rather than a decrease in the loan balance as monthly payments are made.
   (a) deferred interest
   (b) negative amortization
   (c) both of the above
   (d) none of the above
7. When a loan payment is made, the amount is first applied to:
   (a) principal
   (b) interest
   (c) paying insurance
   (d) paying taxes

8. Which of the following loan techniques would likely prove beneficial for an elderly couple whose house is free and clear?
   (a) Reverse Annuity Mortgage
   (b) Graduated Payment Mortgage
   (c) Adjustable Rate Mortgage
   (d) Share Appreciation Mortgage

9. Which of the following usually offers below-market interest rates?
   (a) Reverse Annuity Mortgage
   (b) Fixed Rate Mortgage
   (c) Shared Appreciation Mortgage
   (d) Dual Rate Variable Rate Mortgage

10. Your client borrows $100,000 at 12% and agrees to pay $900 per month. What is the loan balance after the first month's installment?
    (a) $ 98,800
    (b) $ 99,900
    (c) $100,000
    (d) $100,100

11. Which of the following characterizes a Balloon Payment Mortgage (BPM)?
    (a) Short-term duration
    (b) No guaranteed renewal periods
    (c) Balloon due at the end of specified predetermined time
    (d) Each of the above is characteristic of a balloon loan

12. Advantages of an Adjustable Rate Mortgage include:
    (a) lower initial cost than fixed rate loans
    (b) lower risk when compared to fixed rate mortgages
    (c) rate of appreciation on the property always exceeds the rate of interest
    (d) all of the above

13. One of the following is likely to contain negative amortization:
    (a) graduated payment mortgage
    (b) flexible payment mortgage
    (c) level payment mortgage
    (d) reverse annuity mortgage
14. The major difference between a Graduated Payment Mortgage (GPM) and a Graduated Payment Adjustable Rate Mortgage (GPARM):
   (a) In a GPM payments can only go up, while GPARM payments can only decline.
   (b) In a GPM only the payments change, while in a GPARM only the interest rate changes.
   (c) GPM is a fixed rate mortgage, while GPARM uses variable rates.
   (d) none of the above

15. Important features of a Graduated Payment Mortgage include:
   (a) negative amortization during the life of the loan
   (b) occurrence of full amortization as monthly payments increase
   (c) choice of alternative plans
   (d) all of the above

16. California savings & loan associations sometimes use an "average cost of money" index for changing their interest rates on real estate loans. This index is published by the:
   (a) Federal Home Loan Mortgage Corporation
   (b) California Savings & Loan League
   (c) Federal Home Loan Bank
   (d) U.S. League of Savings and Loans

17. Your client borrows $48,000 at 10% and agrees to pay $400 per month. This illustrates a:
   (a) partially amortized note
   (b) fully amortized note
   (c) negative amortization note
   (d) straight note

18. Homeowner borrows $30,000 at 9% and agrees to make monthly payments of $240 per month. The loan balance after the first month's payment will be:
   (a) $29,985
   (b) $30,000
   (c) $30,015
   (d) $30,225

19. You just purchased a home for $250,000, borrowing $150,000 to be repaid monthly at 10% per annum for 25 years. Assume monthly payments of principal and interest are $1,363 and that this year's interest portion totals $10,500. In itemizing your tax deductions your home interest expense will amount to:
   (a) $1,363 x the number of months remaining in the year
   (b) only the interest attributable to the first $100,000 borrowed
   (c) $15,000
   (d) $10,500
20. You bought a home 10 years ago for $100,000, obtaining a loan for $80,000. The unpaid balance is now $75,000, and the current market value is $200,000. You apply for a $100,000 home equity loan. The most debt on which you will qualify for interest deductions is:

(a) $100,000
(b) $175,000
(c) $180,000
(d) $200,000
PREVIEW:
In this section conventional loans are described and compared with non-conventional loans. The principal characteristics of this type of financing will be described along with an understanding of the advantages and disadvantages of using conventional financing as opposed to non-conventional or government-backed loans. This discussion is aimed at helping students become better informed borrowers and agents for buyers of real estate seeking loans.

PERFORMANCE OBJECTIVES:
At the conclusion of this lesson, you should be able to:

1. Define what is meant by a conventional loan.
2. List three advantages to borrowing through conventional financing.
3. List three disadvantages of conventional financing.
4. Describe the process of selecting a lender.
5. Determine how and why lender policies periodically change.
6. Given a set of numbers, calculate loan fees, prepayment penalties and loan-to-value ratios.

I. WHAT IS A CONVENTIONAL LOAN?

Any loan not insured or guaranteed by a government agency is called a conventional loan. This includes so-called privately insured loans. Unless a government stands behind the loan, it is "conventional".

A. Non-Conventional Loans.

By far the most significant non-conventional loans are through major "government-backed" or non-conventionals, namely the Federal Housing Administration (FHA), the U.S. Department of Veterans Affairs (DVA), and California Department of Veterans Affairs, or Cal-Vet for short - all discussed in Lesson Six.
II. WHERE DO CONVENTIONAL FUNDS COME FROM?

The principal sources of funds for conventional loans are the institutional lenders: savings and loan associations, commercial banks, mutual savings banks, life insurance companies, pension and retirement funds, credit unions, and mortgage companies that represent conventional lenders. Each of these types of institutions differ between themselves and within themselves in a number of ways.

A. In What Ways do Conventional Lending Institutions Differ?

1. Loan-to-Value (LTV) ratios. Conventional lenders are permitted to make loans of up to 95% of market value, though most confine themselves to 80% of LTV. Where they exceed 80%, private mortgage insurance (PMI) is usually required, insuring up to the top 25% of the loan, as detailed in Lesson 11.

2. Preferred Properties. Lenders differ on the type and quality of properties on which to lend. Most prefer single-family, owner occupied houses. Some limit their lending exclusively to high-rise apartments, others to commercial and industrial properties, still others to farmlands only. Most lend on condominiums and other forms of own-your-own. Many lenders prefer to finance only properties within close proximity to their offices.

3. Qualifications of Borrowers. There is no single standard for qualifying loan applicants. Some lenders are very strict, looking to borrowers as the primary source for repayment, while others look primarily to the property as the security.

4. Interest Rates. Conventional lenders vary widely in rates offered. A lender may quickly reduce its rate in order to place idle funds to productive use, or to make weekly and even daily changes in response to supply and demand in the marketplace.

5. Form of Loan. All conventional lenders make adjustable rate mortgages (ARM) or variable rate loans. Most offer fixed-rate loans, graduated payment mortgages (GPM), rollover mortgages (ROM), and others discussed in Lesson Four.

6. Loan Fees. The greater the risk, the higher the amount of fees charged. Example: Where a 90% loan is sought, a fee of three points, or 3%, might be charged, compared to only 1% to 2% for an 80% LTV. Loan fees also vary by type of property, competition, and other criteria.
7. **Prepayment Penalties.** An extra charge may be levied against borrowers who pay off their loans before maturity, or prepay in excess of 20% of the unpaid principal loan balance. The reasoning behind the charge is that it permits a lender to recover interest that would have been earned if the loan was not prepaid.

a. Such **prepayment penalties**, as they are labeled, usually amount to up to six months of projected interest - called **unearned interest** - during the first five years of the loan term.

b. California law precludes penalties for most loans after the 5th year. This will not apply to loans issued or originated by federally regulated lenders as they do not abide by state law.

c. Prepayment penalties are negotiable. A strong borrower might be able to negotiate a smaller penalty. Often the penalty is waived altogether if a subsequent purchaser agrees to borrow from the same institution. Sometimes the payment of an additional fee will alleviate the need for a prepayment penalty.

d. Prepayment penalties are not allowed on FHA, DVA, and conforming conventional loans.

8. **Maximum Loan Amounts.** Lenders can set their own maximum loan amounts, which will largely depend upon type of property and condition of the market. Many loans will top out at the maximum amount purchased through secondary markets (discussed in Lesson Seven), where only "conforming" loans are purchased. Non-conforming, or "jumbo" loans, are usually offered at higher interest rates, lower LTVs, shorter repayment terms, or other less desirable feature when compared to conforming loans.

9. **"Quick Qualifier".** Also referred to by such names as "easy qualifier", these are not loans as such, but a means by which to cut down on loan processing time where home buyers have larger than average down payments and their income supports the loan. In such cases lenders may waive employer verification of loan applicant's salary. Some lenders may even waive credit verification where down payments exceed 25%; since housing prices plummeted through much of California from late 1989 to 1994, however, lenders are more stringent in underwriting requirements.
10. Balloon Mortgages. Loans of 7- and 10-year fixed rates are offered below market rates, including both the rate of interest and points charged for granting the loan. Payments are structured the same as fully-amortized loans, but all due in 7 or 10 years. An "extended term option" is usually built into these, so that the buyer is not stranded altogether at the end of the period. Loan fees or points may be higher for extensions beyond 7 years. But if the buyer takes advantage of this renewal provision, the loan will be subject to the then prevailing market rates, which may be higher.

B. What are the Advantages of Conventional Financing Over Government-Backed Loans?

{Show T 54}

1 Status. Anyone who can qualify for a loan may apply. Applicants do not need to be veterans (or even citizens) to qualify.

2. Processing Time. Conventional loans have historically taken less time to process than government-backed loans. While a conventional lender may take 30 days or less to process a typical home loan, government-backed loans traditionally have taken 45 days or longer. This has been due to the red tape involved when dealing with government agencies. FHA and DVA have been successful at shortening their loan processing time by using FHA's "direct endorsement" alternative or DVA's automatic program, both of which are described in Lesson Six.

3. Amount of Loan. There are few legal restrictions on loan amounts that conventional lenders may make, the principal constraint being the 80% of loan to value without requiring private mortgage insurance. The limits are set by the lender's policies at any given time, dictated by market forces, lender liquidity, and secondary markets (discussed in Lesson Seven).

4. Selectivity. When a loan application is rejected by a conventional lender, help may be around the corner, or directly across the street! A competing conventional lender might be more receptive, even if the loan is ultimately approved on less desirable terms.

5. Flexibility. There is only one set of standards for FHA, DVA, or Cal-Vet loans. Once a loan has been turned down by one of these agencies, there may be no viable alternative except to turn to conventional lenders.
1. Higher Down Payment. Conventional lenders are generally restricted to lower loan-to-value ratios. The "80% loan" is the most commonly associated with conventional home loans. This translates into a 20% down payment, unless secondary financing is involved. A 75% LTV means a 25% down payment, a 70% loan translates into a 30% down, and so forth. By contrast, no down payments are associated with DVA loans, while very small down payments are involved with FHA and Cal-Vet loans (detailed in Lesson Six). Conventional lending sources and secondary market purchasers have experimented with 3% and even zero down payment options.

2. Loans Are Not Assumable. Conventional loans are generally not ordinarily assumable by subsequent purchasers. Buyers must first qualify and be approved by the existing lender.

3. Prepayment Penalties. Prepayment is the early payoff of a loan, before it's scheduled due date. Some conventional lenders charge a penalty for paying off a loan on fixed interest rate loan before it's maturity. Penalties are virtually non-existent for adjustable rate loans. However, it is a good idea to check the promissory note and deed of trust provisions for confirmation and terms.

D. Comprehensive Example of Conventional Lender Flexibility:

The Problem:

A 3,000 square foot house located in a metropolitan area had only one bedroom. The bedroom was extra large, with two adjoining bathrooms - a "his" and "hers." It sold for $200,000 to a childless couple. They made a down payment of $50,000, or 25% of the purchase price, and planned to finance the $150,000 balance with a conventional loan. However, the sellers, buyers and agent recognized that a house with only one bedroom posed a serious problem.

They realized what every lender and investor knows: the house had limited marketability, so the risk is greater than houses containing two or more bedrooms. Committing $150,000 for a non-conforming house for 30 years is risky business: if foreclosure occurs, the lender would likely end up with a property having limited resale marketability.
The Solution:

The purchasers dealt with a bank with which they had previous, and very satisfactory, experience. They did have to accept a higher interest rate in order to obtain the commitment. But the bank was willing to lend $150,000, representing 75% of the appraisal value, at 10% interest per annum, for 20 years, with a loan fee of 21/2 points. The points clearly exceeded the prevailing 11/2 percent being charged then, and the term was ten years shorter than the normal thirty years. But the buyer-borrower wanted the house very badly because the home was ideally situated for entertaining, so they agreed to these terms.

In exchange for the higher rate of interest, the bank was willing to make certain concessions. It had agreed that the borrower could pay off the loan at any time without penalty. Further, the promissory note contained an assumption clause, allowing a subsequent purchaser to assume the then existing loan at exactly the same terms as were contained in the original note.

III. HOW DOES ONE CHOOSE A LENDER?

A. Terms and Services. Deciding on a lender is ultimately based upon which lender offers the best terms and services. Invariably tradeoffs are made, such as:

1. Loan size. As a trade off for the largest possible loan that you may require, be prepared to pay a higher interest rate.

2. Loan-to-value ratio (LTVR). This is the percentage of the purchase price that is financed.
   a. Example. Mr. Lo Leverage is buying a $200,000 property with 25% down payment. He obtains a $150,000 trust deed loan to finance the balance. The loan-to-value ratio is said to be 75%, that is, the $150,000 loan is 75% of the purchase price (which is also presumed to be market value).

3. Interest rate and points. In exchange for a lower interest rate, you may need to pay more loan fees up front.
   a. How are loan fees or points calculated?

   Loan fees or points are fees charged on the principal for the use or forbearance of money. One point is equal to 1%.
i. Example. You borrow $150,000 and the lender charges 2 points. You will pay the lender $3,000 (2% x $150,000) for the use of the money. This is over and above the interest on the loan itself. To decrease the amount of points, the borrower may opt for a higher interest rate.

4. Prepayment penalties. As noted earlier, a prepayment penalty may be charged when a borrower under a conventional loan pays off that loan prematurely. In California this penalty cannot exceed six months of interest on the amount exceeding 20% of the original loan amount.

a. Example. Assume from the above example that after four years you decide to pay off the loan. The loan was at 9% interest, and its balance at the time of payoff is $140,000. The prepayment penalty is calculated in four steps:

Step 1. Determine the loan balance calculated by the lender (and verified by borrower) -- $140,000 in this case.

Step 2. Calculate 20% of the original loan amount:

\[ .20 \times 150,000 = 30,000. \]

Step 3. Find the amount over the 20% limit. Using the loan balance from step 1, subtract 20% of the original loan amount computed in step 2:

\[ 140,000 - 30,000 = 110,000 \]

Step 4. Compute six months of interest on the amount over the 20% limit, using the formula

\[ I = PRT \]
\[ I = 110,000 \times .09 \times 1/2 \]
\[ I = 4,950 \]

There is no minimum penalty, only maximums, for owner-occupied housing of up to 4 dwelling units. So you are free of course to negotiate a lesser penalty.
B. Other tradeoffs include:

1. Length of time required to process a loan.
2. Relationship with the lender, if any.
3. Miscellaneous factors, such as quality of service offered by the lender, assumption provisions, etc.

IV. WHEN MAY A PURCHASER ASSUME A CONVENTIONAL LOAN?

This section is important to know and understand at this early stage of the course, but will be especially useful when we get into the subject of creative financing in Lesson 14. There are a dozen circumstances under which loans can be assumed:

A. Alienation. Recall from Lesson One that this provides that if there is a sale or transfer of a property, the entire loan is due and payable. If the trust deed or note makes no reference to the subject, that is, if the loan documents say nothing about alienation or due-on-sale, the loan is assumable.

B. Agreement. Borrower and lender, or seller and lender, can agree to make the loan assumable. Occasionally buyers and sellers will execute an "assumption agreement" through a hidden document, such as an unrecorded deed, but smart lenders will likely call that is accelerate the loan if it is in the lender's best interest to do so. So be careful about any agreement between buyer and seller for the buyer to assume an existing loan: this is not binding upon the lender.

C. Death of joint tenant. Sometimes a lender will attempt to accelerate a note when a joint tenant dies, since there is a technical transfer, but courts have ruled that the note is not subject to the alienation provision. The reasoning here is that it would be unfair to penalize surviving joint tenants by requiring them to pay off the existing loan just because of the death of a tenant.

D. Inheritance. As long as a dwelling is owner-occupied, lenders cannot arbitrarily call the loan just because the owner died and left the property to another by WILL. The reason for unenforceability of such alienation clauses is the same as that of death of joint tenant.

E. Marriage. When a single person with property in his or her own name marries and adds the spouse to the title, lenders cannot call the loan. This same principle applies in the case of remarriages.
F. Dissolution of marriage. When divorce occurs and transfer of the property to one of the spouses takes place, lenders cannot accelerate the loan. The same is true if the dissolution agreement provides for the property to go to an offspring instead of to one of the parents.

G. Trusts. When title is transferred into a living or inter-vivos trust, the transfer is treated the same as if the owners were transferring ownership from themselves back to themselves.

H. Liens. Simply because owners borrow against their property does not permit lenders to accelerate. This is true even if the note contains a "due-on-encumbrance" or "due-on-further-encumbrance" provision.

I. Lease. Where a property is leased for less than three years, the loan cannot be accelerated. But there is a catch: the lease cannot be accompanied with an option to purchase (popularly termed a "lease-option").

J. Moving. Property owners often move out of their homes and rent them. They may be motivated by income tax considerations, a poor market, or other factors. Whatever the reason, simply moving out of the house is not an event requiring acceleration. An exception is when buyers move out of the house within six months of purchase, unless for hardship and other extenuating circumstances, such as a job transfer. In any case, it will always be up to the borrower to justify his or her personal situation.

K. Judicial. Court decisions may restrict enforcement of acceleration clauses on the basis of equity or fairness.

L. Government programs. Severe restrictions are placed on lenders making loans that are to be insured or guaranteed by a government agency. This applies to institutional lenders that are normally involved with conventional loans, and to private lenders, discussed in Lesson Six.

V. WHAT ARE SOME OF THE CONVENTIONAL LOW- OR NO-DOWN PAYMENT LOAN PROGRAMS?

A. Underwriting and qualifying. Many lenders offer loan programs that permit a portion of the down payment, usually up to 2% of the purchase price, to be borrowed from a relative or other non-lending source. Such a source is a retirement fund. This means that many buyers can qualify with only a 3% down payment. If the buyer does not have the normal closing costs, these may also be borrowed. The normal loan ratios of 28% front-end and 36% back-end (see Lesson Nine) are often also waived, with buyers being
being qualified at ratios as generous as 33% front-end (housing expense as a percentage of income) and 38% on the back-end (total fixed obligations, including housing expenses, as a percentage of income).

These low- or no-down payment programs go by various names, such as Community Home-Buyers Program (CHBP), FNMA Neighbors, Neighborhood Advantage, etc.

B. The benefits of these types of programs include:

1. Higher loan amount permitted, which vary by county.
2. Higher front-end and back-end qualifying ratios.
3. Minimum credit or no credit. For example, the CHBP program allows borrowers to establish credit with copies of paid utility bills.
4. No reserve requirements.
5. Some cities and counties have programs to help buyers with closing costs and down payment.
6. A borrower may earn up to a certain amount, which varies by county and by program. To cite just one example, the Community Home Buyer Program, the upper income limits are:

<table>
<thead>
<tr>
<th>County</th>
<th>Upper Income Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Orange County</td>
<td>$63,200</td>
</tr>
<tr>
<td>Alameda and Contra Costa</td>
<td>56,200</td>
</tr>
<tr>
<td>San Francisco, San Mateo</td>
<td>59,900</td>
</tr>
<tr>
<td>Marin County</td>
<td>71,400</td>
</tr>
<tr>
<td>Santa Clara County</td>
<td>59,000</td>
</tr>
<tr>
<td>Santa Barbara County</td>
<td>54,400</td>
</tr>
<tr>
<td>Santa Cruz County</td>
<td>58,100</td>
</tr>
<tr>
<td>Ventura County</td>
<td>51,600</td>
</tr>
<tr>
<td>All Others</td>
<td></td>
</tr>
</tbody>
</table>

In addition, wage-earners in certain high-price census tracts are permitted to go as high as 150% of the above figures. Check with local lending institutions that participate in the program for up-to-date information.

The Community Home Buyers Program requires that prospective buyers read and complete a 125 page study manual called A Guide to Homeownership published by Fannie Mae. The study guide is an excellent source of information for the first-time homebuyer, available by contacting:
Loan agents who offer the CHBP must attend a class and pass a short test before presenting the program to a prospective borrower.

C. Public Employee's Retirement System (PERS).

The California Public Employee's Retirement System offers a program through many lenders in the state which allows any borrower who is employed by a public entity, including State, City, School District, Special District, and who has a retirement system with PERS, to borrow 100% of the purchase price. This is accomplished by placing a conventional loan of up to 95% loan-to-value ratio on the property and utilizing up to a 5% personal loan secured by the buyer's retirement funds. Thus a qualified buyer can purchase with just the funds required for closing costs. This can be a simple and inexpensive way for a qualified buyer. For agents working with public-employee clients, this important source of financing should not be overlooked!
1. The most common loan-to-value ratio associated with home loans made by conventional lenders is for:
   (a) 60%
   (b) 75%
   (c) 80%
   (d) 90%

2. One of the following is an advantage of a conventional loan:
   (a) discount points charged
   (b) higher down payment
   (c) shorter processing time
   (d) low prepayment penalty

3. Assume an application for a $100,000 loan is made for the purchase of a $150,000 house and that the lender demands 3 1/2 points. The loan fee will be:
   (a) $ 525
   (b) $ 3,500
   (c) $ 5,250
   (d) $35,000

4. Private mortgage insurance is designed to protect the lender against loss from which portion of the loan:
   (a) upper
   (b) middle
   (c) lower
   (d) entire loan commitment

5. The term that designates a privately insured real estate loan is called a:
   (a) private loan
   (b) PRT loan
   (c) PMI loan
   (d) protected loan

6. Interest rates that are subject to change as market rates fluctuate are referred to as:
   (a) fluctuating
   (b) irregular
   (c) fixed
   (d) adjustable

7. In event of foreclosure of a privately-insured conventional loan, the insurer may:
   (a) pay off the lender in full and take back the property
   (b) pay the lender up to the amount of insurance
   (c) do either (a) or (b)
   (d) do neither (a) nor (b)
8. You borrowed $250,000 on a conventional loan at 11% six years ago. The balance is now $245,000. The promissory note contains the standard prepayment penalty. What is the maximum prepayment penalty that may be charged?

(a) $0
(b) $10,725
(c) $13,475
(d) $21,450

9. Mr. Bigbucks purchases an apartment building for $500,000 with a downpayment of $65,000. What is the loan-to-value ratio?

(a) 0.13%
(b) 15%
(c) 87%
(d) none of the above

10. In choosing a lender, it is usually best to go with the one that

(a) charges the lowest prepayment penalty
(b) offers the highest loan-to-value ratio
(c) charges the lowest interest rate and points
(d) offers a choice between fixed and variable rates

11. A conventional loan is any loan that:

(a) is not backed by the government
(b) is insured by the government
(c) is either guaranteed or insured
(d) contains an acceleration clause

12. A lender may enforce an acceleration clause when:

(a) a single woman adds her husband to the title after marriage
(b) property is transferred to a parent
(c) the owner moves out of the house
(d) title is placed in trust

13. PMI may be required on a conventional loan if the loan-to-value-ratio is:

(a) below 75%
(b) between 75% and 80%
(c) above 80%
(d) applied to re-financed properties only

14. Where a large down payment is made, generally defined as 20% or more, borrowers on owner-occupied dwellings may obtain the advantage offered in:

(a) seven-year balloon mortgage
(b) waiver of prepayment penalty
(c) higher loan-to-value-ratio loan
(d) quick qualifier loan
15. The maximum prepayment penalty that may be charged by conventional lenders for an owner-occupied dwelling is:
   (a) one year's interest
   (b) six month's interest
   (c) three month's interest
   (d) none of the above

16. Conventional loans are usually:
   (a) assumable
   (b) not assumable
   (c) guaranteed
   (d) insured

17. Loans can usually be assumed under one of the following circumstances:
   (a) exchange of property
   (b) death of joint tenant
   (c) leasing for over 3 years
   (d) transfer to family member

18. "Extended term option" is used in connection with:
   (a) balloon payments
   (b) loan-to-value ratios
   (c) quick qualifiers
   (d) prepayment privileges

19. On a conventional loan, the borrower can negotiate a reduction in the interest rate by:
   (a) paying more points up front
   (b) securing secondary financing
   (c) buying a property with greater risk
   (d) increasing amount of leverage

20. Which of the following would NOT be considered a government loan?
   (a) Cal-Vet
   (b) DVA
   (c) FHA
   (d) Conventional
ADVANTAGES OF CONVENTIONAL FINANCING

1. STATUS

2. PROCESSING TIME

3. AMOUNT OF THE LOAN

4. SELECTIVITY

5. FLEXIBILITY
DISADVANTAGES OF CONVENTIONAL FINANCING

1. HIGHER DOWN PAYMENT
2. LOANS NOT ASSUMABLE
3. PREPAYMENT PENALTIES
LESSON SIX
WHAT ARE GOVERNMENT-BACKED LOANS?

PREVIEW:
In this lesson we outline the role of governments at all levels in the housing financing process. Advantages and disadvantages of FHA programs is detailed next. Then an explanation of DVA-guaranteed loans, together with eligibility and entitlements. We conclude with the purpose and functions of the California Department of Veterans Affairs, together with characteristics of Cal-Vet financing.

PERFORMANCE OBJECTIVES:
At the conclusion of this lesson, you should be able to:

1. Discuss the meaning and characteristics of FHA loans.
2. List five characteristics of DVA guaranteed loans.
3. Contrast differences between DVA and FHA loans.
4. List eligibility requirements for Cal-Vet loans.
5. Cite advantages and disadvantages of Cal-Vet financing.

I. GOVERNMENT-SPONSORED REAL ESTATE LOAN PROGRAMS

A. What Are Some of the Goals of Government-Backed Programs?

The operation of a free market presents difficulties in providing sufficient housing for everyone. Government agencies at local, state and national levels step in to fill the gap. Their stated goals are:

1. To provide "safe, sanitary, and decent" housing for everyone.
2. To provide incentives to both lenders and home buyers through insurance or guarantees.
3. To provide subsidies in the form of interest rate and rental supplements for low- and moderate-income families.
4. To offer tax incentives to builders and developers in order to attract venture capital into depressed and deprived areas.
5. To eliminate discrimination at all levels of housing.

6. To furnish benefits to those who have served or are now serving in military service.

7. To establish minimum housing standards, and to upgrade existing housing.

8. To offer income tax incentives to those piloting and utilizing energy and cost-saving techniques in the construction field.

B. What Types of Government Programs Are There for Home Buyers?

The typical real estate licensee is concerned mainly with the following three governmental agencies that participate in real estate financing:

1. Federal Housing Administration (FHA)
2. U.S. Department of Veterans Affairs (DVA)
3. California Department of Veterans Affairs (Cal-Vet)

II. WHAT IS THE FEDERAL HOUSING ADMINISTRATION (FHA)?

FHA is a federal regulatory agency administered by the U.S. Department of Housing and Urban Development - HUD, as it is otherwise known. Due to fast-moving changes, it is highly advisable readers are advised to secure the latest information from HUD area offices, approved lenders, or the Internet before applying for an FHA loan.

A. What Are the Objectives of FHA?

FHA was established in 1934 with the following objectives:

1. To insure loans made by approved lenders. FHA itself is not a lender, only the insurer.

2. To encourage home ownership through smaller down payments and lower closing costs than offered through conventional financing, long repayment terms, and no prepayment penalties.
3. To stabilize the mortgage market.
4. To improve the quality of construction. FHA has established standards of construction and design that must be met in order to qualify for FHA insurance.

B. What Does the FHA Achieve?

1. FHA insures lenders against loss due to borrower defaults. The borrower pays premiums in one of two ways: the premium is paid up-front by the borrower at closing along with his or her other closing costs or is financed (included in the loan), payable in monthly installments.

2. FHA approved appraisers evaluate and approve properties as well as borrowers and FHA insures the loan made by non-governmental lenders. Through its Mortgage Insurance Premium (MIP), FHA protects lenders in event of default. In case of foreclosure, FHA takes back the property and pays off the lender either in cash or with debentures guaranteed by the U.S. Government.

3. FHA is involved in social programs, particularly in the areas of subsidies for low- and moderate-income families.

4. FHA is not:
   a. a direct lender
   b. tax-supported
   c. a builder.

5. FHA works through approved lenders by way of the Direct Endorsement program, which allows lenders to underwrite loans.

C. What Are Some Advantages to FHA Financing?

   { Snow T 6 3 }

1. Down payment. Historically, the down payment percentage has been lower than conventional financing.

2. Competitive interest rates. Interest rates float with the market, allowing borrowers and lenders to negotiate the rate. This allows FHA to compete with the conventional market.

3. Credit standards. Credit qualifying criteria is not as restrictive when compared to conventional loans.
4. **Location.** Where the property is located is frequently not too important: FHA will go into neighborhoods where conventional lenders would not place loans. (This is not difficult to understand, since housing for everyone is one of government's goals.)

5. **Buyer qualifications.** When compared to conventional lenders, buyers with lesser incomes or net worth may qualify under FHA.

6. **Prepayment privileges.** No penalty is assessed for premature payoff.

7. **Assumption.** FHA allows new buyers to take over the existing FHA loan. However, buyers must undergo a "credit-worthiness review" for any loans made after 12/15/89. The interest rate cannot be increased, though a nominal assumption fee may be charged. There are limitations on assumptions by non-owner occupants (investors).

8. **Minimum property standards.** Government housing officials have instructed its approved appraiser panel to evaluate property, according to certain standards of acceptability. However, this evaluation process does not provide any guarantee that the property is defect free. Borrowers are cautioned not to rely on these standards, but to make their own investigations as to the condition of the property.

D. **What Are Some Disadvantages to FHA Financing?**

1. **Points.** Lenders may charge discount points as the market dictates. Either buyer or seller may pay the points.

2. **Processing time.** Because of bureaucratic red tape, time to process and close an FHA loan takes longer than comparable conventional transactions. However, those lenders who are approved as "Direct Endorsement Underwriter" may process, appraise, approve and fund loans in-house without having to submit the loan to FHA. This can typically save 3 to 4 weeks in the approval process.

3. **Repairs.** FHA requires repairs to be made before approval. It will not ordinarily insure a property until it is satisfied that the property complies with local building codes. This should not be taken as a guarantee of property condition after the required repairs are accomplished.
4. Investment vehicle. Investors cannot initiate an FHA home loan to acquire a residence as a rental. Borrowers must sign document that they will use the house as their principal dwelling.

5. Loan limits. FHA programs are designed to meet the needs of low to moderate income families, and as consequence the loan limits are less than normal conventional financing. These ceilings vary according to market. As of 2002, the ceiling on single-family dwellings vary from $144,875 for low-cost areas to $251,609 for high-priced areas.

E. What Are the Mechanics of an FHA Loan?

There are a wide variety of programs under FHA, but certain general rules apply to each:

1. Loans are available on 1 to 4 residential family units and for planned unit developments (PUDs). Condominium projects are eligible if the project meets prescribed "Minimum Property Standards" under FHA specifications.

2. A loan origination fee may not exceed 1% of the loan amount, and is usually paid by buyers. If the seller pays the fee, the loan amount will be reduced by the same amount.

3. Secondary financing is allowed with FHA loans, however it would be rare to find a lender who would allow it because most investors will not buy an FHA loan with secondary financing.

4. Maximum term is 30 years for most FHA loans.

5. There is no maximum purchase price. Buyers may pay more than appraised value, but the loan is based on the lower of the FHA appraisal or actual purchase price.

6. FHA appraisals are good for six months.

7. FHA does not determine interest rates. Interest rates and points are negotiated between borrower and lender, with interest rates based on the number of discount points paid at close of escrow.

8. Purchasers must agree to occupy the property as their principal residence in order to obtain the maximum loan.

9. FHA requires certification that the property has no evidence of termite infestation, fungus, and wood rot.
10. Mortgage insurance premium (MIP) is required for almost all FHA loans.

F. Non-recurring closing costs.

1. A seller may pay any part of the buyer's non-recurring closing costs, up to 6% of the loan amount. However, the loan amount will be reduced by a like amount for anything paid to buyer's recurring closing costs by seller, except for any amount paid by seller towards buyer's discount points.

2. Buyer's non-recurring closing costs are as follows:
   - Title Insurance Policy (Lender's)
   - Escrow Fee (one-half)
   - Loan Origination Fee (1%)
   - Appraisal Fee
   - Pest Control Inspection Fee
   - Credit report
   - Recording and Notary Fees

G. FHA Mortgage Insurance Premium (MIP).

1. Mandated. FHA requires mortgage insurance premiums to be paid by borrowers to protect the lenders.

2. Payment Premium Options. Section 203(b) borrower may pay the MIP in one of two ways:
   a. Pay the up-front portion of MIP in full as a one-time charge at close of escrow (COE)
   b. Add the up-front premium amount to the loan amount and amortize it along with the principal and interest payment. Note that there is also a new monthly MIP cost, in addition to the up-front premium. When added to the loan amount, the aggregate is known as the gross loan.

3. The maximum allowable loan amount (without MIP) will be based on the loan amount as calculated or the appraised value, whichever is less.

   a. Under Section 203(b), a portion of the mortgage insurance premium (MIP) is paid to FHA as a one-time lump sum at the start of the loan. It may be paid in cash or it may be added to the loan amount. The amount of up-front MIP payable is 1.50% for 30 and 15-year loans. This up-front MIP charge is made on single family residences and PUD loans, but not on condos. Any unused portion of the up-front MIP may be refunded within the first 84 months of the loan.
4. Additionally, there is an annual premium that is assessed on the loan amount of .5%. The amount is paid on a monthly basis and is renewable. This addition to the premium is payable on all FHA loans. However, the 1.50% annual premium does not apply to condo loans.

5. Calculating The Premium. Assume a loan amount of $100,000, involving a 95%, 30-year loan, that is, with a 5% down payment, for 30 years:

   **Up-Front Payment:** $100,000 x 0.0150 = $1,500 (in cash or financed in with the loan).

   **Monthly Payments:** $100,000 x 0.0050/12 months = $41.67

6. Effective for all FHA loans closed on or after 1/1/01, FHA's annual MIP will be automatically canceled under certain conditions. FHA will determine when this plateau has been achieved, such as when the loan-to-value has reached a specified percentage. However, the contract of insurance will remain in force for the full term of the loan.

7. Since the FHA insurance programs are self-financing, mortgage insurance premiums must be adjusted to cover costs. Traditionally FHA programs were geared to permit low-cost entry into the housing market for all. FHA premiums may make FHA programs less attractive when compared to other options available to borrowers.

### III. SPECIFIC FHA PROGRAMS.

There are numerous loan programs offered through FHA. We discuss only the three most popular for home buyers.

#### A. FHA 203(b)

1. **Eligibility.** Anyone, including legal aliens, may apply. A 2-year work history and valid Social Security Number are required by FHA.

2. **Maximum loan.** Statutory Loan Limits are based on the type of property and geographic location of the property. FHA provisions allow for 2-4 unit residential properties at higher loan maximums. These loan ceilings are also influenced by the appraised valuation. For example, if the appraised value is LESS than the requested loan, that loan will be reduced to the appraised value. Additionally, the borrower's total investment in the property will influence the actual loan amount provided.

   a. The current basic standard mortgage limits for FHA insurer 1, − ns are:
1-Family 2-Family 3-Family 4-Family
$144,336  $184,752  $233,296  $277,512

b. High cost area limits are subject to a ceiling based on a percent of the Freddie Mac loan limits. The ceilings are currently:

1-Family 2-Family 3-Family 4-Family
$251,609 $334,863 $404,724 $502,990

c. For the loan ceilings associated with any particular area, consult: www.californiaphaloans.com/fha loan limits.htm

d. The maximum loan ceilings are subject to change as limits are raised by HUD, and also as areas move from low-cost to high-cost or vice-versa. It is always wise to consult your nearest HUD office to ascertain maximum loan limits for your locale.

e. HUD Offices: Sacramento (916)551-1351
   Fresno (209)487-5034
   Los Angeles (213)251-7122
   Santa Ana (714)957-3741
   San Diego (619)557-5310

3. Down Payment Requirement.

a. The down payment for 30-year and 15-year loans is 3%.

b. The borrower's down payment and closing costs may be paid by the borrower, a family member, or grants from approved assistance programs.

c. Unless the loan includes a financed UFMIP (up-front MIP), the mortgage amount must be rounded down to a multiple of $50.00.

d. If the UFMIP is financed, the mortgage amount may be rounded down to either the nearest $1.00 or $50.00.

e. If the UFMIP is financed into the mortgage, the UFMIP is neither subject to the mandatory loan amount limits nor the maximum mortgage limitation.
4. Calculating the Buyer's Monthly Ownership Costs:
The costs of home ownership include Principal and Interest on the loan, Taxes, Insurance and the monthly MIP premium. Impounding of the loan is entirely at the discretion of FHA.

Selling Price = $ 150,000.
Down Payment (150,000 x .03) = $ 4,500.
Loan Amount (150,000, 30-years x .97) = $ 145,500.

Assume that the borrower will finance his MIP.

MIP calculation: 145,500 x .0150 = $ 2,183.
Gross Loan: 145,500 + 2183 = $ 147,683.

Principal & Interest, on Gross Loan Amount of $147,683, assume 7.5% fixed, 30 years) = $ 1,032.63
Taxes: Prop 13 estimated at 1.25% of purchase price less Homeowner's Exemption of $7,000 = 148.96
Insurance, estimated $180.00 per year = 15.00
Monthly MIP Premium: $145,500 x 0.005/12 mos. = 60.63
Total Monthly Housing Cost, estimated = $ 1,257.22

B. FHA 203(b) Veteran

1. Purpose. This program is designed for home-buying veterans. Once used, it does not preclude veterans from using their DVA loan entitlement at some later time.

2. Eligibility.
   a. Veterans must have actively served at least 90 days and discharged from service other than dishonorable.
   b. Must occupy as principal residence.
   c. Eligibility has no expiration date.

3. Maximum Loan. Same limits as regular FHA 203(b).

C. FHA 245 - Graduated Payment Mortgage (GPM)
1. A larger down payment than for the FHA 203b is required.

2. Monthly payments increase annually over time and eventually level off, similar to the conventional GPM described in Lesson 4.

3. Because of its negative amortization feature as the required payment in the early years may be insufficient to pay the note interest, it is perhaps the most difficult of all FHA home loans to understand and apply.

4. **Eligibility.**
   
a. Any legal resident of the United States.
   b. Citizenship is not required.
   c. Buyer must occupy the property.

5. **Down payment.** Varies according to the particular plan selected by the borrower from among the five plans available: Plan I, II, III, IV, or V. Since the inception of the 245 loan program, only plans 1, 2 and 3 have been utilized. Even though Plan 3 demands the greatest amount of down payment, it is the most popular of the five. Therefore, only Plan III will be discussed.

6. The required monthly payments made during the early years may result in negative amortization, meaning that the monthly payment will not pay the total interest that the loan is earning. Therefore, the loan balance will INCREASE rather than DECREASE.

7. **Maximum loan.** The maximum available loan is determined. That amount is then divided by the highest "Outstanding Principal Balance Factor" (OPBF).

8. **What is OPBF?** This means that at some time during its loan term the outstanding balance for a loan that starts out with negative amortization will reach a peak. From that point on, the loan will positively amortize. Precisely when it will reach its highest balance is based on the interest rate and the plan. Examples: at 8% the loan balance will be greatest during the 48th month of a 30-year loan; at 16% the balance owed peaks during the 60th month - twelve months later.

9. FHA furnishes tables under each of the five plans showing loan balances at varying interest rates for each year during the life of the loan.
10. Comprehensive Example of an FHA 245 Plan III loan. You buy a home for $100,000 and apply for a 30-year loan at 10% interest. What's the maximum you can borrow, including closing costs estimated at $1,500, and the required mortgage insurance? Before we do the 3-step calculations, let's look at the foreign language involved, the "a-b-c's described below.

a. Outstanding Principal Balance Factor (OPBF). This is the highest balance that a loan with negative amortization will reach during its term. FHA publishes tables, available from most lenders, that show the highest OPBF of 1084.3752 will occur in the 48th month of a 30 year loan at 12 1/2 interest under Plan III for a 30-year loan.

b. Translation. Due to negative amortization (see Lesson 5), the borrower owes $1,084.38 for each $1,000 borrowed, which is an additional $84.38 per thousand dollars initially borrowed. This increase in outstanding balance is due to the fact that the initial payments were not enough to pay back a loan through normal amortization schedules. Stated differently, interest is deferred.

c. Principal and Interest Factors published in FHA tables show the following for the first five years, and leveling off during the remaining term of loan:

<table>
<thead>
<tr>
<th>Year</th>
<th>P &amp; I Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>6.6704</td>
</tr>
<tr>
<td>2</td>
<td>7.1706</td>
</tr>
<tr>
<td>3</td>
<td>7.7084</td>
</tr>
<tr>
<td>4</td>
<td>8.2866</td>
</tr>
<tr>
<td>5</td>
<td>8.9081</td>
</tr>
<tr>
<td>6</td>
<td>9.5762</td>
</tr>
</tbody>
</table>

i Under the standard fully-amortized, level-payment 30-year loan at 10%, monthly payments would be $8.7757 (or $8.78 rounded to nearest penny) per $1000 loan amount.

ii But as can be seen from the chart, under a GPM, payments begin at only:

a' $6.67 per month for year 1,
b' $7.17 per month in year 2,
c' $7.70 in year 3, in

$8.29

d' $8.29 year 4, in
e' $8.91 year 5, and
f' $9.58 for each of the remaining 300 months.
iii. Under Plan III the monthly payments increase by 7.5% per year. Thus negative amortization is present for the first 5 years. Thereafter the borrower "catches up" with full positive) amortization by way of higher payments for the remaining 25 years.

11. The U.S. Department of Veterans Affairs (DVA) has adopted the FHA GPM Plan 3 option, which features a 7 i % annual payment increase over a five year period.

   a. Deferred interest is added to the principal.
   b. Down payment is required.
   c. The program has suffered severe problems due to high default rates.

D. FHA 251 - One-Year Adjustable Rate Mortgage (ARM).

1. Available to owner-occupants only.

2. 1-4 family residential units.

3. Loan amounts are same as for 203b loan program, 30-year loan.

4. Note and payment rates adjust annually.

5. No negative amortization.

6. 1% annual cap and 5% life of loan cap.

7. Buydowns are available.

8. Index is U.S. Treasury security one-year constant maturity.

E. What About Refinancing an FHA Loan?

1. Existing loan may be refinanced through FHA.

2. If the borrower wishes to receive cash back, the loan is limited to 85% of appraised value and is subject to FHA income qualification guidelines.

3. For second homes the maximum mortgage obtainable is 85% of appraised value with no cash back permitted.

4. Refinances involving GPM (Graduated Payment Mortgages) and ARM (Adjustable Rate Mortgages) are allowed, provided that there is a reduction in
principal and interest payment.

5. If the financing is to an ARM from a fixed-rate loan, the first year's interest rate must be at least two percentage points below the existing rate.

E. How About Streamlining the FHA Refinancing Process?

1. A streamline refi' is one obtained strictly for the purpose of obtaining a lower interest rate or better terms on a current FHA loan.

2. An appraisal or credit underwriting is not required.

3. It is available for both principal and secondary residences.

4. No cash back is allowed.

F. Can One Assume an FHA Loan?

1. Mortgages originated prior to 12/1/86 are generally assumable.

2. For Mortgages originated between 12/1/86 and 12/15/89, buyers must undergo a credit-worthiness exam during the first year if the original FHA loan was for a principal or secondary residence; or during the first 2 years, if original FHA loan was for an investment.

3. For mortgages originated after 12/15/89, the credit-worthiness of the party assuming the mortgage is subject to ongoing review.

G. Investor Loans.
The HUD Reform Act of 1989 eliminated all investor loans effective December 15, 1989, with the following exceptions:

1. Foreclosure properties purchased at HUD Property Disposition Sales, on which FHA-insured financing is available to an investor-borrower. The down payment required is 25% of the sales price on a single family residence, or 15% of sales price on two-to-four units.

2. Section 203(k) Rehabilitation Loan Program.
   a. This program was instituted to enable the nation's housing stock to be restored and preserved.
   b. Loans are based on the purchase price and costs of repair or rehabilitation or to refinance existing indebtedness and rehabilitate the existing dwelling
c. It is an owner-occupied program and is not available to investors.

d. Because of its complexity and lender supervision required, higher lender charges are allowed.

e. Construction funds are placed in escrow and lender inspections are made to insure satisfactory completion of the work.

IV. WHAT IS THE PURPOSE AND FUNCTION OF THE U.S. DEPARTMENT OF VETERANS AFFAIRS (DVA)?

A. Guarantee. To DVA-approved lenders against loss up to specified limits for home loans made under the "GI Bill of Rights".

B. Coverage. Like FHA, the DVA is not a direct lender. It merely guarantees loans for up to $60,000, effective 1/1/02, based on a graduated scale, in event of foreclosure.

C. Reward for military service. There is no cost to borrowing veterans for the guarantee, so long as they repay the loan according to its terms.

D. Funding fees. Points charged for DVA loans vary according to down payment and other factors. The basic funding fee is 2 points or 2%, (2.75% for National Guard and 3.00% for subsequent users of the DVA loan program. The ceilings are reduced as follows:

1. For loans with up to 5% down payment, the fee is reduced by a half-point, to 1 1/2%. For National Guard and subsequent users, it is 2.25% and 1.50%, respectively.

2. For loans over 5% but less than 10%, the funding fees are reduced to 1.25% for first-time users of the program and 2.25% and 1.50% for National Guard and subsequent users, respectively.

3. For loans with 10% down payment or more, the funding fees are 1.25% for first-time users, 2.00% for National Guard, and 1.25% for subsequent users.

4. For DVA loans being assumed, 1/2%

5. For manufactured housing loans, the funding fee is 1 point.
F. What are some advantages of a DVA loan?

1. No down payment. This attracts more buyers, broadening marketability for residences.

2. Competitive interest rate. As with FHA, DVA rates float with the market, allowing DVA loans to compete with the conventional market.

3. Property restrictions. Under some circumstances the DVA is more lenient than FHA on requirements for property approval.

4. Location. DVA often approves properties in locations rejected by conventional lenders.

5. Qualifying. When compared to other high loan-to-value lenders, DVA is more lenient in qualifying the borrower.

6. Prepayment penalties may not be charged veterans paying off their loans before maturity.

7. Assumptions. DVA loans are assumable even by non-vets if qualified on the credit front. Prior to March 1988, DVA loans were freely assumable without lender approval. For any loans that are closed after that date, lender approval is required. In addition to a 1/2% funding fee that goes into a DVA loan insurance fund, a nominal assumption fee is charged by lenders. The qualifying buyer may be an occupant or investor. However, if the selling veteran is entitled to additional guarantee ("exchange") benefits, the buyer must be an owner-occupant. The interest rate is not changed.

8. Appraisal. Veterans are not required to purchase a property appraised at less than the amount shown by the "Certificate of Reasonable Value" (CRV) issued by the DVA.
G. What are some disadvantages of a DVA loan?

1. **Points.** Discounts were traditionally charged on DVA loans, which the seller was obliged to pay. However, this was prior to the advent setting the market rate of interest as a DVA guideline.

2. **Processing.** The time and red tape required to process a DVA loan, and the inability to structure the loan to the specific needs of the borrower, is a serious drawback. Offsetting this disadvantage is that many DVA loans are "automatics", allowing DVA-qualified lenders to underwrite loans within 45 days without prior approval from the Department of Veterans Affairs.

3. **Repairs.** In its attempt to protect home-buying veterans, the DVA requires repairs, thus adding to the price and discouraging homeowners from selling under the program.

4. **Loan limit.** Keep in mind that there is NO maximum loan limit set by DVA. It is strictly a lender prerogative as to the loan limit. However, the maximum that most lenders are willing to make without a down payment is $240,000, or for times the entitlement (currently $60,000). Since many properties in California exceed this amount, it is difficult for vets to buy in high-priced areas.

H. Who is eligible for DVA loans?

1. Veterans released from military service through other than dishonorable discharge.

2. Veterans who have served on active duty for the minimum prescribed number of days (except for service-connected disabilities), during the following periods:

<table>
<thead>
<tr>
<th>Date Range</th>
<th>Number of Days</th>
</tr>
</thead>
<tbody>
<tr>
<td>9/15/40 - 7/25/47</td>
<td>90 days</td>
</tr>
<tr>
<td>7/26/47 - 6/26/50</td>
<td>181 days</td>
</tr>
<tr>
<td>6/27/50 - 1/31/55</td>
<td>90 days</td>
</tr>
<tr>
<td>2/1/55 - 8/4/64</td>
<td>181 days</td>
</tr>
<tr>
<td>8/5/64 - 5/7/75</td>
<td>90 days</td>
</tr>
<tr>
<td>5/8/75 - 9/7/80</td>
<td>181 days</td>
</tr>
<tr>
<td>9/8/80 - 8/2/90</td>
<td>24 months</td>
</tr>
<tr>
<td>8/2/90 to present</td>
<td>90 days</td>
</tr>
</tbody>
</table>

Reserves and National Guard after 10/20/92 must have been in the service for six years and discharged under honorable conditions to qualify for a DVA loan.

Currently in active military service: 180 days or more
I. Entitlements. The guarantees to lenders against loss are called entitlements, shown by the amounts increasing periodically as and into effect:

<table>
<thead>
<tr>
<th>Entitlement Date</th>
<th>Maximum Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>pre 12/28/45</td>
<td>$2,000</td>
</tr>
<tr>
<td>12/28/45</td>
<td>4,000</td>
</tr>
<tr>
<td>07/12/50</td>
<td>7,500</td>
</tr>
<tr>
<td>05/07/68</td>
<td>12,500</td>
</tr>
<tr>
<td>12/31/74</td>
<td>17,500</td>
</tr>
<tr>
<td>10/01/78</td>
<td>25,000</td>
</tr>
<tr>
<td>10/01/80</td>
<td>27,500</td>
</tr>
<tr>
<td>02/01/88</td>
<td>36,000</td>
</tr>
<tr>
<td>12/18/89</td>
<td>46,000</td>
</tr>
<tr>
<td>10/13/95</td>
<td>50,750</td>
</tr>
<tr>
<td>01/01/02</td>
<td>60,000</td>
</tr>
</tbody>
</table>

J. Maximum loan amount. There is no maximum mandated by the DVA. The maximum loan offered by DVA-approved lenders is a function of DVA's guarantee and the amount of risk secondary markets are willing to take. Prudence dictates that lenders limit the loan to 4x the entitlement so that the guarantee figure represents, in effect, a down payment of 25%. When the guarantee increased from $50,750 to $60,000, for instance, lenders increased their loan commitments from a maximum of $203,000 (4 x $50,750) to $240,000 (4 x $60,000).

1. Eligible veterans can purchase more expensive homes but for every $4 they borrow above the maximum of $60,000, they must put down $1 of their own money.

K. Qualifying for partial entitlement. As changes in the guaranty occur, veterans who have received DVA loans may qualify for another through a "partial entitlement" (or "partial eligibility"). Partial entitlements are available to veterans even if their existing DVA loans have not been paid off. Thus a veteran may purchase another property for occupancy and still retain the first property.

1. Application. If a veteran had purchased a home in 1949, the vet would have used the maximum entitlement of $4,000. If the veteran bought in 1969, $12,500 was guaranteed. If he or she delayed purchasing until 1979, the veteran would have used $25,000. Only if the veteran purchased after 12/31/01 would all of the $60,000 entitlement be absorbed.

2. Comprehensive Example. To determine how much entitlement a veteran is eligible for, use the following process:
   a. Determine the selling price.
   b. Multiply the selling price by 75%.
c. Determine current maximum entitlement.
d. Determine date of previous loan.
e. Subtract c from d
f. Subtract e from b to determine maximum new loan.
g. Required down payment: a (above) - f.

For a vet who used up the $12,500 entitlement in 1969, the remaining entitlement under the $60,000 maximum guarantee is $47,500, and maximum loan typically $197,500:

<table>
<thead>
<tr>
<th>New Home Purchase</th>
<th>$200,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multiply $200,000 by 75%</td>
<td>$150,000</td>
</tr>
<tr>
<td>Current maximum entitlement</td>
<td>$60,000</td>
</tr>
<tr>
<td>Less: previous entitlement</td>
<td>12,500</td>
</tr>
<tr>
<td>Remaining entitlement</td>
<td>$47,500</td>
</tr>
<tr>
<td>Add remaining entitlement to $150,000</td>
<td>$197,500</td>
</tr>
<tr>
<td>Required down payment to complete the DVA loan transaction</td>
<td>$2,500</td>
</tr>
</tbody>
</table>

Thus vets who have used their GI Bill for housing and have not been reinstated as their old DVA loans were not paid off are entitled to additional loans every time the entitlement increases. As shown above, the veteran is eligible for another $197,500 home loan. Note: cash-out refinance are limited to $144,000.

**Sliding scale entitlement.** Understanding the subject of entitlement is difficult at best, since it is based on the amount of loan involved. The table below shows how much the VA guarantees for different loan amounts:

<table>
<thead>
<tr>
<th>Loan Amount</th>
<th>Entitlement or Guaranty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under $45,000</td>
<td>50% of the loan</td>
</tr>
<tr>
<td>$45,001 to $56,250</td>
<td>$22,500</td>
</tr>
<tr>
<td>$56,251 to $240,000</td>
<td>the lesser of $36,000 or 40% of the loan</td>
</tr>
<tr>
<td>Over $240,000</td>
<td>the lesser of $60,000 or 25% of the loan</td>
</tr>
</tbody>
</table>

1. **Example 1.** You apply for a $150,000 loan. What is the maximum guaranty? Answer: $36,000 vs. 40% of $150,000 or $60,000 = $36,000.

2. **Example 2.** You apply for a $244,000 loan. The guarantee is limited to $60,000 or 25% of the loan ($61,000), whichever is less. The lender may grant the loan if the lender does not intend to sell the loan in the secondary market, or if the lender is accommodating the borrower due to such overriding considerations as past favorable banking relationships, etc.
M. What are some other things to know about DVA financing?

1. Type of property. DVA guarantees loans of from one to four units, planned unit developments (PUDS), and condominiums. If not built under DVA inspections, the borrower may need to wait for one year after construction is completed.

2. Loan fee. While there are limits to the amount of funding fee buyers may pay, there is no restriction for points that may be charged sellers.

3. Term. The maximum term of loan is 30 years, but may be reduced if the economic life of the property is less.

4. Down payment. DVA does not require a down payment. However, if the veteran is willing to pay more than the reflected in the CRV, he or she must pay the difference in cash through escrow.

5. Maximum loan. While there is no statutory maximum, lenders and the Secondary Market have impose limits based on prudent lending policies and market conditions. Most will not exceed $240,000 since this is the maximum amount that investors will purchase in the secondary market (covered in Lesson Seven).

6. Impounds. In addition to principal and interest, DVA recommends pro rata taxes and insurance be included in the monthly payments. This is known as limpounds.1

7. Secondary financing. The general rule is that no junior financing can be a part of a DVA loan. Exception: where the lender's commitment is less than CRV, and the seller is willing to carry the balance under the same terms as the first loan.

8. Termite reports. DVA requires a termite report and clearance for existing houses.

9. Closing costs. DVA will not allow veterans to pay for costs of the termite report, repairs, lender's fees such as underwriting and document preparation, tax service, notary fees and CRV if ordered prior to date of purchase. The seller is permitted to pay for all the closing costs, including prepaid taxes and fire insurance premiums.

10. Purchase agreement. If the veteran signs an agreement to purchase a home before issuance of the CRV, the agreement must provide that the vet may cancel without any obligation or penalty.
11. Full Reinstatement. A previously-used eligibility may be restored in full, providing the previous loan is fully repaid and the property sold.

V. WHAT IS THE CAL-VET PROGRAM?

A. Cal-Vet Financing Has The Following Characteristics:

1. Low-cost and Low-interest rate loans are available to eligible and qualified veterans. There is no residency requirement. As a result of a decision of the California Supreme Court in 1992, it is no longer necessary for the Cal-Vet applicant to have been born in California nor to have been a resident of California at the time of entry or reentry into active military service. Any veteran meeting the other criteria of Cal-Vet is eligible, so long as they want to purchase a home IN California.

2. The California Department Of Veterans Affairs (DVA) administers the program through its Division Of Farm & Home Purchases. Veterans formerly were required to deal directly with this agency. Cal-Vet approved and certified Mortgage Brokers can now offer the Cal-Vet loan program to prospective qualified veteran borrower applicants. The veteran can originate the loan with a local Cal-Vet District Office (10 statewide) or apply through the use of a Mortgage Broker.

3. Funds for the program are obtained from the sale of Veterans Revenue bonds and General Obligation bonds. General Obligation bond funds may be used to finance loans for Vets who have been discharged from active duty service within the prior 30 years. The provisions governing the uses of Cal-Vet revenue bonds are dictated by federal laws contained in the Internal Revenue Code.

4. Cal-Vet also has a limited amount of funds which can be used to fund veterans who do not qualify for general obligation bonds. The applicant or certified mortgage broker can check with Cal-Vet for the availability of these funds.

5. Cal-Vet program now parallels the DVA loan program in many respects. Cal-Vet is now an authorized DVA lender with authority to close loans on an automatic basis. Its credit standards are those used by DVA and its forms are also similar.
B. Who is Eligible?

1. Any California resident veteran who served at least 90 days on active duty (or less if discharged sooner due to a service related disability); or received or is eligible to receive a campaign or expeditionary medal authorized by the U.S. Government which meets the definition of wartime service; or was called to active service from reserves or National Guard by presidential executive order during a time of military conflict and was thereafter released honorably after serving less than 90 days. Service for training does not qualify.

2. Applicants current serving in the military on active duty must provide a statement of service from his or her commanding officer which verifies qualifying days of active service and that the veteran is serving honorably.

3. Effective 1/1/98, peacetime era veterans are now eligible to apply, subject to the criteria for use of revenue bonds.

4. If no campaign medal was awarded, at least one day of active service must have been during any of the following periods or operations:

   a. Operation Restore Hope - Veterans who worked directly to support troops in Somalia.

   b. Operations Desert Shield and Desert Storm - August 2, 1990 through a closing date which is still to be determined.


   e. World War II - December 7, 1941 - December 31, 1946.

5. Career members of the military, currently serving. Requires a statement of satisfactory performance from the service branch.

6. The unremarried surviving spouse of an eligible veteran, provided the veteran:

   a. died after filing a Cal-Vet application. or

   b. died in the line of duty on active duty. or

   c. was discharged and died from injuries incurred in active duty. or
B. General Information.

1. Getting started. A completed loan application must be submitted by the vet or approved and certified mortgage broker.

2. Property Standards. These generally are the same as for FHA and DVA. The property must consist of a single family or condominium dwelling or a home in a Planned Unit Development (PUD). Also permitted are mobile homes on land owned by the owner or in approved mobile home parks and farms. Eligible farms must demonstrate that there is sufficient net income to provide for loan and tax payments (aka debt service).

3. CAL-VET Loan Limits:
   a. $250,000 for single family homes, which include houses built on site, condominiums, homes in planned unit developments, and manufactured homes affixed (permanent foundation system) to land owned (not rented) by the borrower.
   b. $300,000 for farms that will debt service.
   c. $70,000 for mobile/manufactured homes in approved mobile home parks.
   d. $5,000 additional loan funds for an active or passive solar heating system for the house. The passive solar system must be designed to collect, store and distribute heat.

4. Loan Guarantee Fee. Cal-Vet needed to have such a fee to remove the risk associated with defaulted loans. This is a one-time charge paid at the time of the loan. The fee is charged as a percentage of the loan amount. The seller can pay the fee.
   a. For loans with less than 5% down payment, the loan guaranty fee is 2% of the loan amount (subsequent loans at 3%).
   b. For loans with at least 5% down but less than 10% down, the loan guaranty fee is 1.5% of the loan amount.
   c. For loans with at least 10% down but less than 20% down, the loan fee is 1.25%.
   d. There is NO loan fee if the applicant pays at least 20% down payment.
e. There is NO loan fee if the applicant is disabled (rated by DVA as 10% disabled and receiving disability compensation), regardless of the down payment.

5. Loan Origination Fee. The fee is 1% of the loan amount. It must be paid in escrow, by either the buyer or seller, or split between both. This fee may be used to pay the brokerage fee for loans originated by mortgage brokers, or to offset program costs for loans originated by staff.

6. Down Payment. The minimum required down payment is 2% of the selling price or appraised value, whichever is less. Down payment assistance from the seller would be considered to be a gift and therefore, a price reduction.

7. Term. Most loans are approved for a term of 30 years. Mobile homes in parks are generally scheduled for 10 to 20 years.

8. Interest Rate. It is a flexible rate. It has changed infrequently, based upon the continuing cost of bonds sold to support the program's operation. For the first time, the rate on new loans is separate from the rate charged on the existing loan portfolio. This should lead to Cal-Vet being able to get competitive new loan rates in the future. For mobile homes in rental parks, the rate is 1% higher than the standard rate. The standard rate is capped at 7.5%.

9. Secondary Financing. Junior loans are permitted under special conditions but combined total 1st & 2nd may not exceed 98% of Cal-Vet appraised value. The secondary lender must agree to subordinate.

10. Pre-payment Penalty. A loan may be repaid at any time, however if a loan was made prior to 3/3/98 and is paid off within the first two years, it is the policy of Cal-Vet to administer a pre-payment service charge of 2% of the original loan amount. For loans made after 3/3/98, the Cal-Vet contract does not have a prepayment service charge.

11. Occupancy. Veterans must certify that they are purchasing the property as their principal residence. The veteran or the veteran's spouse must occupy the property within 60 days after signing the Cal-Vet loan contract, and must continue to reside in the property as the principal place of residence until the loan is paid in full. The veteran may obtain a Waiver of
Occupancy for a temporary period if they plan to return or need time to sell the home. Cal-Vet has the option of extending the waiver indefinitely upon a showing of good cause.

12. Title. Legal title is conveyed to the state by the seller for properties financed through Cal-vet. The state then sells the property to the veteran under a land contract.

a. Use of this security instrument allows the Department to provide more benefits and at better prices to the veteran.

b. It also provides Cal-Vet with more flexibility in assisting delinquent borrowers and that agency is able to provide home improvement funds without a new escrow nor an additional lien.

c. Prior written consent from Cal-Vet is required if property is to be assigned, transferred, encumbered, leased, let, or sublet.

13. Monthly Payments. To principal and interest is added pro-rata property taxes and hazard insurance, plus life and disability insurance premiums.

D. What Are Some Advantages to Cal-Vet Financing?

1. Low interest rate.
2. Low down payment.
3. Inexpensive fire and hazard insurance.
4. Life and Disability insurance at lower group rates.
5. Disaster Indemnity and Catastrophe Program
6. Low closing costs.

E. What Are Some Disadvantages to Cal-Vet Financing?

1. The security instrument is a land contract.
2. Possibility of interest rate increases at a time when the vet may not be able to afford increased payments.
3. Requirement to purchase life and disability insurance. Though desirable, this adds to the monthly payment, and may even preclude use of the program altogether for uninsurable vets.
4. For those desiring life and disability insurances, they may be excluded due to age (62 years old).
LESSON SIX MULTIPLE CHOICE QUESTIONS

Directions: Underline the letter representing the correct answer

1. To be eligible for a Cal-Vet loan, a veteran must have enlisted in the armed forces while a legal resident of California.
   (T)  (F)  **(F)**

2. The goal(s) of the FHA program include the following:
   (a) To upgrade the nation's housing standards and quality.
   (b) To provide affordable long-term financing on a reliable basis.
   (c) To further the goal of universal home-ownership.
   (d) All of the above

3. The major difference between an FHA loan and a DVA loan is:
   (a) The maximum loan amount.
   (b) The method by which the buyer takes title.
   (c) The mechanism by which lenders are protected in the event of default.
   (d) The methods of appraisal used to value the home.

4. You purchase a home to be used as your principal residence for $100,000. Under FHA 203(b), the maximum 30-year loan including MIP that you can obtain, assuming that you paid closing costs, is
   (a) $103,750
   (b) $ 99,833
   (c) $ 99,949
   (d) none of these

5. Given the information in Question 4, what will be the minimum down payment, excluding closing costs, available to these buyers?
   (a) $2,420
   **(b)** $2,250
   (c) $ 920
   (d) $4,703.75

6. A Cal-vet buyer is actually purchasing his property under a:
   (a) Conditional Grant Deed
   (b) Life tenancy
   (c) Long-term easement
   (d) Land contract of sale
7. Which of the following is true of FHA loan assumptions?
   (a) Mortgages assumed after 12/1/86 require a credit-worthiness exam.
   (b) Mortgages assumed after 12/15/89 require an on-going review of credit-worthiness.
   (c) Mortgages originated prior to 12/1/86 are generally assumable to investors.
   (d) All of the above are true of FHA loans.

8. An FHA loan is always best for a cash-poor buyer.
   (a) True
   (B) False

9. FHA loan amounts are always rounded:
   (a) Up, to the nearest dollar
   (b) Down, to the nearest dollar
   (c) Up, to the nearest $50.00
   (d) Down, to the nearest $50.00

10. A Cal-vet loan may be used to purchase a:
    (a) business
    (b) duplex
    (4) single-family home
    (d) a live-aboard yacht

11. A couple purchased a single-family home for $150,000 using FHA financing. Assuming they paid their own closing costs, how much will their monthly MIP insurance be?
    (a) $ 45.61
    (b) $185.78
    (c) $247.70
    (d) $ 61.10

12. Cal-Vet, FHA, and DVA loans should always be considered when advising buyers because:
    (a) There is no qualifying, since applicants cannot be denied
    (b) Interest rates are lower than conventional loans
    (c) Origination costs are always lower than conventional loans
    (d) Buyers may qualify more easily for a larger loan amount than with a conventional loan

13. Both FHA and DVA loan programs are intended to be an inducement to conventional lenders to make these types of loans. The protection to lenders under FHA loans is in the form of guarantee, whereas with the DVA program it is a insurance on a portion of the loan amount.
    (T)
    (F)
14. The interest rate charged on an FHA loan is established by:
   (a) The Department of Housing & Urban Development (HUD)
   (b) The Federal Reserve Open Market Committee
   (c) The lending institution making the loan
   (d) The Federal Housing Administration (FHA)

15. The interest rate charged on a Cal-Vet loan is established by:
   (a) The Federal Housing Administration
   (b) The 11th District Cost-of-Funds Index Committee
   (c) The interest rate established at time of bonds sale
   (d) The California Governor, acting as Commander-in-chief of the State National Guard

16. The up-front portion of the FHA Mortgage Insurance Premium is charged on the following types of properties.
   (a) Single-family residences only
   (b) Single-family residences and Planned Unit Developments only
   (c) all types of properties
   (d) Condominiums only

17. A Korean veteran wants to buy a home using his GI bill, but cannot meet the income requirements. The vet's father is not currently in the service, but can qualify financially. Solution:
   (a) Take title as tenants in common
   (b) Father can co-sign for the son
   (c) Request waiver if the father himself is a vet
   (d) None of the above

18. The maximum loan available for a single-family dwelling under FHA Title II, Section 203(b) is:
   (a) $ 90,000
   (b) $101,250
   (c) $239,250
   (d) none of the above

19. You purchase a house to be used as your principal residence for $100,000, and incurred closing costs of $1,500. Under FHA 203(b), the maximum loan that you can obtain, ignoring MIP, is for:
   (a) $97,750
   (b) $96,925
   (c) $98,500
   (d) None of these

20. Cal-Vet financing:
   (a) requires no down payment
   (b) provides for prepayment penalties
   (c) allows the veteran to buy for a relative
   (d) uses a mortgage as security for the loan
TYPES OF GOVERNMENT PROGRAMS

- FEDERAL HOUSING ADMINISTRATION (FHA)
- U.S. DEPARTMENT OF VETERANS AFFAIRS (DVA)
- CALIFORNIA DEPARTMENT OF VETERANS AFFAIRS (CAL-VET)
SOME ADVANTAGES OF AN FHA LOAN

1. LOW DOWN PAYMENT
2. COMPETITIVE INTEREST RATE
3. LESS RESTRICTIVE CREDIT STANDARDS
4. LESS RESTRICTIVE ON LOCATION OF PROPERTY
5. BUYER QUALIFICATIONS
6. PREPAYMENT PRIVILEGES
7. ASSUMPTION PRIVILEGES
8. MINIMUM PROPERTY STANDARDS
SOME ADVANTAGES OF A VA LOAN

- NO DOWN PAYMENT
- LOW INTEREST RATE
- PROPERTY RESTRICTIONS
- III LOCATIONS
- QUALIFICATION
- NO PREPAYMENT PENALTY

- ASSUMPTION OF LOANS
- APPRAISAL (C. R.V.)
HOW DO POINTS AND DISCOUNTS OPERATE IN THE SECONDARY MARKET?

PREVIEW:
Points and discounts is a relatively complicated subject, but understanding them will help licensees to explain to buyers and sellers the importance of points and discounts in the financing process. Few transactions involving third party loans would ever be consummated without the use of discounts. Here we explain their application to FHA, DVA, Conventional and Junior loans. Throughout this lesson bear in mind that the secondary markets have become the primary source of funding for residential housing of from 1 to 4 units.

PERFORMANCE OBJECTIVES:
After completing this lesson, you should be able to:

1. Differentiate between "points" and "discounts".
2. Describe the relationship of "price" and "yield".
3. Illustrate the use of points for government, conventional and junior loans.
4. Define the term "secondary mortgage markets".
5. Describe how the big three Government Sponsored Enterprises, Fannie Mae, Freddie Mac, and Ginnie Mae function in the secondary market.
6. Describe the role of investment bankers in the secondary market.

I. WHAT ARE POINTS AND DISCOUNT POINTS?

A. Loan fee. Assume that you as a broker have just written an offer for a client to purchase a home for $100,000, subject to buyer's ability to obtain a DVA loan for $100,000. Before the transaction is accepted, the sellers will naturally want to know the cost of such loan to them, the points or fee to obtain the DVA-guaranteed loan.

B. Inter-relationship of the terms. The terms points and discounts are used interchangeably. A point represents one percentage (1%) of the loan amount. With a $100,000 loan, one point will equal $1,000, which is 1% x $100,000. The term discount is the dollar amount of the loan fee that
is deducted, or discounted, from the proceeds paid to the seller at the close of escrow.

C. Equivalency. Suppose you called a lender for a DVA (or any other type of loan) commitment and the lender quoted two points.

1. Example. A $100,000 DVA-guaranteed loan is quoted at two points. The point charge, or discount, is $2,000:

| Loan amount | $100,000 |
| Less: discount of 2 points | x .02 |
| Discount | $ 2,000 |
| Money disbursed: $100,000 less $2,000 = | $ 98,000 |

II. WHY ARE POINTS USED?

Lenders use discounts to increase their actual or effective return, also called yield.

A. Example without point charge. Assume you borrowed $100,000 for one year at 10% interest. At the end of the year, you would pay back the $100,000, plus $10,000 interest. The lender's effective yield is equivalent to the quoted interest rate of 10%, computed as follows:

\[
\text{Interest} / \text{Disbursement} = \text{Yield} \\
\frac{10,000}{100,000} = 10\%
\]

The effective interest rate here is the same as the stated or nominal rate.

B. Example with point charge. Suppose the lender in the above example charged two points. The effect would be the same as discounting the loan for 2%. This would be 2% x $100,000, or $2,000. The borrower would receive only $98,000 ($100,000 - $2,000). The effective interest rate will be 12.24%, calculated as follows:

\[
\frac{\text{(Interest} + \text{Discount})}{\text{Disbursement}} = \text{Yield} \\
\frac{10,000 + 2,000}{98,000} = 12.24\%
\]

C. Simplifying computations. To determine effective interest rates for loans in which discount points have been paid, lenders use tables such as those shown below. To calculate true yield, one needs to know: stated interest rate, point charge, loan term, and exactly when the loan is repaid in advance of its maturity. This chart is for a 9% loan, but tables are available for any interest rate desired.
Determining Effective Rate of Interest at Various Discounts

<table>
<thead>
<tr>
<th>Discount Points</th>
<th>10 years</th>
<th>Prepaid in 12 years</th>
<th>Prepaid in 20 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.0</td>
<td>9.16</td>
<td>9.14</td>
<td>9.12</td>
</tr>
<tr>
<td>1.5</td>
<td>9.24</td>
<td>9.22</td>
<td>9.18</td>
</tr>
<tr>
<td>2.0</td>
<td>9.32</td>
<td>9.29</td>
<td>9.24</td>
</tr>
<tr>
<td>2.5</td>
<td>9.40</td>
<td>9.36</td>
<td>9.30</td>
</tr>
<tr>
<td>3.0</td>
<td>9.48</td>
<td>9.44</td>
<td>9.36</td>
</tr>
<tr>
<td>3.5</td>
<td>9.57</td>
<td>9.51</td>
<td>9.42</td>
</tr>
<tr>
<td>4.0</td>
<td>9.65</td>
<td>9.59</td>
<td>9.49</td>
</tr>
<tr>
<td>4.5</td>
<td>9.73</td>
<td>9.67</td>
<td>9.55</td>
</tr>
<tr>
<td>5.0</td>
<td>9.82</td>
<td>9.74</td>
<td>9.61</td>
</tr>
<tr>
<td>5.5</td>
<td>9.90</td>
<td>9.82</td>
<td>9.68</td>
</tr>
<tr>
<td>6.0</td>
<td>9.99</td>
<td>9.90</td>
<td>9.74</td>
</tr>
</tbody>
</table>

Notice that the higher the number of points, the greater the effective yield to the lender. For example, the chart shows that a 9% loan with a discount of 3 points and prepaid in 10 years yields an effective return of 9.48%. If the discount was 4 points, the effective rate would be 9.65%.

Note also that the yield decreases as the prepayment term extends. For example, the effective rate of interest for a 30-year, 9% loan at 3 points prepaid in 10 years is 9.48%. But if that same loan was not prepaid until the 20th year, the chart shows that the effective return is reduced to 9.36% (a difference of twelve basis points).

To test your understanding of points and prepayments, answer the following: What is the effective rate for a 30 year loan discounted 2 points and prepaid in 12 years?

[Answer. 9.29%]

III. PRICE and YIELD

When real estate licensees deal with lenders, they use the terms "points" and "discounts". But when lenders sell loans to other lenders or to investors, they use the terms "price" and "yield".

Price is another way of quoting the discount. A lender selling a loan at a 5-point discount would quote a price of 95. This is another way of saying that it will sell the loan for 95% of the face amount of the loan. A $100,000 loan would sell for $95,000 at 95; that is, 5% x 100,000, or $5,000, represents the discount from the face amount of the note (par).
Price and discount added together always equal 100. To
determine price, simply subtract the discount from 100.
If a lender granted a loan at zero points, the discount
would be zero and the price would be 100.

Example 1, Computing Price.
Assume a loan commands a discount of 3 points. What is the
price?

| Par (face) | 100 |
| Less: Discount | 3 |
| Price | 97 |

To determine the discount, the process is reversed. One
would simply deduct the price from 100.

Example 2, Computing Discount.
Assume a loan is sold at 97. What is the discount?

| Par | 100 |
| Price | 97 |
| Discount | 3 |

If the price is known, it is relatively easy to determine
the effective interest rate, which lenders call yield. When
a loan is sold without a discount, at par, the interest rate
on the loan and the yield are the same as the interest rate
stated in the note. To determine the yields at various rates
one can use tables such as the one reproduced below.

<table>
<thead>
<tr>
<th></th>
<th>8.5% Interest Rate</th>
<th>30 Year Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>Prepaid in</td>
<td></td>
</tr>
<tr>
<td>95.0</td>
<td>10 years</td>
<td>12 years</td>
</tr>
<tr>
<td>95.5</td>
<td>9.30</td>
<td>9.23</td>
</tr>
<tr>
<td>96.0</td>
<td>9.22</td>
<td>9.15</td>
</tr>
<tr>
<td>96.5</td>
<td>9.14</td>
<td>9.08</td>
</tr>
<tr>
<td>97.0</td>
<td>9.06</td>
<td>9.00</td>
</tr>
<tr>
<td>97.5</td>
<td>8.98</td>
<td>8.93</td>
</tr>
<tr>
<td>98.0</td>
<td>8.89</td>
<td>8.86</td>
</tr>
<tr>
<td>98.5</td>
<td>8.81</td>
<td>8.78</td>
</tr>
<tr>
<td>99.0</td>
<td>8.74</td>
<td>8.71</td>
</tr>
<tr>
<td>99.5</td>
<td>8.66</td>
<td>8.64</td>
</tr>
<tr>
<td>100.0</td>
<td>8.58</td>
<td>8.57</td>
</tr>
<tr>
<td></td>
<td>8.50</td>
<td>8.50</td>
</tr>
</tbody>
</table>

Example. At a price of 97, based on an 81/2% loan that will
be paid off in 12 years, the table shows a yield of 8.93%.
Investors who purchase loans are said to be investing in the
"secondary market". Published tables show the maximum price
they may pay in order to achieve a desired yield. They do
this to compare mortgage loans with other forms of
investments, such as corporate bonds, in order to make
better informed decisions as to where their investment dollars will go.

IV. HOW AND WHEN ARE DISCOUNTS USED?

A. FHA and DVA Loans

At one time FHA and DVA interest rates were set by the governmental agencies involved, namely, the Federal Housing Administration and the U.S. Department of Veterans Affairs. Today rates are negotiated directly between lender and borrower. Thus lenders may charge more than the rates that used to be set by the FHA and DVA.

Not all lenders make FHA and DVA loans. Conventional lenders could be persuaded to make DVA loans at lower rates than conventional loans if a higher yield could be obtained. For example, a yield can be increased from 8 1/2% to 9% by charging a discount. Without the aid of discount tables, a rule of thumb lenders use for effectively increasing FHA and DVA rates is to charge one discount point for each 1/8% increase in yield. Hence, to increase a yield from 8 1/2% to 9% would entail a charge of 4 discount points - that is, 9% less 8 1/2% = 1/2%, or 4/8, which equates to 4 points.

B. Conventional Loans

Discounts are also used to adjust yields on conventional loans.

1. Example. Assume a lender quotes a 9% rate, but the borrower insists on paying no more than 8 3/4%. The difference of 1/4% can be made up by the payment of a discount. Using the same rule of thumb as is used for government-backed loans: one point = 1/8 yield, hence the discount would amount to 2 points. The lender's yield would be effectively increased by 1/4% to 9%.

C. Junior Loans

Junior mortgages are bought and sold by investors in the secondary market much the same as senior mortgages.

1. Example. The seller of a house agrees to carry back a second trust deed. After the sale, he wishes to sell this so-called purchase money trust deed in order to raise cash. This usually entails the sale at a discount. Discounts on junior loans vary widely, based upon a wide variety of factors. As the risk increases, so will the discount, resulting in a higher yield to the investor (or purchaser) of the junior loan. Stated differently, the lower the discount which a junior loan commands, the lower the yield.
Yields at various discounts are readily determined by published tables such as the one reproduced below.

### Yields at Various Discounts

<table>
<thead>
<tr>
<th>Yield</th>
<th>Discount Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>0.0</td>
</tr>
<tr>
<td>12%</td>
<td>7.1</td>
</tr>
<tr>
<td>14%</td>
<td>13.6</td>
</tr>
<tr>
<td>16%</td>
<td>19.5</td>
</tr>
<tr>
<td>18%</td>
<td>25.0</td>
</tr>
<tr>
<td>20%</td>
<td>29.9</td>
</tr>
<tr>
<td>22%</td>
<td>34.5</td>
</tr>
</tbody>
</table>

The payoff rate is expressed as percentage, calculated by dividing monthly payment by the original principal balance.

**Example.** You borrow $100,000 for 7 years, payable $1,000 monthly including interest at 11% per annum. What is the payoff rate?

**Solution:** $1,000 payment / $100,000 loan = 1%

1. **Use.** The table furnishes yields and discounts for trust deeds at 10% interest rate, where the entire remaining balance is due in five years. The rate of monthly payoff strongly influences the amount of discount. For example, where an investor requires a 16% yield, the table shows that the note would need to be discounted by 19.5% where the note is paid off at the rate of 1% per month. Where faster payoff is made, the discount drops. For instance, the same investor could buy a note where the rate of payoff is at 2% and still obtain the same 16% yield by purchasing the note at a 13.4% discount. Stated differently, the investor would be buying the note for 86.6% of its remaining value [100% - 13.4%].

2. **Problem.** If a 10% second note due in 5 years has a balance of $10,000 and monthly payments of $200, for how much would the note be discounted to yield 20%?

**Solution:**

\[
\text{Monthly payment} / \text{Principal balance} = \text{Pay-off rate}
\]

\[
\frac{200}{10,000} = 2\%
\]

To achieve a 20% yield, the last column in the table shows that a discount rate of 20.9% will be required. The **amount** of discount is 20.9% x $10,000, or $2,090. Now you can readily determine the price that you could pay for the note to achieve a 20% yield:
Principal Balance - Discount = Purchase price

\[
\begin{align*}
10,000 - 2,090 &= 7,910
\end{align*}
\]

V. WHAT IS A SECONDARY MORTGAGE MARKET?

A. Existing loans. The secondary market is a market for the sale and purchase of existing trust deeds and mortgages. It does NOT mean second (or junior) mortgages.

B. Contrast to primary market. When a lender makes a loan directly to a borrower, the action takes place in the primary market, regardless of whether it is a first, or prime loan, or whether the loan is secured by a junior mortgage or trust deed. The loan may be subsequently sold to investors. Today, once loans are closed, they are sold off in the Secondary Market, regardless of what financial entity originated the loans.

C. Parties. The secondary market consists of lenders, investors, and government agencies which buy and sell mortgages to each other. In this market, discounts are constantly used to adjust yields.

VI. WHAT ARE THE FUNCTIONS OF THE SECONDARY MARKET?

A. Flow of Money

One of the main purposes of the secondary market is to have money flow to areas where it is needed. Lenders short of capital often sell mortgages as a means of raising cash. Lenders with a surplus of capital, on the other hand, purchase existing loans in order to put their idle money to productive use.

B. Stabilize the Money Market

The money market is dynamic, never static. It has cycles of "tight money" and "loose money". The secondary market helps to stabilize these cycles by providing funds during tight money situations and offering loans for sale during times of loose money.

VII. WHO ARE THE CHIEF PLAYERS IN THE SECONDARY MARKET?

The principal organizations involved in the stabilization of mortgage markets are what are technically called Government Sponsored Enterprises, or GSEs:

\{Show T 7 7\}

Fannie Mae, formerly known as the Federal National Mortgage Association or FNMA.

Freddie Mac, formerly known as the Federal Home Loan Mortgage Corporation or FHLMC.

Ginnie Mae), otherwise known as the Government National
A. What is Fannie Mae?

Fannie Mae was established by Congress in 1938 to provide a secondary market for the purchase of existing FHA loans. It is very instrumental in providing mortgages for specialized needs, for example, in allocating $150 billion from 1994-2000 for low- and median income minorities and immigrants. Today, Fannie purchases DVA loans as well as conforming conventional loans.

1. Sources of Money
Where does Fannie Mae obtain capital with which to buy mortgages?

a. Borrowing. This is done in the capital markets by selling short-term notes and debentures. Debentures are medium to long-term unsecured debts. Due to the indirect backing of the U.S. Government, Fannie Mae is usually able to obtain a more favorable interest rate than other corporate borrowers.

b. Government assistance. The Secretary of the Treasury is authorized to purchase substantial amounts of Fannie Mae securities, a valuable assist to boost Fannie Mae's credit standing. There have been legislative efforts attempting to sever this relationship, allowing Freddie Mac and Fannie Mae to stand on their own financial foundations.

c. Stock. Since Fannie Mae is a private corporation whose stock is listed on the New York Stock Exchange, it can issue and sell its own securities.

2. What types of loans can Fannie Mae buy and sell?

a. FHA and DVA loans.

b. Conforming conventional loans. These may be for 1-4 family residential dwellings as well as condominiums and planned unit developments.

3. What are the loan limits? Fannie purchases existing loans subject to maximum amounts that are adjusted each January, indexed to the average national house price as reported by the Federal Housing Finance Board. The following prevailed on January 1, 2002:

<table>
<thead>
<tr>
<th>Number of Units</th>
<th>Maximum Loan Purchase</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$300,700</td>
</tr>
<tr>
<td>2</td>
<td>$384,900</td>
</tr>
<tr>
<td>3</td>
<td>$465,200</td>
</tr>
<tr>
<td>4</td>
<td>$578,150</td>
</tr>
</tbody>
</table>
a. These limits are 50% higher in Hawaii, Alaska, Guam, and the U.S. Virgin Islands.

b. These maximums are to insure that they can be sold in bulk in the securities market.

c. These loan limits can be exceeded. They are referred to as Jumbo or Non Conforming loans and may be kept in the lender's portfolio or sold to some specific investor. Interest rates, in the case of jumbo loans, may exceed as much as 1/2% percentage point or more over that of conforming interest rates. Underwriting guidelines may mirror those of Fannie Mae and Freddie Mac specifications, or they can instead be more liberal or conservative.

d. The conforming loan limits have increased in 2002 almost 9.5% over last year's 2001 loan ceiling.

B. What is Freddie Mac?

*Freddie Mac* was organized in 1970 by the Emergency Home Finance Act specifically to provide a secondary market for savings and loan associations. *Freddie Mac* as well as *Fannie Mae* fall under HUD oversight.

*Freddie Mac*, as this organization is now officially known, may buy loans from savings and loan associations that are supervised by OTS and from institutions where deposits are insured by an agency of the federal government as well as *Freddie Mac*-approved lenders, such as mortgage bankers.

1. Types of Loans

*Freddie Mac* may buy FHA, DVA, and conforming conventional loans secured by single-family homes, condominiums, planned unit developments, and FHA multifamily projects.

2. Loan limits

*Freddie Mac* buys loans subject to the maximum amounts that *Fannie Mae* buys. In this respect the two agencies move in tandem. Reference Page 8 for the loan limits as of 1/1/2002.
C. Government National Mortgage Association

Nicknamed Ginnie Mae, this is a wholly-owned corporation of the U.S. Government. It operates under the supervision of the Department of Housing and Urban Development (HUD). It was created in 1968, when Fannie Mae converted to a private corporation. At that time, Fannie Mae was relieved of its duties and transferred to Ginnie Mae. Its duties are:

1. To manage and liquidate mortgages previously acquired by the U.S. Government.

2. To develop mortgage-backed security programs (called "special assistance functions").

3. Through the Mortgage-Backed Securities program:
   a. DVA-guaranteed and FHA-insured loans are securitized in pools of loans, totaling $2,000,000 or more.
   b. These pools are sold in undivided share form to individual investors.
   c. Ginnie Mae guarantees the time payments of both principal and interest by the securities issuers to the securities purchasers.

4. To provide incentives for new money to flow into the housing market. Ginnie does this through mortgage-backed securities. Through such securities it is able to attract pension funds into the mortgage market, since pension funds had until recently invested very little in mortgages, despite very substantial assets. Ginnie had traditionally placed their funds primarily into stocks and bonds, because these types of investments were easier to purchase and monitor.

The mortgage-backed security was structured to make investing in mortgages as simple as buying stocks and bonds. Under the program, an investor purchases a pool of mortgages and receives a certificate evidencing ownership, eliminating the need to examine and approve each mortgage separately.
a. What are the benefits of Ginnie Mae securities?
   i. Purchasers invest in mortgages without time-consuming paper work. Since there is no need to review each mortgage, there is no need for highly-trained staffs.
   
   ii. The security is guaranteed by the U.S. Government, including the periodic payment of principal and interest.
   
   iii. Ginnie Mae securities are liquid investments, traded just like stocks and bonds. An active market for these securities exists through organized exchanges on Wall Street and other financial centers, making them readily salable.

D. Other market players. Fannie and Freddie comprise 50-60% of the 1-4 family mortgage loans purchased each year. The following are examples of others comprising this vast and active market:

   1. Savings institutions
   2. Insurance companies
   3. Pension and retirement funds

VIII. WHAT ARE SOME OF THE ACCOMPLISHMENTS OF SECONDARY MARKETS?

{Show T 711}

A. New Sources of Funds
   Secondary markets largely alleviate problems of disintermediation by providing access to sources of money other than depository accounts.

B. Provide Funds During Periods of "Tight Money"
   The combined actions of just the three principal players pump billions of dollars into the mortgage market to help stabilize the supply of funds needed for new construction and the purchase of existing housing.

C. Increase Flow of Money
   The use of Ginnie Mae securities makes it easier for money to flow from area to area. Savings and loan associations with a lot of cash to invest in mortgages purchase securities from lenders in other parts of the country that are strapped for cash. It is simpler to purchase securities than to buy individual loans.
D. Standardization of Forms
A major accomplishment brought about by Fannie Mae and Freddie Mac has been the standardization of conforming conventional loan forms. FHA and DVA loans have been readily sold in the secondary market for years, due to the standardization of the loan application and appraisal forms. Investors in any part of the country can rely on uniform loan provisions, regardless of originator. FHA and DVA have taken steps to bring their forms into compliance with those of Freddie Mac and Fannie Mae.

E. Awareness of Environmental Hazards
Under the Comprehensive Environmental Response, Compensation and Liability Act, Freddie Mac and Fannie Mae may be liable for the recovery of clean-up costs on properties contaminated with hazardous wastes. Hence these agencies require lenders to disclose the presence of hazards to loan applicants, and requires borrowers to safely store hazardous wastes.

IX. WHAT IS THE IMPACT OF THE SECONDARY MARKET ON PRIVATE MORTGAGE INSURERS?
Both the mortgage industry and regulators are increasing their emphasis on loans for low- to moderate-income families for purchase of modest housing. Private mortgage insurers are assisting in this effort through a variety of programs, including the "97% Loan".

Example:

GE Capital Mortgage Insurance Corporation offers a plan called "Community Home Buyer's Program", in which it insures loans with as little as 3% down payment. It is aimed toward low- and moderate-income borrowers. To qualify, applicants must complete a pre-purchase home buyer education course, because experience demonstrates that educated buyers are better prepared for home ownership and present lower risk of default.

Fannie Mae has agreed to purchase these 97% loans, provided that these loans conform to Fannie's guideline that applicants' income not exceed 100% of an area's median income. (It may be of interest to those with securities backgrounds to know that one of the nation's largest securities dealers, Goldman Sachs, agreed to jointly purchase with GE Capital loans of up to 115% of an area's median income.)
LESSON SEVEN MULTIPLE-CHOICE QUESTIONS

Directions: Underline the letter representing the correct answer.

1. You buy a home for $150,000 with one-third down payment, and obtain a conventional loan for the balance for 30 years at 9%, all due and payable in 10 years. The loan calls for a discount of two points. The effective loan to you, the borrower, is:
   (a) $100,000
   (b) $98,000
   (c) $97,000
   (d) $102,000

2. FHA interest rates are set by:
   (a) the lender
   (b) the FHA
   (c) agreement between borrower and lender
   (d) the DVA

3. A lender selling a loan at a six-point discount would quote a price of:
   (a) 94
   (b) 100
   (c) 106
   (d) none of the above

4. Your client applies for an FHA loan that carries a nominal interest rate of 8.5%. If the lender wishes to increase the yield to 9.5%, a commonly used rule of thumb used by lenders generally would require the payment of how many points?
   (a) 4
   (b) 6
   (c) 8
   (d) 10

5. Accomplishments of the secondary mortgage market include all but one of the following
   (a) Providing funds during periods of tight money
   (b) Offering uniform loan provisions
   (c) Disclosing presence of hazardous wastes to loan applicants
   (d) Making below-market loans to home buyers

6. A home is listed for $125,000 and sells for $120,000. Buyer applies for a $100,000 loan. The lender quotes three points to make a commitment. Assuming no other costs, proceeds to be disbursed will amount to:
   (a) $121,500
   (b) $116,400
   (c) $97,000
   (d) none of the above
7. The amount of principal to be repaid in the previous transaction, as shown on the promissory note, is:
   (a) $100,000  
   (b) $120,000  
   (c) $125,000  
   (d) none of the above

8. Interest rates on government-backed loans are usually conventional rates:
   (a) more than  
   (b) less than  
   (c) the same as  
   (d) none of the foregoing, since government rates fluctuate according to market conditions.

9. The following agency is significantly involved in the secondary mortgage market:
   (a) Federal Reserve Board  
   (b) Federal Housing Administration  
   (c) California Savings and Loan League  
   (d) Federal Home Loan Mortgage Corporation

10. Medium to long-term unsecured debts of a corporation are evidenced by the issuance of:
    (a) debentures  
    (b) bonds  
    (c) mortgages  
    (d) trust deeds

11. Secondary market dealers pay close attention to the yields on loans that they buy and sell because:
    (a) they must compare yields with those of competing investments  
    (b) the maximum discount allowable is 10%  
    (c) yields are always based on 30 year payoffs  
    (d) yields are more meaningful than discounts paid

12. In discussing real estate loans, the term points:
    (a) is used interchangeable with the term discounts  
    (b) is based on a property's sales price  
    (c) measures the loan's rate of interest  
    (d) has little if any relationship to yields

13. Investors deal in the secondary mortgage market in order to:
    (a) borrow money  
    (b) buy and sell existing trust deeds  
    (c) buy and sell existing trust deeds  
    (d) lend money
15. Freddie Mac purchases:
   (a) DVA and FHA loans only
   (b) FHA and conventional loans only
   (c) DVA and conventional loans only
   (d) Conventional, DVA, and FHA loans

16. Which of the following agencies is wholly owned by the U.S. Government?
   (a) Fannie Mae
   (b) Ginnie Mae
   (c) Freddie Mac
   (d) PMI

17. The secondary mortgage market is designed to:
   (a) provide a significant source of funds
   (b) increase the flow of money
   (c) provide funds when money is tight
   (d) accomplish each of the above

18. Mortgage money is shifted from areas that have surplus funds to areas short of funds by:
   (a) buying and selling existing mortgages in the secondary market
   (b) creating new mortgage funds in capital-surplus areas
   (c) creating new junior mortgages
   (d) each of the above activities

19. The secondary mortgage market is affected most of all by the activities of
   (a) FHA
   (b) Freddie Mac
   (c) FRB
   (d) DVA

20. An important source of capital for Fannie Mae originates from:
   (a) the sale of stock on the major exchanges
   (b) borrowing in the short-term money markets
   (c) borrowing from the U.S. Treasury
   (d) issuing bonds guaranteed by the government
PRINCIPAL ORGANIZATIONS INVOLVED IN THE STABILIZATION OF MORTGAGE MARKETS

1. Formerly FEDERAL NATIONAL MORTGAGE ASSOCIATION

\[ f\text{ANNe MAC} \]

2. Formerly FEDERAL HOME LOAN MORTGAGE CORPORATION

\[ f\text{P6PRO MAC} \]

3. GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

\[ O\text{NO MAC} \]
ACCOMPLISHMENTS OF SECONDARY MARKET SOURCES

- NEW SOURCES OF FUNDS
- PROVIDE FUNDS DURING TIGHT MONEY MARKETS
- INCREASE FLOW OF MONEY
- STANDARDIZATION OF FORMS
LESSON EIGHT

WHAT ROLE DOES QUALIFYING THE PROPERTY PLAY IN LOAN UNDERWRITING?

PREVIEW:
The loan underwriting process consists of two parts, the property and the borrower. In this lesson we explore the first part. In Lesson Nine we examine the borrower. Before a lender decides to make a loan, the lender must consider the collateral for the loan, the property itself. In this lesson we discuss what is meant by qualifying a property for a loan, marketability of properties, various standards which lenders apply to properties, and how to work with appraisers.

PERFORMANCE OBJECTIVES:
After completing this lesson, you should be able to:

1. Describe what is meant by "qualifying the property" for a loan.
2. Describe how properties are appraised under three separate approaches to value.
3. Give an example of how Fannie Mae and Freddie Mac influence property standards.
4. Define "marketability" of a property.
5. Determine how the savings & loan bailout bill impacts upon the real estate financing process.
6. List the ways in which licensees can assist appraisers.

I. WHAT IS MEANT BY "QUALIFYING THE PROPERTY"?

The first question a lender must consider is: "Do we want to make a loan on this property?" If the answer is yes, the next step requires an appraisal of the property in order to determine its market value.

Following the appraisal, the lender must decide what loan-to-value ratio to apply. Will it be 75%? 80%? Or perhaps 90% and even more? These and other questions must be properly answered in the underwriting process referred to as "qualifying the property".
II. HOW ARE PROPERTIES QUALIFIED?

What is the process lenders follow in qualifying properties for a loan?

A. Appraisal. A valuation of the property is made. This is accomplished by a fee or staff appraiser. Staff appraisers, full-time employees of FHA, are used to review appraisals in-house, rather than in the field. Staff appraisers are also employed by such sources as commercial banks and savings and loan associations, performing appraisal work or auditing the work of others. Fee appraisers are independent contractors who work with lenders and for the public. They charge predetermined fees for each job.

B. Review. After the appraisal is made, the completed forms are subject to review and approval by a staff appraiser. FHA now allows approved lenders to select appraisers. Formerly, the selection was in the hands of FHA. FHA audit of the appraisal, as a part of the loan package, is subject to review when the MIP approval is issued. The FHA appraisal, or Conditional Commitment,1 may include conditions and repairs that must be accomplished before the final commitment is issued.

C. Approval of appraisal. The DVA operates in much the same way, except that it still maintains an approved appraisal panel that the lender must select from. The DVA appraisal is referred to as a Certificate of Reasonable Value or CRV. The CRV may include conditions and repairs which the DVA may require on the structure as a condition for a loan guarantee.

III. CONVENTIONAL LENDERS.

A. What are the Steps in the Qualifying Process?

1. Preliminary information. The qualifying process typically begins by the borrower or salesperson calling upon a prospective lender. Applicants are referred to a loan officer who obtains information on location, age of the structure, number of bedrooms and bathrooms, and other property data.

2. Acceptable valuation. Conventional lenders utilize both staff and fee appraisers. The lender must make certain that the appraisal is high enough to grant the loan being
sought. The loan cannot exceed statutory limits. If the property is acceptable and the value sufficiently high to meet the requested loan amount, the lender will continue processing the loan by going through the next underwriting phase, qualifying the buyer/borrower.

3. Loan review and approval. Lenders use underwriters, staff and approved fee appraisers as well as committees who review and approve submitted appraisals,
4. In accordance with regulatory requirements, most institutional lenders are required to pre-approve fee appraisers which constitutes their appraisal panel. This process is normally approved by the Board of Directors upon recommendation from management.

IV. WHAT IS THE RELATIONSHIP BETWEEN MARKET VALUE, MARKETABILITY, AND SALES PRICE?

A. Market value. This is generally defined according the Fannie Mae wording that is intended to reflect adjustments for any special or creative financing, as follows:

"The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus". The language goes on and on, but the bottom line is that market value represents the price at which sellers are willing to sell, and buyers willing to buy.

B. Marketability of property. Marketability is closely correlated to value, but not in all cases. It may be defined as acceptance of a given property by potential buyers.

Example. A one-bedroom house may be highly valued, but have limited market appeal, therefore its marketability is said to be low. This would likely reduce its real value, unless a second bedroom can be added at a cost that is economically justified.

C. Market Value vs Sale Price. Sales price and market value are not necessarily synonymous. An example will help to illustrate the difference.

Example. A couple purchases a home for $180,000 and apply for a first trust deed loan. The house is located in a new suburban subdivision. The appraiser is able to find a number of comparable sales and arrive at a fair market value of only $144,000. Why such a large (20%) discrepancy between the sales price and valuation? The answer becomes apparent when it is discovered that the buyer has just moved into the area and is not aware of values. He is not a well-informed, knowledgeable buyer.

Incidentally, the definition of market value for many years included fully-informed buyer until Fannie Mae changed it to well-informed. After all, who is ever really fully informed about everything concerning a given property, including the most expert appraiser? Recall from R.E. Principles that an appraisal is only as good as the experience, skill and knowledge of the appraiser.
V. PROPERTY STANDARDS

A. Policies. In setting up company policy, lenders look especially close at:
   1. Age of the property
   2. Area (square footage)
   3. Number of bedrooms and bathrooms
   4. Location
   5. Degree of conformity to surrounding neighborhood

B. Guidelines. Property standards are merely guidelines. Exceptions may occur according to such factors as down payment, financial strength of buyers, availability of funds, competition, previous borrower relationships with the lender, and changing market conditions.

C. Influence of Fannie Mae and Freddie Mac. Both Fannie Mae and Freddie Mac strongly influence property standards on the part of conventional lenders. This is because lenders who sell loans to either of these agencies must conform their property standards to these two Secondary Market purchasers of originated conforming conventional loans as well as DVA and FHA loan originations.

D. Influence of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA). In 1989, Title XI of FIRREA was enacted by Congress, mandating all states to license real estate appraisers who appraise real property in federally related transactions. All federally-insured lenders must comply or be subject to stiff penalties. All 50 states must conform to the federal standards, developing training and licensing requirements that meet minimum requirements.

1. In response to the federal mandate, the Real Estate Appraiser's Licensing and Certification Law was passed by the California Legislature in 1990 (AB 527, Chapter 491 of 1990). The law charged the Office of Real Estate Appraisers (OREA) with licensing real estate appraisers in the State of California and enforcing national ethical and professional standards and qualifications that comply with the mandate.

2. The mission of the OREA, a division of the Business, Transportation and Housing Agency in Sacramento, is to protect public safety by ensuring the competency and integrity of licensed real estate appraisers.

3. OREA consists of two primary program components, which are Licensing and Enforcement. The latter investigates complaints and ensures that licensees adhere to all applicable laws and regulations.

4. Four levels of OREA licensing are in effect in California.
   a. Trainee. The category of licensing allows the appraiser to appraise any property which the
supervising appraiser is permitted to appraise.

b. Residential. An appraiser so licensed is permitted to appraise any non-complex 1-4 family property with a transaction value up to $1 million; and non-residential property with a transaction value up to $250,000.

c. Certified Residential. An appraiser with this category of licensing is allowed to appraise any 104 family property without regard to transaction value or complexity; and non-residential property with a transaction value up to $250,000.

d. Certified Residential. This category of licensing allows the appraiser to appraise all real estate without regard to transaction value or complexity.

E. Federal Housing Administration (FHA) and the Department of Veterans Affairs (DVA). If a property meets the minimum standards imposed by the FHA or DVA, it will qualify for the maximum loan amount permitted by law, in the case of FHA loans; or by prudent lending practices in the case of DVA loans.

VI. Appraising a Property.

Accurate appraisal reports are vital because lenders rely on them to determine acceptability of a property for loans.

A. Location. Where a property is located has a major influence on its value and marketability. What are some of the factors viewed by appraisers and lenders assessing location?

1. City. Why is city location important? A developer built a subdivision partly located in a city that had an outstanding reputation, and partly in a city considered average. In walking around the subdivision, one could not tell that the houses were actually located in two different cities. Yet the sales results differed dramatically. Houses located in the city with the better reputation sold quickly, while those in the adjacent city did not. The only difference was the address - the city and the school district. The developer increased the prices of the homes with the prestige address. These continued to outsell the others because buyers were willing to pay more for a good address. The same houses on the same street sold for different prices for only one reason: status.

2. Neighborhood. What does an appraiser look for when checking a neighborhood?

a. Approach to the Property. Is the drive to the property through a pleasant neighborhood, or is it through a run-
down area?
b. Appeal. Does the neighborhood have sales appeal? Is it attractive? Does it have tree-lined streets? Is it laid out in a drab grid pattern, or does it have winding streets with cul-de-sacs?

c. Homogeneity. Homogeneous neighborhoods are considered more desirable by most buyers and lenders than are heterogeneous neighborhoods. Most people want to live next to people with similar tastes, backgrounds, and interests. If you live in a $250,000 house, you don't want to be surrounded by $100,000 houses. Economists refer to this as the principle of conformity.

d. Maintenance. Houses in well-maintained neighborhoods have greater value and marketability.

e. Trends. Is the neighborhood improving, stable, or declining? Some neighborhoods are in a state of transition where single dwellings are being replaced by apartments, inevitably affecting the desirability of the neighborhood.

f. Adverse Influence. Airport flight patterns, slide and flood areas, inclement climate, obnoxious odors, and other adverse influences reduce property values.

g. Schools and shopping. Buyers with young children are interested in the quality of schools in the neighborhood, including distance from the property. Proximity to shopping facilities is also important.

h. Miscellaneous. Other factors considered by appraisers and lenders include the amount or percentage of neighborhood build-up, demand-supply balance, price range, present and prospective uses.

3. Subject Property. Appraisers examine properties for such things as conformity to the neighborhood, appeal, landscaping, extent of improvements, condition of roof, and so forth.

After measuring or "taping" the exterior of the structure, the appraiser enters the house to complete the inspection, and summarizes the findings in the appropriate sections of the report. Many appraisers make a special effort to view the house as potential buyers might.

B. How Do We Determine Value?

{Show T 8-6}
After inspecting the property, the appraiser determines its value. Three methods are used to help determine reasonable value.

1. What is the Cost Approach?
   a. The principle behind this approach is that buyers will not pay more for a property than what it would cost to replace or reproduce an equally desirable substitute property. Economists refer to this as the principle of substitution.
   b. It should be noted that cost does not equal value.
   c. This approach involves a five step process:
      Step #1: Estimate value of the land (site value)
      Step #2: Estimate cost of replacing the improvements, i.e., dwelling, garage, pool, patio, at current prices (estimated reproduction cost new of improvements)
      Step #3: Determine the amount of depreciation (physical, functional, and external factors) that has accumulated over the years affecting the improvements estimated in Step #2, above.
      Step #4: Determine as is value of any other site improvements, i.e., landscaping, fences, driveways, etc.
      Step #5: Value indicated = a + b - c + d = e

2. What is the Market Data Approach?
   a. Also referred to as the sales comparison method, this approach to value assumes that buyers should not pay more for a property than the price of a comparable substitute property.
   b. Adjusting for price. Real estate salespeople use an abbreviated form of the market data approach in determining the value of houses. They do this by mentally observing what other houses have been selling for in the neighborhood, noting differences in style, quality, size, condition, amenities, and so on. They are constantly comparing differences, adding and deducting for these differences, called "adjustments". The lender's appraiser does essentially the same thing, but more systematically, noting common but significant property variables that sanction price adjustments. Depreciation is not a factor to be calculated as in the cost approach as it is measured directly from the market.
c. Sources. Appraisers and licensees obtain information for comparable sales from:

i. Files in appraiser's own office

ii. Multiple Listing Service (MLS) files

iii. Real estate brokers and salespersons in the area.

iv. Public records, especially the County Assessor and County Recorder

v. Society of Residential Appraisers, a professional organization that publishes quarterly summaries of sales by county.

vi. Real estate lenders that maintain records.

vii Commercial information vendors.

3. What is the Income Approach?

a. Gross Rent Multiplier. The foundation for this method of appraising residences is that a relationship exists between what a property rents for and its value. A relationship is established by means of a gross rent multiplier (GRM). The GRM is arrived at by dividing the sales price of a house by its gross monthly rent. It is by no means an accurate index and is only used in 1-4 family situations. It should not be relied on for 5 or more units. A more sophisticated analysis of income is warranted in this instance.

b. Estimating value. Once the GRM is found for a type of property in a particular area, it can then be used to find the probable sales price of the subject property. The formula for computing value is:

Estimated Value = Monthly Rent x Gross Rent Multiplier

i. Example. Assume a monthly gross rental of $5,000 and a gross rent multiplier of 100. The probable sales price or estimated value (EV) is:

Estimated Value = $5,000 x 100, or $500,000

c. Two to Four-Unit Properties. Duplexes, triplexes, and fourplexes - the "plexes" - are appraised similar to single family dwellings. However, when employing the market data approach, the following is also considered:
ii. Selling price per room. If the fourplex consists of 16 rooms, the price per room is:

\[
\frac{200,000}{16} = \$12,500 \text{ per room}
\]

d. Use of the GRM, whether on a monthly or annual basis, can be very helpful if rental data on similar properties is sufficiently available.

e. There should be less emphasis placed on the GRM as it is a broker-driven rule of thumb to determine value. Net operating income before debt service and depreciation with allowance for vacancies and maintenance is appropriate for apartments of five or more units, office buildings, multi-purpose commercial, industrial, and shopping center properties. Two to four unit residential structures follow the sales or market comparison approach.

C. Correlatiuil vi Market Value

1. Cost. The cost approach has several major weaknesses. An accurate valuation of the land as if it were unimproved is difficult at best. It is also very difficult to estimate depreciation, particularly on older structures. But the cost approach provides a reliable estimate of value for newly-built houses, since little or no adjustment is needed for depreciation. The Cost Approach is the principal approach used to determine the value of improvements in new construction and unique structures, such as public holdings (libraries, museums, etc.).

2. Market. The market data approach is the one appraisers rely on most heavily for single-family dwellings. But there is at least one serious drawback: locating enough comparable homes that have sold in the recent past. Lenders ordinarily rely on sales that are not older than six months, are as comparable to the subject property as possible, and are as near to the subject property as possible. Deviations from these basic criterion may be accepted, subject to an explanation and justification by the appraiser.

3. Income. The use of the income approach to single-family residences is used sparingly, and is done chiefly as a check against the other two approaches to value.

   a. An important drawback is that usually there are not enough rentals of similar homes in the neighborhood to arrive at a valid GRM. In such cases, most appraisers will ignore using it altogether.

4. Judgment. The final determination as to which approach is best depends upon the type of property, and the skilled

   i. Selling price per unit. If the property consists of a fourplex and has sold for $200,000, the selling price is broken down into so much per unit:
judgment of the appraiser. Correlation or reconciliation is not the averaging of the three approaches. An
experienced appraiser, for example, would not rely on the market data approach in appraising apartment buildings, since there would be few if any similar structures in the area that sold, say, within the past year. Rather, the appraiser would place most emphasis on the income approach, unless the building was just constructed. In this instance, the cost approach might be the most valid.

5. In the final analysis, the reconciliation process employed by the appraiser will determine the most relevant approach that most accurately reflects the value that the appraiser is seeking.

VII. CONDOMINIUMS, TOWNHOMES, AND PLANNED (UNIT) DEVELOPMENTS

A. Condominiums and planned developments are not types of structures, but types of ownership. A townhouse, on the other hand, refers to its architectural and structural form, rather than an ownership interest. Typical townhomes include attached or row housing.

B. Definition: A CONDOMINIUM consists of an undivided interest in common in a portion of real property coupled with a separate interest in space called a unit, the boundaries of which are described on a recorded map, parcel map, or condominium plan in sufficient detail to locate all boundaries thereof. The interior of a unit is not only occupied by the owner, but owned in severalty to the exclusion of all others. The owner also receives an undivided interest in the common areas, including hallways, elevators, heating system, roof, grounds, and recreational facilities. In effect, the owner of a condominium unit owns the air space within the cubicle occupied. Beyond the inside walls, common ownership exists.

C. Definition: A PD or PLANNED DEVELOPMENT consists of parcels owned separately and lots or areas in common and reserved for the use of some or all of the individual lot owners. Generally, an owner's association provides management, maintenance, and control of the common areas and has the power to levy assessments and enforce obligations which attach to the individual lots. Unlike condominiums, planned developments involved maximum individual ownership coupled with some common ownership. Typically, an owner in a planned development owns the land and the structure that it is on while an area or other areas outside of his or her property is owned in common with others.

D. A PD could be a group of single-family homes if there is joint ownership of common areas. In a PD, no one resides in the "air space" above or below another. In short, PDs may be either separate units (Single Family Dwellings) or joined townhouse units.
E. Checklist. Lenders appraising condos and PDs are naturally interested in more than just the one unit for which there is a loan request. The total project is important because the value of a single unit is affected by the quality and operation of the entire project. Lenders are also interested in the sales activity surrounding the condo or PD project. When appraising a project, lenders check for the following additional items:

1. General appearance of the project.
2. Recreational facilities: adequate and well maintained?
3. Adequate parking for owners and guests?
4. Maintenance of common areas.
5. Amount of association dues assessed to each unit owner.
6. Provision for reserves for repairs and replacements.

VIII. WHAT ROLES DO ENVIRONMENTAL FACTORS PLAY IN APPRAISING A PROPERTY?

A. Due to an increased awareness of environmental issues that may affect property, a special area of appraisal investigation has emerged, which affects and also protects owners, purchasers, renters, lenders, and builders.

B. Appraisers' Role.

Appraisers are expected to give thought to the effects of environmental factors on the value of a property. These factors may be external to the property in the form of obsolescence such as polluted soil or groundwater from off-site impacting the subject property, or within the property itself, such as lead-based paint, formaldehyde, asbestos or radon gas contamination. If an appraisers suspect contamination of any kind they need to red flag the condition so that the lender may evaluate any risk it may be undertaking by making a loan on the subject property. This is an integral part of the process of qualifying the property.

C. Lenders' Role.

The lender may call for a Phase 1 environmental assessment, which consists primarily of a search of the prior land use records for evidence of potential contamination. If suspicious information is uncovered, the lender may call for a Phase II evaluation, which includes soil and groundwater sampling under controlled conditions.
D. Environmental Assessment.

A lender may reject a loan for no other reason than the environmental condition of the site. It is likely that a property-owner would opt to walk away from a property that has become an environmental liability, leaving the cost of clean-up, which can often exceed the value of the property, to the lender. Such an undertaking should be performed by one who is specially trained in Environmental Assessments.


California has enacted a lead-based paint disclosure requirement that brings the state into compliance with the federal Residential Lead-Based Paint Hazard Reduction Act of 1992, referred to as "Title X". Under that law, all buyers or tenants of a pre-1978 home or housing unit must receive an informational pamphlet and a warning about lead-based paint hazards. Real estate agents, loan agents, buyers and sellers must all be aware of the potential for lead poisoning, especially to children, that may exist in pre-1978 homes, and ensure that the required disclosures are made to all parties. Appraisers will likely be paying more attention to this problem area in all affected homes, estimated to number over 50 million throughout the United States. A HUD study estimates that some 3.8 million are a "priority-hazard" because the homes shelter children and the paint is deteriorating or peeling.

F. Earthquake and flood hazards.

1. Insurance is offered by private companies in concert with the federal government, providing coverage to property owners from negative effects caused by flood or tidal wave conditions.

2. Primary as well as secondary lending institutions regulated by the federal government require flood insurance on any financed property that falls within certain designated flood-prone areas as identified by the Federal Emergency Management Agency (FEMA).

3. The appraiser should indicate through site analysis as whether a particular site falls within earthquake or flood zones. If the property is in a flood hazard area as indicated by a FEMA map, the flood zone map number, zone code, and date of the map may be required for completion of the URAR.

4. Geologic and seismic-fault maps are produced by the national and state topographic and geologic agencies. Places where these maps can be viewed are at city and county engineering offices. Site drainage can play a significant role in the use of any particular site.
IX. WORKING WITH APPRAISERS

Virtually every licensee will come into contact with appraisers. It is important then to know some "do's" and "do nots" in dealing with appraisers.

A. Access.

Be considerate of appraisers' time and make it convenient for them to see the property.

B. At the property.

Following the appraiser around or talking constantly about all of the good features of the property is distracting. Allow the appraiser to ask questions if she desires.

C. Comparable sales.

If you have information on comparable houses that you have sold, the appraiser will appreciate data that will assist in the appraisal. Furnish complete information, however, including addresses, dates of sale, number of bedrooms and bathrooms, square footage, age of structure, etc.

D. Influencing the appraiser.

Don't try to influence the appraiser by a lot of sales talk. Most appraisers can differentiate between fact and fiction. Appraisers must be completely objective. If they are intimidated or harassed by an overly aggressive individual, it may cloud their outlook on the property.
LESSON EIGHT MULTIPLE-CHOICE QUESTIONS

Directions: Underline the letter representing the correct answer.

1. An appraiser who operates as an independent contractor is a(n):
   (a) independent appraiser
   (b) fee appraiser
   (c) staff appraiser
   (d) certified appraiser

2. Adverse influences that tend to reduce property values include:
   (a) change in street pattern
   (b) obnoxious odors
   (c) local assessments
   (d) interest rates

3. To arrive at total square footage of a structure, appraisers measure the:
   (a) exterior of the structure
   (b) interior dimensions of the house, plus the garage
   (c) interior dimensions of the house, excluding the garage
   (d) length, width, and height of the building

4. Which approach to value would be given greatest consideration in appraising a fifty-year-old dwelling?
   (a) replacement cost
   (b) capitalization of income
   (c) sales comparison
   (d) correlation

5. The most reliable approach to establishing the value of a unique new house is likely to be:
   (a) cost
   (b) income
   (c) gross multiplier
   (d) market approach

6. Buyers will not pay more for a property than the cost of acquiring an equally desirable property. This illustrates the principle of:
   (a) conformity
   (b) desirability
   (c) acquisition
   (d) substitution

7. To arrive at value using the gross rent multiplier, one would apply which formula?
   (a) Monthly rent / Gross multiplier
   (b) Monthly rent x Gross multiplier
   (c) Sales price / Monthly rent
   (d) Monthly rent / Sales price
8. Generally considered the best street pattern for residential neighborhoods:
   (a) Grid
   (b) Straight
   (c) Perpendicular
   (d) Cul-de-sac

9. In qualifying property for a loan, lenders most likely seek which type of value?
   (a) depreciated cost value
   (b) book value
   (c) adjusted cost value
   (d) market value

10. Which of the following best represents an appraisal?
    (a) CRV
    (b) provisional commitment
    (c) broker’s estimate
    (d) original purchase price plus value of improvements

11. If the gross multiplier for a given area is 9, and the gross rents are $90,000 per year, the property would probably sell for approximately:
    (a) $ 90,000
    (b) $ 540,000
    (c) $ 810,000
    (d) none of the above

12. In using the market data approach, an appraiser needs to determine:
    (a) cost per square foot
    (b) NOI
    (c) sale prices of comparable properties
    (d) all of the above

13. By FIRREA standards, the most qualified valuation of real property is likely to be made by a:
    (a) Classified appraiser
    (b) Licensed appraiser
    (c) Qualified appraiser
    (d) Certified appraiser

14. Market value is best defined as:
    (a) the highest price, in terms of cash, that a property will sell for
    (b) the most probable price, in terms of cash, the property will sell for
    (c) the most probable price, including financing, that the property will sell for
    (d) the highest price, including favorable financing, the property will sell for
15. Sale price and market value:
   (a) are always the same
   (b) are never the same
   (c) interact according to market forces
   (d) are a function of buyer preferences

16. Before committing themselves to home loans, lenders need to know:
   (a) age of the property
   (b) location
   (c) number of bedrooms
   (d) all of the above

17. Your client buys 25 units for $1,000,000 with seller carrying back a loan for $900,000. What is the price per unit?
   (a) $ 11,111
   (b) $ 36,000
   (c) $ 40,000
   (d) $ 90,000

18. When financing condominium units, lenders will usually check for such items as:
   (a) recreational facilities
   (b) parking
   (c) maintenance of common areas
   (d) all of the above

19. When working with an appraiser, it is best not to:
   (a) provide "comps" for the appraiser
   (b) follow the appraiser around and talk a lot about the property's virtues
   (c) be considerate of the appraiser's time
   (d) do any of the above

20. If a client pays $150,000 in cash and executes a trust deed for $650,000 to acquire a 15-unit building, what is the price per unit?
   (a) $ 50,333
   (b) $ 43,333
   (c) $ 33,333
   (d) $ 53,333
METHODS OF DETERMINING VALUE

- COST APPROACH
- MARKET DATA APPROACH
- INCOME APPROACH
LESSON NINE
WHAT ROLE DOES QUALIFYING THE BORROWER PLAY IN LOAN UNDERWRITING?

PREVIEW:
The second part of real estate loan underwriting deals with the prospective borrower. In this lesson we discuss the reasons for qualifying those seeking loans to be secured by real property, and how lenders assess the credit-worthiness of potential borrowers.

PERFORMANCE OBJECTIVES:
After completing this lesson, you should be able to:

1. Cite some of the more important reasons why lenders need to scrutinize applicants for real estate financing.
2. Offer an example for each of the "Cs of Credit".
3. Discuss how lenders assess the credit-worthiness of prospective borrowers.
4. Evaluate the stability and durability of income, and the quantity and quality of borrower assets.
5. Contrast income and expense requirements for conventional, FHA, DVA, and Cal-Vet loans.
6. Consider the roles that Fannie Mae and Freddie Mac play in the qualification process.

I. WHY QUALIFY BORROWERS?

A. Role of lender. Lenders are not buyers and sellers of real estate. Therefore, they are not interested in foreclosing or taking back properties on which they lend. The lender's goal is to lend money (with the property given as security) and enjoy the repayment of that debt with interest.

B. High LTV Ratios. With today's high loan-to-value-ratio loans, particularly in government-backed financing, lenders must rely even more heavily on borrowers' qualifications, since there may be little, if any, equity.

C. Borrower obligations. A loan approved strictly upon the security of the value of the house may be a disservice to the borrower who is not fully aware of the heavy financial
in the property.
burden required to maintain the home. No loan is a good loan unless it is good for both lender and borrower.

D. FICO Scoring. FICO, or Fair Issac and Company, is a formula of scoring the applicant to evaluate the credit risk that is believed to be highly predictive of future payment risk.

1. The subjectivity is removed from the qualifying process

2. The applicant's score is derived by evaluating the credit information at a particular point in time and assessing points for each credit item.

FICO scores, however, do vary, depending on the credit depository used and the applicant's geographical location. Care should be taken by the applicant in allowing potential creditors to pull credit reporting information on him on her for the purpose of securing credit. These credit pullings, commonly referred to as inquiries on the credit report, affect one's FICO score.

II. WHAT IS MEANT BY THE EXPRESSION, Cs OF CREDIT?

The factors considered in assessing risks are conveniently classified into five categories the "Cs of Credit". Though lenders may not formally call this underwriting process by that title, they essentially go through such a process with virtually every application for a real estate loan.

A. Collateral. This is the security for the loan, and is covered in Lesson Eight. It is important to the lender that the property not be in the fair to poor category.

B. Capacity. This represents the ability of borrowers to repay loans. Thus when lenders evaluate an applicant's capacity to pay, they look at:

1. Income sufficient to make the payments on the borrowed funds

2. Quality of that income in terms of steadiness, dependability and durability

3. Cash position to purchase the property.

4. The subject of gross income is discussed in Section IX.
C. Character. Even with good capacity and good collateral, do the borrowers meet their financial obligations in timely fashion? Credit reports are designed to reveal the answer to how well the applicant has met past financial obligations. In evaluating an applicant's desire to pay, many factors are considered (discussed in section XIII).

D. Capital. What is the financial condition of borrowers so that they can tap other assets to meet their mortgage obligations in case of disability, job loss, etc.?

E. Changing Conditions. This criteria is especially useful in adjustable mortgages, where changes in the economy, borrowers' income and financial status, and other changes may make it difficult to meet increasing monthly payments.

F. Notations

1. Of the five above, the first three form the basis of sound underwriting. Can the borrower make the payments? Will the borrower make the payments? How does the property measure up?

2. Each "C" of credit is a check upon the others, so that even though the applicants qualify on the basis of capacity, for example, they may fail the character test as revealed in their credit report.

{INSTRUCTOR: YOU MAY WANT TO OBTAIN BLANK LOAN APPLICATIONS FROM A LOCAL LENDER FOR STUDENTS TO COMPLETE IN CLASS FOR DISCUSSION AND ANALYSIS. THEY WILL SEE WHAT GOES INTO AN APP AND BETTER UNDERSTAND THE QUALIFYING PROCESS}

III. HOW DO CONVENTIONAL LENDERS QUALIFY BORROWERS?

A. Borrowers are qualified by lenders according to ratios (in addition to credit standards and property value and condition), which measure the borrower's gross income to the proposed housing expense and gross income to total debt obligations (housing expenses plus current liabilities).

1. Example. Assume monthly loan payments for principal, interest, property taxes, and insurance total $1500. If the lender uses a multiplier of four, a common the practice, they would need a monthly income of 4 x $1500, or $6,000 to qualify. Stated differently, the ratio of monthly payments of $1500 to monthly income is 25%, computed as follows:

\[
\text{Ratio} = \frac{\text{Total monthly payment}}{\text{Gross monthly income}} = \frac{1,500}{6,000} = 0.25, \text{ or } 25\% \text{ of monthly gross income}
\]
2. Example. Assume the above facts in place plus debt obligations at $500 per month.

Ratio = Total monthly obligations / Gross monthly income
Ratio = $1,500 + $500 / 33%
Ratio = 0.33, or 33% of monthly gross income

3. How are ratios selected?

a. Qualifying ratios differ from lender to lender. Fannie Mae and Freddie Mac have selected ratios that are to be used in loans that are sold to either of these two secondary market loan purchasers.

b. Ratios are also determined by the borrower's and property's relationship to the 5 Cs and to the loan program.

c. These 5 Cs include collateral, capacity, character, capital, and changing conditions. Lenders place particular emphasis on the first three Cs.

B. What about Front-End (or top) and Back-End (or bottom) Ratios?

1. Front-end ratio.

This is a fraction whose numerator is the monthly mortgage payment. Mortgage payments consist of principal, interest, taxes, insurance (PITI), private mortgage insurance and, in the case of condominiums and planned unit developments, homeowner association dues. The denominator is gross income. Most lenders like to see no higher than a 28% front-end ratio.

Example: Your income is $6,000 per month, and your PITI will be $1,500 per month. What is the front-end ratio?

\[
\begin{align*}
\text{Monthly Mortgage Payment} &= 1500 \\
\text{Gross Monthly Income} &= 6000 \\
\text{Ratio} &= \frac{1500}{6000} = 0.25 = 25%
\end{align*}
\]

On the front end, you'd qualify for the loan, since your below the 28% requirement.

2. Back-end ratio.
10 months. The denominator is gross income. Most lenders like to see no more than a 36% back-end ratio.

Example: Your income is $6,000 per month, your PITI will be $1,500 per month, and other monthly payments are $600 per month, for a total fixed monthly outlay of $2400. What is the back-end ratio?

Total Monthly Expenses = $2,400
Gross Monthly Income = $6,000

40%

On the back end, you'd be disqualified for the loan, since you're above the 36% threshold. In general practice, these ratios are GUIDELINES. They are not etched in stone.

C. The Gap Ratio. A new credit standard for judging loan applicants from Freddie Mac, the second largest source of mortgage money in the country.

1. Freddie considers high overall utilization of revolving credit an important factor.

2. Freddie spells out risk-layering factors in three broad categories:

a. Credit. Its internal test is whether you have more than one credit line, such as credit cards, with more than 50% of the credit maximum utilized.

b. Capacity. This is the borrower's ability to manage the debts he or she is taking on, including such things as cash reserves and whether the borrower is applying for a cash-out refinance.

c. Collateral. Freddie views the borrower as a higher risk whenever he or she is applying for a loan with a small down payment, seeking maximum financing, or are financing 2-4 units, a condominium, or a manufactured home.

3. Total monthly income to total household debt, commonly expressed at a maximum of 36%, has been creeping in the 1990s above 40% and lately to 55% and higher.

4. The Gap Ratio is used in so-called manual underwriting. Freddie's automated program is called Loan Prospector.

5. The Gap Ratio is the difference between the monthly debt payment to income ratio and the monthly housing expense to income ratio. If the gap between these two ratios should not exceed 15% percentage points.

This is a fraction whose numerator is the total monthly expense, including mortgage payment and long
D. What are the restrictions on amounts of debts?

1. Short-term vs Long-term Debts
   Lenders classify debts into short-term and long-term. Short-term debts are usually ignored while long-term debts, such as auto loans, play a critical role in qualifying the borrower.

2. What constitutes a qualifying long-term debt depends upon the lending institution or government agency backing the loan, but they run from as few as six months to one year before full repayment.

3. A buyer who is debt-free may NOT be treated in the same way as a buyer who has many debts. It may prove difficult to qualify such a borrower as there is no track record to evaluate how he or she handles monthly obligations.

E. Offsetting factors. Such items as time on the job, credit rating / scoring, propensity to save, asset accumulation and job promotion possibilities can offset high ratios that might otherwise disqualifying a loan applicant.

F. Computerization in loan qualification. Secondary market loan purchasers, including Fannie Mae and Freddie Mac, are providing programs to aid lenders in the loan qualification process. This has not, however, led to an elimination of live underwriters.

1. Fannie Mae's processing program is called Desktop Underwriter.
2. Freddie Mac's processing program is called Loan Prospector.

IV. HOW DOES THE FEDERAL HOUSING ADMINISTRATION QUALIFY BORROWERS?

The FHA used to apply a seven-step process, but changed it to a very simple formula that patterns the process used for qualifying conventional borrowers according to the guidelines as set forth by Fannie Mae and Freddie Mac. The only difference is that FHA used a 29% front-end ratio, and a 41% back-end ratio.

Using the same data and formulas shown for the conventional loan in III C above, the borrowers had a front-end of 25% and
back-end of 40%. They would qualify on both ends.
V. HOW DOES THE DEPARTMENT OF VETERANS AFFAIRS QUALIFY BORROWERS?

A. Two separate sets of calculations are applied by the DVA as part of the loan approval process. The first is called the residual method, and the second is the application of income ratios.

1. Residual Method. This is a multi-step summation process:

   a. Gross Monthly Income
      - Tax liabilities (Federal, State, Social Security) = Net take-home pay
      - Housing expenses (PITI, utilities, maintenance, special assessments)
      - Fixed obligations (Debts over 6 mos, job-related expenses such as union dues) = Residual income

   The minimum residual income must be sufficient to cover the applicants' cost of living (COL). This is for food, clothing, transportation, medical care etc. A prescribed minimum amount is established by the DVA which varies by region, family size, and loan amount.

   b. Example 1. Tables furnished by the DVA will show a family of one, applying for a loan for less than $70,000 secured by a home located in California, requires a residual monthly income of only $379.

   c. Example 2. DVA's table show a family of five, applying for a loan for over $70,000 secured by a California residence, requires a monthly residual income of $1,031.
d. Example 3. Assume the numbers shown below for a $100,000 DVA loan by applicant with 3 dependents. Does the veteran qualify under the residual method?

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross monthly income</td>
<td>$5,000</td>
</tr>
<tr>
<td>Tax liabilities</td>
<td>- $1,950</td>
</tr>
<tr>
<td>Net take-home pay</td>
<td>$4,050</td>
</tr>
<tr>
<td>Housing expenses</td>
<td>- $1,500</td>
</tr>
<tr>
<td>Balance</td>
<td>$2,550</td>
</tr>
<tr>
<td>Fixed obligations</td>
<td>- $1,400</td>
</tr>
<tr>
<td>Residual Income</td>
<td>$1,150</td>
</tr>
</tbody>
</table>

A reference to the DVA "residual income" tables will show that the applicant qualifies on the basis of the residual income method.

Any balance remaining after all deductions and COL expenses is called "excess residual income". This excess may be used to help qualify marginal applicants. Dividing this excess by the minimum required residual produces an "excess residual ratio" that is used in the application of the income qualifying ratio.

2. Income Ratio Method. Loan applicants may still qualify even though the income ratio guidelines are not met, if the excess residual income is 20% or more. The formula differs here from the residual method, as shown in the following model:

a. Total Gross Income

b. Housing expenses, but PITI only
   + Fixed obligations, including state & local taxes, but not Federal taxes
   = Total monthly obligations

c. Ratio: The maximum percentage of total monthly obligations (b) to gross income (a) cannot exceed 41%. If over 41%, the loan underwriter reviews the amount that applicants' residual income exceeds the minimum residual. If this is more that 20%, applicant may still qualify.
d. Example. Same facts as in Example 3 in the Residual Income approach. However, the housing expenses of $1,500 in that approach drop to $1,100 in the Income Ratio approach because utilities and maintenance, estimated here at $400 per month, are not included.

<table>
<thead>
<tr>
<th>Total gross income</th>
<th>$1,100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Housing expenses</td>
<td>$1,400</td>
</tr>
<tr>
<td>Other fixed obligations</td>
<td>$5,000</td>
</tr>
<tr>
<td>Total monthly obligations</td>
<td>$2,500</td>
</tr>
</tbody>
</table>

Ratio of total obligations to total gross income: $2,500 / $5,000 = 50%

Since this is beyond the maximum 41% required under the Income Ratio method, the veteran does not qualify for the home loan. It should be noted that ratios exceeding 41% do not absolutely disqualify a veteran.

e. Other considerations. Even if the applicant fails in both of the above ratios, the veteran may still be approved based upon such factors as: larger than normal down payment, wise use of credit, work experience and history, likelihood of income changes ("changing conditions"), etc.

VI. HOW DOES THE CALIFORNIA DEPARTMENT OF VETERANS AFFAIRS (CAL-VET) QUALIFY BORROWERS?

Cal-Vet use to employ a rather complicated qualifying ratio process. It now has changed to mirror that of the DVA, with the 41% debt to income ratio and the residual method of qualifying veteran applicants.

VII. HOW DO FANNIE MAE AND FREDDIE MAC INFLUENCE THE QUALIFICATION PROCESSES?

A. Purchase of qualifying loans. While borrowers do not deal directly with either Fannie Mae or Freddie Mac, these two agencies vitally affect the process of qualifying loan applicants. This is due to the secondary markets in which these agencies operate. Conventional lenders sell loans in the secondary market, and Fannie Mae and Freddie Mac are by far the biggest purchasers of real estate trust deed and mortgage loans in this market.

B. Uniformity. Loans sold to either Fannie Mae or Freddie Mac must comply with the qualifying ratios of the purchasing agency. Consequently there is greater standardization and uniformity in qualifying borrowers if lenders expect to sell any of their loans to either of the "big players". Any loan sold to these agencies, for example, cannot exceed $275,000 on a single dwelling fixed rate loan (effective 1/1/2001). Hence most lenders
will limit their loans secured by houses to $275,000. Of course this figure is subject to periodic changes (as noted by the effective date provided), usually upward as house prices go up.

C. Qualifying guidelines for the borrower:

1. Housing Expenses / Gross Income, should not exceed 28%
2. Combined Fixed Obligations / Gross Income, should not exceed 36%
3. Ratios can be exceeded if offsetting factors are present, such as time on the job, credit scoring, propensity to save, assets owned, down payment, credit rating, and opportunity for job advancement.

VIII. WHAT ABOUT THE ROLE OF PRIVATE MORTGAGE INSURANCE COMPANIES?

A. Mortgage insurance is provided to protect the lender or purchasing investor from loss due to a foreclosure action. This is not to be confused with mortgage insurance that an applicant may opt for that is activated at his or her death. Loans exceeding 80% loan-to-value (less than 20% down payment) will probably require a borrower applicant to pay for private mortgage insurance. The cost of the insurance will depend on the loan program, the loan-to-value, and the lender coverage requirement.

B. In practice, private mortgage insurance companies pattern their qualifying guidelines after that of Fannie Mae and Freddie Mac.

IX. ACCOUNTING FOR INCOME

A. Gross Income:

1. There are many components that make up the borrower's income potential - occupation, employment tenure, opportunities for future advancement, educational background, and occupational training.

2. Both the primary and secondary markets have requirements that measure income and employment stability, the types of income considered acceptable, and the methods for calculating certain types of income.
3. Borrowers must establish long-term, stable income from employment or other sources.

4. The lender must verify the borrower's total income picture for two full years that preceded the mortgage loan application.

B. Various areas that will makeup the borrower's gross income are discussed below.

C. To What Extent is the Spouse's Income Considered?

1. Both federal and state statutes prohibit different treatment of the sexes. The Equal Credit Opportunity Act reiterates this fact. Income standards must apply equally for both sexes. For instance, if the lender requires that a man be on the job for at least one year before his income is counted, that same lender cannot apply a two-year minimum qualifying requirement for a woman.

2. All of the Spouse's income is includable, without regard to sex, so long as she meets all other normal lender requirements. If her application is turned down, such rejection must be for the same reasons that a man would be declined: insufficient time on the job, poor credit due to slow-pay habits, etc. Thus she cannot be turned down because she is pregnant, for example.

D. How are Commissions Treated?

1. Those who are compensated by commission, such as real estate licensees are treated on the basis of stability and durability of the income. Most lenders require at least two year's experience in the commissioned position.

2. Others who are paid on an irregular basis, such as carpenters, painters, electricians, and other trades people are treated essentially the same way as commissioned employees. Lenders verify income by means of W-2 or income tax returns. Some lenders are also asking for current year-to-date earnings in addition to W-2s.

E. How are Self-Employed Evaluated?

Self-employed borrowers are asked to supply lenders with:

1. A balance sheet showing the assets, liabilities, and net worth of the business,

2. A-profit and loss statement for at least two years, and
two years of Federal tax forms (1040s).

F. How is Income From Real Estate Investments Treated?

1. Only the cash flow from income-producing real property counts. For most properties on which there are loans, cash flow may be relatively small.

2. For duplexes, triplexes, and fourplexes, lenders usually discount the income heavily. For VA loans, the Veterans Administration requires vets to have enough cash to make 3 to 6 months' payments independent of any income from the units, except for the one occupied by as their principal dwelling. The general guideline is 75% of the gross income minus the mortgage payment including property taxes, insurance, and PMI (if applicable). The result may very well so a loss rather than a profit once this formula is applied to the earnings from rent.

G. How is Overtime, Bonus, and Part-Time Work Treated?

1. Overtime. Lenders are reluctant to count overtime pay because of its uncertainty, unless it can be demonstrated that the overtime is consistent and dependable and is currently being earned. Lenders also consider how long it has been earned.

2. Bonus income. Requires substantiation to prove that this source of added income can be relied upon. Lenders require as many as three years of bonus pay before crediting it. One-time signing bonuses, however, are not considered.

3. Part-time. Work in another job is placed into the same category as overtime. Applicant must prove that the work will continue in the future, that the borrower will be able to work both jobs without too much difficulty.

H. How is Income from Alimony and Child Support Treated?

Experience has proven these sources of reserve to be unreliable and irregular. However, some lenders view such income as supplementary, adding to rather than supplanting regular income. Inclusion is dependent on the duration of such income. Lenders will require at least three years or more of likely continuance. An important consideration is that the IRS will withhold refunding to non-paying parent for back payments for child and spousal support, or take it out of social security payments to the defaulting recipient.
I. How is Income from Pension Funds and Social Security Treated?

Income from these sources are fully counted if it can be shown to be steady and reasonably permanent. Most pensions are insured by the Pension Guarantee Corporation.

J. How is Income From Military Service Treated?

In addition to their base pay, military personnel receive extra pay for quarters, clothing, and rations. The value of these, plus an allowance for free medical service, is added to basic salary to arrive at true income. Educational benefits, on the other hand, do not qualify.

K. How is Income From Unemployment and Welfare Treated?

Acceptable sources of income if they are properly documented by letters or exhibits from the paying agency. The amount, frequency, and duration of such payments must be shown in the submittals. Two years tax returns establishing a history are required.

X. ADDITIONAL SECURITY

Income solely from the borrower is what lenders seek in virtually all cases. But marginal borrowers may be acceptable if they are able to offer security in addition to income and the property itself.

A. How do Lenders View Co-Mortgagors?

1. Relationship. A co-mortgagor is simply a co-borrower, other than husband and wife who are treated as one for lending purposes. Lenders look closely at the type and soundness of the relationship of the co-mortgagors. A father and son purchasing a home together would normally be viewed very favorably. So also might two single women (or two single men) who have lived together for years in order to economize on expenses. The key to any relationship is its stability and durability.

2. Credit-worthiness. Like the primary borrower, the co-mortgagor must have earnings, assets and credit acceptable to the lender. The co-mortgagor must have resources sufficient to support not only his/her own housing debt, but all of the proposed new housing debt if the primary borrower defaults.

3. Risks. A marginal co-mortgagor may do more harm than good where the LTV is very high, such as 90%, since the lender will ordinarily require the co-mortgagor to occupy the property.
B. What About Co-Signers?

1. Definition. A co-signer is a second party who is to sign the promissory note, along with the primary borrower. Many lenders do not accept co-signers because if there are doubts about the primary borrower's credit, the loan probably would not be sound.

2. Supplement. Some conventional lenders give some weight to co-signors under certain circumstances: When borrowers are close to qualifying on their own, co-signors may add just the amount of strength needed to qualify.

3. Government-backed Loans. The VA will not accept co-signors. FHA will consider co-signors only after applying specific guidelines.

XI. STABILITY OF INCOME.

Lenders ask the following questions in order to ascertain how stable the income is.

A. How Long Has the Prospective Borrower Been On the Job?

Anywhere from 2 to 3 years time in the same line of work is what lenders consider sufficient to qualify. If an employee has been less than that, the income is not considered stable. Exceptions: Those in the professions, such as doctors and lawyers; where applicants have changed employers in order to improve themselves.

B. In What Type of Work is the Applicant Engaged?

Highly skilled individuals whose services are in great demand, such as physicians and attorneys, need not worry about employability. Civil servants and tenured teachers are also considered highly stable. However, careful scrutiny is given to seasonal or short-term employees, such as those in the highly volatile construction industry, where a dependable, steady income is not assured.
C. How Much Longer Will the borrower be Able to Continue
Making Payments?

This goes to one of the five Cs of credit referred to as 
"changing conditions". At one time, the age of a 
prospective borrower was of critical importance since 
retirement ordinarily amounted to not much more than a 
small pension or social security check. Today, however, 
even an applicant nearing the age of retirement could 
qualify for a 30-year loan so long he or she can 
demonstrate that his or her present income is sufficient 
to meet the borrower’s total debts, including a 
contemplated home loan.

XII. ASSETS OF BORROWERS

Why are lenders concerned about assets of the borrower if 
there is enough current income to repay the installments due 
on the loan?

A. Sufficiency. If borrowers cannot show enough capital, 
the assumption is that they would have to borrow funds 
for the down payment plus closing costs. The additional 
debt would need to be considered in qualifying the 
applicant.

B. Back-up Support. To provide a cushion of security in the 
event of loss of job, temporary layoffs, absence due to 
ilness, etc. If the borrower has substantial liquid 
assets, the lender can feel more secure, since the 
borrower is able to continue making loan repayments.

C. Start-up Funds. Most lenders frown on the practice of 
borrowing money for the down payment. FHA is especially 
strict about borrowing such "front money" except under 
certain prescribed circumstances, including:

1. Borrowing against one's life insurance policies.

2. Using one's stock and certain other collateral as 
security. Because of its high depreciation and limited 
resale value, furniture does not qualify as 
collateral.

3. Loan applicants over age 60, who may be permitted to 
borrow the necessary down payment.

XIII. WHAT IS MEANT BY THE CONCEPT, DESIRE TO PAY?

On the basis of credit and other reports, lenders must ask 
themselves the perennial question: Will the borrower 
continue making payments even in the face of difficulties?

At the time of application for a loan, applicants
invariably demonstrate willingness and ability to make the required payments, but lenders need to rely on more tangible evidence than mere intent. If a borrower does not understand or intend to meet the "promise in the promissory note, the loan is in jeopardy at the outset.

A. How do Lenders Determine and Measure Desire to Pay?

1. Past Payment Record. If applicants have developed good paying habits, they will likely continue to do so. If they have experienced problems meeting their debts, chances are that they may be a poor risk.

2. Exceptional circumstances. A poor credit history will not automatically disqualify an applicant even where the credit rating is highly undesirable if extenuating circumstances were present. Examples include death, disability, serious illness, unemployment, etc.

3. Motivation. In attempting to measure motivation, lenders look at such factors as:

   a. Down payment. A reasonable assumption that a lender can make is that the larger the down payment, the more likely the borrower will meet payments. A person making a down payment of $50,000 on a $170,000 house is not likely to lose it through foreclosure. If it becomes impossible or extremely difficult to meet the debts, the borrower would seek out alternative outlets, such as sale of the residence.

   b. Reason for buying. If the buyer is acquiring the house for family use, the motive is a strong and positive one from a lender's standpoint. If purchased for speculation or as a rental, lenders are likely to require larger down payments and apply more stringent qualifying standards.

XIV. WORKING WITH LENDERS

A. Varying Points of View. There are no hard and fast rules when it comes to qualifying applicants for loans. Two underwriters looking at the same loan application will often come up with divergent opinions. The human element cannot be ignored. Licensees must learn to recognize differences, and to work with them: Some lenders are extremely selective about the property or collateral, while lenient in qualifying the buyer. Other lenders are highly selective in qualifying the buyer, while exercising leniency in qualifying the property.
1. Absurdity. Do not present a lender with a loan application which patently cannot be approved.

Example: a request from one who had just filed bankruptcy a few months ago.

2. Honesty is the best policy. If the prospective borrower has had credit problems, level with the lender. If the applicant tries to hide the problems, the lender will certainly find out after a credit report is received.

3. Cooperate with the lender. Arguing with a lender over the necessity for certain documents requested by the lender will not help with loan approval.

Example: Lender insists on audited Profit and Loss and Balance Sheet statements for self-employed loan applicants. Even though the loan applicants consider such a lender requirement to be an infringement on their privacy, they must nonetheless comply or loan approval can legitimately be denied.

4. Further inquiry. If the lender says that the borrower is not qualified for the loan, ask the lender what will help to qualify the applicant. An interested lender may offer some useful suggestions, such as larger down payment, different terms, securing a co-signer, etc. in order to make the loan acceptable.

5. Government-backed. When working with FHA and DVA lenders, the loan package may have to be sent to the appropriate federal agency if the lender does not have its direct endorsement (FHA) or automatic (DVA) underwriting approvals. Since these agencies do not deal directly with borrower, they must rely on the information furnished by the lender. Approval or disapproval may largely depend upon how well the information is presented. Make sure the lender does a thorough job processing FHA and DVA loans. Without these agency underwriting approvals, the entire loan process may require additional time to complete.

6. Second-chance. If the borrower does not qualify under normal guidelines, be prepared to prove to the lender that it should reconsider and possibly make an
7. **Self-examination.** If in doubt as to how to proceed with a particular loan, ask yourself this question: "If I were going to use my own money to make this loan, what would my reactions be"? Your responses may help you in dealing more effectively with lenders and to understand them better.

C. **Is it Really Best For the Client?** Finally, it should be noted that licensees owe a fiduciary duty to their principals. A particular loan may not necessarily be best for the client. Remember, if the loan isn't good for the lender, it's also unlikely to be beneficial to the borrower interests.

The old adage, "you can't win 'em all", occasionally applies. We must be realistic enough to realize that not everyone can qualify for a loan.
UNIT NINE MULTIPLE-CHOICE QUESTIONS

Directions: Underline the letter representing the correct answer.

1. One of the five Cs of credit is:
   (a) Consideration
   (b) Capitalization
   (c) Credit
   (d) Character

2. To arrive at "gross income":
   (a) many components of the borrower's income potential are evaluated.
   (b) Both the primary and secondary markets have requirements that measure income and employment stability.
   (c) borrowers must establish long-term, stable income from employment and other income sources.
   (d) all of the above.

3. A borrower has a six-months furniture loan repayable at $250 per month, and a three year car loan at $500 per month. If the monthly mortgage payment would be $1,000 and a conventional lender uses a ratio of 36%, how much income per month will it take to qualify?
   (a) $ 630
   (b) $ 4,862
   (c) $ 695
   (d) none of the above

4. Federal law prescribes that % of a spouse's income must be includable in qualifying for a loan.
   (a) 25%
   (b) 50%
   (c) 75%
   (d) 100%

5. In all probability, income from one of the following sources would not be acceptable for real estate loan purposes:
   (a) military service
   (b) social security
   (c) unemployment insurance
   (d) overtime work

6. When applying for a Cal-Vet loan, the applicants' combined housing and long-term debts may not exceed % of gross income.
   (a) 25%
   (b) 33-1/3%
   (c) 45%
   (d) 41%
7. Capacity refers to:
   (a) willingness of the borrower to repay a loan
   (b) ability to meet mortgage payments
   (c) past activity in the loan market
   (d) total assets of the applicant for a loan

8. In the process of making a loan, the lending officer correlates certain characteristics of the borrower, characteristics of the property, and prospective terms of the loan requested. This is part of the process called:
   (a) credit rating
   (b) mortgage evaluation
   (c) property appraisal
   (d) applicant analysis

9. FHA allows buyers to borrow money for the down payment from which of the following sources?
   (a) Life insurance
   (b) A commercial bank
   (c) Any solvent savings and loan association
   (d) The FHA itself

10. You are applying for a government loan. Your gross income is $4,600 per month, against which $700 is withheld for federal income tax. Housing payments and expenses will amount to $1,400. Another $700 is paid out monthly for recurring expenses. The ratio of total housing expense to gross income is:
    (a) 35.9%
    (b) 45.7%
    (c) 30.4%
    (d) 26.4%

11. Using the same data from problem 10, the ratio of total fixed payments to gross income is:
    (a) 45.7%
    (b) 30.4%
    (c) 35.9%
    (d) 39.6%

12. A lender uses a total housing expense ratio of 28%. A borrower is applying for a loan of $100,000 with a monthly payment of $1029, not including monthly charges for taxes and insurance of $170. In this instance, the borrower's annual income should be at least:
    (a) $36,815
    (b) $44,100
    (c) $51,400
    (d) need recurring debts to determine
13. With respect to a borrower's debt situation, the FHA:
   (a) ignores all short-term obligations
   (b) rejects all loan applicants that do not meet the "39% and 41% ratios
   (c) defines long-term debt in the same way as does DVA
   (d) uses its qualifying ratios as flexible guidelines

14. Assume that you are applying for a mortgage loan and you have the following debts: auto payments, $100 for another 16 months; dental bill, $50 monthly, maturing in 4 months; and a personal loan for 5 years at $150 per month. Which of the debts will be includable for qualifying purposes?
   (a) $300
   (b) $250
   (c) $150
   (d) None. All debts must be at least two years to be

15. Using the same data from problem 14, and with a total expense ratio of 41% and a gross annual income of $100,000, monthly payments of principal, interest, taxes and insurance may not exceed:
   (a) $3,030
   (b) $2,980
   (c) $3,130
   (d) $3,530

16. Fannie Mae and Freddie Mac use qualifying income ratios of:
   (a) 28% of total monthly expenses to gross income
   (b) 28% of total housing expense to gross income
   (c) 36% of mortgage payments to gross income
   (d) none of the above is correct

17. In qualifying for a DVA loan, the Department of Veterans Affairs applies two separate sets of calculations, including:
   (a) Gross Effective Method
   (b) Net Effective Method
   (c) Residual Income Method
   (d) Recurring Charges Method

18. Which of these is likely to be the most important factor in qualifying a buyer for a loan?
   (a) Amount of savings
   (b) Type of job
   (c) Number of dependents
   (d) Adequacy of income

19. FHA uses a variety of criteria in evaluating home loan applicants. Which of the following is least likely considered in qualifying borrowers?
   (a) Net effective income
   (b) Non-recurring closing costs
   (c) Size of the family
   (d) Long-term debts
20. The concept, "excess residual income", is used in connection with which financing program?
   (a) Cal-Vet
   (b) FHA
   (c) DVA
   (d) Fannie Mae

**********
FIVE C'S OF CREDIT

1. COLLATERAL
2. CAPACITY
3. CHARACTER
4. CAPITAL
5. CHANGING CONDITIONS
ACCOUNTING FOR INCOME

- To what extent is the co-borrower's income considered?
- How are commissions treated?
- How are self-employed evaluated?
- I. How is income from real estate investments treated?
- How is income from pension funds and social security treated?
- How is income from alimony and child support treated?
- How is income from military service treated?
- How is overtime, bonus, and part-time work treated?
LESSON TEN

HOW DO PROCESSING, UNDERWRITING, FUNDING, CLOSING, AND SERVICING LOANS TAKE PLACE?

PREVIEW:
In this lesson we discuss the concept of loan processing and those activities that make up the processing procedure. Questions that will be raised and answered include: What is a loan application? How, when, and where are applications completed? What restrictions are there against discrimination in lending? What is a loan package, and how do practices in approving loans differ based upon type of lender? Truth in lending is detailed, showing relationship between residential and non-residential closing costs to APR. Finally, post-lending activities are discussed, including servicing, prepayment privileges and penalties, and assumptions.

PERFORMANCE OBJECTIVES:
After completing this lesson, you should be able to:

1. Delineate information sought by lenders on a typical real estate loan application.
2. Cite the principal characteristics of the Equal Credit Opportunity Act.
3. Differentiate between the Verification of Employment and Verification of Deposit forms, and explain their use in the processing of a loan.
4. Briefly describe the steps involved in final loan approval.
5. Describe the role of the Real Estate Settlement Procedures Act in real estate lending.
6. Define Truth-in-Lending and its relationship to APR.
7. Differentiate between prepayment privileges and prepayment penalties.

I. HOW DO LENDERS PROCESS LOANS?

A. What is the Qualifying Procedure?

In underwriting real estate loans, the property is qualified before the applicant is qualified. However most lenders at least pre-qualify applicants through a credit report and income ratios before the appraisal is made.
This saves the cost of an appraisal if the applicant is financially deficient. Bear in mind that a residential loan is a credit loan.

1. Collateral. The lender must be satisfied that the property is acceptable as security for the type and amount of loan requested.

2. Terms. The type and quality of property usually determines the loan-to-value ratio, maximum amount, interest rate, term, and points.

3. Appraisal. The loan amount is calculated on the basis of the lower of appraisal or sale price.

B. Loan Application. If an application is filled out completely, accurately, and truthfully, lenders should have all the information they need. This leaves only verification of the data included in the application as well as any supplementary information that is required.

1. Uniformity. There is no uniform or standard loan application. However, almost all institutional lenders use the form adopted by the Fannie Mae and Freddie Mac, known commonly as the 11003.1 The Federal Housing Administration, the Federal Department of Veterans Affairs, and the California Department of Veterans Affairs each use their own special forms.

2. Information. Applications vary in format and length, but they all ask the same basic questions, seeking data on the following items:
   a. Employment
   b. Income
   c. Assets
   d. Debts
   e. Credit history

C. Completing the Application

1. Thoroughness. How an application is completed can make the difference between approval and rejection. The loan application is, after all, a representation of the borrower's financial condition. An incomplete or inaccurate application may be rejected because the lender cannot make an objective evaluation when all of the facts are not known.

2. Execution. The application is completed by the borrower, often with the assistance of the salesperson. Some lenders require a personal interview with the applicants. Such interviews are desirable because:
a. There may be information about the borrower that is important but is not asked for in the application. For instance, the borrower may be receiving a promotion or an increase in salary in the near future. An informed loan officer will recognize that this information may help qualify the applicant, and will make a notation to that effect.

b. Many borrowers are applying for the first time and are not sure what to expect. Loan officers can answer questions and explain the procedures to borrowers.

c. Supporting papers and documents may be required by the lender. A commissioned salesperson, for example, might bring along current tax returns. The self-employed would be wise to submit a current balance sheet and profit and loss statement, in addition to tax returns. Having account numbers available for checking, savings, and installment debts will accelerate the qualifying process.

D. What is the Equal Credit Opportunity Act (ECOA)?

1. Purpose. Designed to provide equal access by both men and women to credit markets, this federal law prohibits discrimination in credit transactions on the basis of sex, marital status, race, color, national origin, religion, age, receipt of public assistance.

2. Inquiries. Forbids lenders from asking applicants if they are divorced or widowed. They may ask, however, whether the borrower is married, unmarried, or separated. ECOA defines unmarried as single, divorced, or widowed.

3. Support payments. Lenders may not ask about receiving alimony (spousal support) or child support unless the applicant is first notified that it need not be revealed. However, lenders may ask about obligation to pay such support.

4. Birthing. Lenders cannot ask about birth control practices or child-bearing intentions or capabilities.

5. Action. Lenders must notify every borrower within a reasonable time what action has been taken on his or her loan application. As required by Federal Reserve Regulation B, a formal letter of credit denial must be provided to the borrower outlining the basis for such denial of credit.
6. Joint accounts. If an applicant requests, lenders must submit a statement to the effect that a bad history of a joint account does not reflect on his or her credit.

E. How Is The Application Processed?

What happens after the application is completed? The lender verifies the information submitted, including:

1. Verification of employment. This is facilitated by sending a "Request for Verification of Employment" form to employers who certify the accuracy of the employment history.

2. Verification of saving and checking accounts. This is accomplished by mailing out a "Request for Verification of Deposit" form to institutions in which the applicants maintain depository accounts.

3. Credit Report. The standard factual, as it is known, itemizes current debts, balances, payments, and other important data. Payment obligations are rated, i.e., 31-60 days late, delinquent, etc. An assessment is made of each debt rating and as well as the maturity of the debt. Generally, debts that mature in more than 10 months or any large debt maturing in less than 10 months are considered.

4. Telephonic verification. Most conventional lenders verify employment, savings, and credit data by phone, even at the point of funding. However government-backed loans require verifications to be in writing. Similarly, if the loans are to be sold in the secondary market, such as to Fannie Mae and Freddie Mac, the verifications and credit report must also be in writing.

F. Loan Package

1. Purpose. Consists of all the forms, documents, and reports which the lender needs in order to make a decision on a loan application.

2. Review. The assembled package is given to the loan underwriter or committee that is authorized to make a decision about the loan.

3. Contents. a loan package typically includes the following:

{SHOW T 10-4}

a. Appraisal Report
b. Borrower Application

c. Verification of Employment

d. Verification of Deposit

e. Credit Report

f. Purchase Contract and Receipt for Deposit

g. Escrow Instructions

h. Other supporting documents, such as income tax returns, W-2s, verification of securities ownership and values, cash value of life insurance policies as well as other documentation to further explain any items of question.

G. How is a Loan Approved?

1. Conventional Lenders

   a. Individual underwriters or loan committees are usually given authority to approve loans up to certain amounts and for specified types of properties. For example, a branch manager of a bank or savings and loan may have the power to approve home loans up to $100,000. Loans exceeding that amount would be referred to the next level.

   b. Loan committees vary in size and composition. One committee may be empowered to approve loans on 1-4 unit buildings up to $100,000, while another might be authorized to grant loans on any type of property up to $1,000,000.

   c. Committees meet as often as needed. In the larger institutions, they may meet every other day, while in smaller institutions, once a week may be enough.

2. Federal Housing Administration and Department of Veterans Affairs.

   a. Non DVA automatics.

      (1) Loan packages are given to the mortgage credit section of these agencies, where the job of qualifying the borrower takes place (underwriting process).

      (2) Loan examiners analyze each application. If they are unable to make a decision because of
inadequate information they request additional information from the lender in writing. If the borrower qualifies, the approval is mailed to the lender.

(3) If the examiner concludes that the application does not qualify, the loan application is turned over to a supervisor. Upon concurrence the loan is rejected. One examiner may approve a borrower, but it takes at least two to reject.

b. DVA automatics.

DVA loans may also be automatically approved by supervised lenders, such as banks and savings and loans, as well as non-supervised lenders, such as mortgage companies that qualify for such "automatic DVAs".

II. WHAT IS THE REAL ESTATE SETTLEMENT PROCEDURES ACT (RESPA)?

A. Purpose

To reduce and standardize "settlement costs". These are all costs and expenses associated with the closing of real estate transactions. RESPA's intent is to aid buyers in making better informed decisions.

B. Major Provisions

1. Settlement statements. Use of a standard settlement form must be furnished buyers at least one day prior to close of escrow.

2. Estimated charges. A home buyer must be given an information booklet explaining settlement costs and the settlement process. A "good faith" estimate of such charges must be furnished within three business days of a completed loan application.

3. Prohibitions. Certain practices are prohibited, including kickbacks, referral fees, seller unilaterally designating title company, excessively large impound accounts.

4. Coverage. RESPA applies only to first mortgages, and only for one to four-family properties, including houses, condominiums, cooperatives, a lot with mobile home, and a lot on which a home or mobile home will be placed.
5. Administration. RESPA is administered through the Office of the Assistant Secretary for Consumer Affairs and Regulatory Functions at the Federal Department of Housing and Urban Development.

III. WHAT IS THE FAIR CREDIT REPORTING ACT (FCRA)?

A. Who and What is Impacted by FCRA?
This federal law applies to all credit reporting agencies and users of credit information.

B. What Types of Credit Reporting Agencies Are There?
There are two basic kinds of agencies that prepare credit reports.

1. Credit Bureaus collect objective financial data for use by banks, retailers, landlords and credit card issuers. Experian (TRW) is the largest, maintaining over 155 million files on individuals. Data includes credit and debt repayment history, bankruptcies, tax and property liens, employment, credit card usage, credit limits, marital and family information. Other major credit bureaus include Trans Union and Equifax.

2. Investigative Reporting Agencies are used by insurance companies, prospective employers, mortgage lenders involving large properties. They tend to issue subjective assessments of lifestyle and character. Investigators may go to neighbors or employers to discover whether the credit applicant has a drug problem, dangerous hobbies, friends of questionable character, etc.

C. How Long Are Credit Files Kept? Files can be kept for 7 years on everything except bankruptcies, which stay in files for 10 years. If you are denied credit, you're entitled to obtain a free copy of your file so that you might determine reasons for the rejection.

D. What If My Application for Credit is Denied?

1. Lenders. Borrower must be notified by the lender denying the credit in a timely manner, usually not more than 30 days following rejection.

2. Reporting agencies. Applicant is entitled to obtain from the credit reporting agency:
   a. All of the information it has in its file on the borrower.
b. Sources of the information.

c. Names of all creditors to whom the agency had furnished reports within the preceding six months.

3. Errors. If a mistake is found, the credit reporting agency must quickly correct it. If there is a dispute over a debt, the agency must include the borrower's side of the story (up to 100 words).

. Examples: Information could be out-of-date. Data might be incomplete. Details may be inaccurate. Rejected applicants have the right to confirm, correct, or delete information from each credit reporting agency containing negative data. This is accomplished by the rejected applicant completing a "consumer's 100-word statement" clarifying the dispute. Agencies must maintain these in their files and send a copy to the denying creditor.

IV. LOAN CLOSING

A. Who is Responsible for Closing the Loan?

Handled by independent third parties, usually independent escrow or title insurance companies. In Southern California it is customary for the escrow function to be handled by independent escrow companies or the escrow department of banks and title companies. In Northern California, it is more common for escrow departments within the title companies to handle the escrow.

B. Who Else is Involved?

All parties involved in the real estate transaction deliver their instructions, documents, and money to the escrow agent. These include the lender, buyer-borrower, seller, and broker.

C. When Do I Get My Money?

After all the instructions have been complied with, the escrow is closed. The escrow agent records certain documents such as the grant deed and deed of trust, prepares closing statements, and disburses the funds that have been deposited from lender and buyer.
V. LOAN DOCUMENTS

A. What is the Role of a Preliminary Title Report?

A preliminary title report is ordered during the course of the loan escrow. Issued by a title company, it contains the legal description and information regarding taxes, bonds, assessments, conditions and restrictions of record, existing deed of trust, liens, and judgments - in short, all encumbrances of record. This information is useful to the lender, escrow, and the borrower.

B. What Documents Are Prepared by the Lender?

1. Promissory Note.
2. Deed of Trust.
3. Federal Reserve Board’s Regulation Z Disclosure Statement, reflecting the loan Annual Percentage Rate (APR). This must be given to the borrower before the loan is closed.
4. Escrow instructions and rescission statement, in the case of refinance transactions.

C. Where Are these Loan Documents Maintained?

After escrow is closed, the original note is returned to the lender. The deed of trust is recorded, then returned to the lender by the Title Company.

VI. TRUTH IN LENDING (TIL)

A. What is the Purpose of TIL?

To help borrowers understand the cost of borrowing money. Since each lender is required to disclose its costs in the same way, the borrower is able to compare the lender's costs against others. The comparison tool is called the Annual Percentage Rate, or APR for short.

B. What is the APR? It is more than just an interest rate. It is a simple way of informing the borrower of the real cost of the loan in percentage terms. To arrive at this, the interest is added to certain other costs and charges, as shown in the Disclosure Statement. The APR computation is considered accurate if the rate is within 1/8% of the actual rate, rounded to the nearest 1/4%
C. How is the Effective Rate computed?

INSTRUCTOR: THIS SECTION MAY BE DELETED ALTOGETHER BY SIMPLY POINTING OUT THAT TABLES ARE USED BY LENDERS THAT DO ALL OF THE CALCULATIONS. OR USE A FINANCIAL CALCULATOR, SUCH AS APPLIED IN LESSON THIRTEEN, TO ILLUSTRATE APR CALCULATIONS.)

1. Example 1. Assume you borrow $10,000 for one year. The interest quoted is 9%. Assume that there are no loan costs. At the end of the year, you agree to pay back the $10,000 principal plus 9%, or $900 in interest. In this simplified example, the APR is identical to the quoted, or nominal, rate of 9%, computed as follows:

\[
\text{APR} = \frac{\text{Interest}}{\text{Money Received}} = \frac{900}{10,000} = 9\
\]

2. Example 2. Same as above, except lender collects a $200 service fee in advance. You would receive $9,800, not $10,000. The APR is computed as follows:

\[
\text{APR} = \frac{\text{Interest and Service Charge}}{\text{Money Received}} = \frac{1,100}{9,800} = 11.22\%\
\]

D. How Do Prepaid Finance Charges Impact APR?

1. Federal Reserve Board tables. The APR is computed by adding the total interest paid over the life of the loan plus so-called "prepaid finance charges". This figure is then compared to the "amount financed" and, with the use of tables provided by the Federal Reserve Board, an APR is derived, calculated to the nearest 1/4%.

2. Elements of prepaid finance charges. When there are no prepaid finance charges, the APR is identical to the nominal rate. It is prepaid finance charges that increase the APR. Prepaid finance charges include loan origination fees, interest paid in advance, tax service fees, and "discounts", even if these are paid by the seller.

E. Rescission Rights.

Certain loans are rescindable within three days. This means that the borrower has three full days after agreeing to the loan to cancel if desired. Rescindable rights apply only to refinancing of a borrower's existing home and to junior loans. There are no rescission rights for a loan purchase.
VII. CLOSING COSTS

A. Non-recurring Closing Costs

These represent a one-time charge that borrowers pay at close of escrow, including:

1. Loan Origination Fee. This compensates the lender for expenses incurred in processing the loan, usually stated as a percentage of the loan. If the loan amount is $1,000 and the loan fee is 1% (or one point), the loan fee will be $10.00.

2. Title Policy. Insures buyer's and lender's interests in the property against title defects. In California there are two basic types of coverages: California Land Title Association (CLTA) form, and American Title Insurance Association (ALTA). Most lenders require the ALTA policy, because it provides added protection for lenders through coverage of so-called "off-record" items.

3. Escrow Fee. This is a charge for handling and supervising the escrow functions. As with title policies, custom indicates who pays for the fee, subject to negotiation by the parties involved.

4. Credit Report. The lender passes on the cost of credit reports to borrower. Charges usually range from $50 or more for each report. The report the lender uses is more than just a credit report. It is referred to as a standard factual and contains credit information from at least two credit bureaus.

5. Appraisal. The cost of an appraisal report varies with the type of loan. FHA and DVA charge $150 to $250 for appraising a single-family dwelling. Appraisals for conventional loans can run much higher, depending upon the property.

6. Tax Service. Paid to a tax service agency in exchange for an annual review of the records of the taxing agencies. The tax service agency reports any delinquency to the lender.

7. Notary Fee. Signatures on certain documents, such as trust deeds, must be acknowledged before a notary public before they can be recorded.

8. Recording Fee. This covers the cost of recording the deed of trust, grant deed, and certain other documents.
9. Pest Control Inspection Fee. This is usually paid by the buyer. The charge varies from area to area.

10. Document Preparation Fee. This is usually paid by the buyer for preparation of the loan documents.

B. Recurring Closing Costs

These costs are also referred to as "prepaid" items, since the buyer is paying for future expenses in advance.

1. Tax Reserve. Also called an impound, escrow, or trust account. It consists of a monthly loan payment of principal, interest, taxes, and hazard insurance. For FHA and DVA loans, the collection is mandatory. In other cases, setting up such reserves is optional.

2. Tax Proration. Virtually all sales agreements call for proration of taxes between buyer and seller. For example, if taxes for the first half of the current fiscal year have been paid and escrow closes on October 15, the buyer would need to reimburse the seller for the unused period, October 15 through December 31, for a total of 2 1/2 months.

3. Hazard Insurance Reserve. When the monthly payments include insurance, a two-month reserve is usually collected.

4. Hazard Insurance Premium. Lenders require that property offered as security for a loan be covered against loss due to fire, windstorm, and other hazards.

5. Prepaid Interest. This refers to interest that is collected in advance at close of escrow, and therefore labeled "prepaid interest". For example, if escrow closed on September 30, there would be one day of interest charged on the loan. If it closed on September 29, interest for two days would be charged. If it closed on October 1, the lender could charge 31 days prepaid interest. Note: interest is always charged on the actual days in the month.


7. Private Mortgage Insurance Premium. Check latest policies and practices that vary from insurer to insurer.
VIII. SERVICING THE LOAN

A. Loan Payments. After the loan has been placed and escrow closed, the borrower is notified about the method of making the payments. The two most common methods are:

1. "Monthly billing" method. Lenders mail notice of payment due prior to the first of each month. This is usually a computerized printout. Borrowers mail back their payments with the notices.

2. "Coupons" method. Once a year lenders send their borrowers a set of twelve coupons. Each month, the borrower sends in a payment along with the coupon for that month. This method of billing is becoming increasingly rare.

3. A third method is an automatic debit to the borrower's bank account.

B. Late Charges

The amount of any late charges and at what point they are assessed is stated in the note or trust deed. But beyond that maximum charges are prescribed by law, as follows:

1. FHA. 2% of the monthly payment if not paid within 15 days of the due date.

2. DVA. 4% of the monthly payment if not paid within 15 days of the due date.

3. Cal-Vet. Payments are late if not made by the 10th of the month. Thereafter a late charge of $10 is due.

4. Conventional Loans. Late charges vary, though they may not exceed 6% of the installment of principal and interest with a $5 minimum. This limitation applies only to single-family, owner-occupied dwellings. Borrowers must also be given a minimum of 10 days from the due date to make the payments.
C. Prepayment Privileges and Penalties

1. Privilege

Most loans allow borrowers to make additional extra payments on the principal balance without a penalty. This is called a prepayment privilege. Typical conventional loans allow 20% per year. As an example, if the original loan amount was $100,000, the borrower could make an extra payment of $20,200 (20% x $100,000 = $20,000) per year. If the borrower exceeds this amount, a prepayment penalty may be charged if the notification is specified in the promissory note and the deed of trust.

2. Penalty

While there is no standard prepayment penalty on a conventional loan, any loans made on owner-occupied, single-family dwellings since 1975 cannot contain a penalty after the fifth year. During the first 5 years, the penalty is limited to six months' interest on the amount prepaid that exceeds 20% of the original principal balance.

3. FHA and DVA

These loans do not permit penalties for early payoff. However, on FHA loans, the borrower must inform the lender within 30 days in advance if the loan is to be paid off in full. If written notice is not given, the lender may charge an additional 30 days' interest.

4. Cal-Vet

For Cal-Vet loans made after March 1, 1998, the Cal-Vet contract does not have a prepayment service charge. For loans made prior to that date, it is department policy to charge approximately 2% of the original loan amount if the loan is paid off within the first two years.

D. Loan Assumptions

1. Occurrence

A loan is said to be assumed when a new buyer-borrower is approved by the lender and a formal assumption agreement is executed.
2. Formalities
For the seller to be relieved of liability, the new borrower must formally assume the loan under an assumption agreement that releases the seller.

3. Alienation clauses
Most conventional loans have alienation clauses giving lenders the right to approve any new trustor. Additionally, lenders may charge an assumption fee and adjust the interest rate.

4. "Subject to"
When a buyer purchases a property and takes over the existing loan without assuming it, he is purchasing "subject to" the loan. In this situation, the original borrower will remain primarily responsible for the loan. If a foreclosure sale results in a deficiency, the original borrower may be held liable under a judicial foreclosure.

5. Note provisions
A loan can be taken "subject to" if the original note and deed of trust do not contain an alienation clause. FHA and VA loans have not contained alienation clauses, but are moving in that direction. These loans can ordinarily be taken subject to or assumed without any change in the interest rate or term, subject to some underwriting restrictions. The lender thereafter changes the records to reflect the new owner.

6. Cal-Vet
These loans may be assumed by another qualified veteran at the same rate of interest.
LESSON TEN MULTIPLE-CHOICE QUESTIONS

Directions: Underline the letter representing the correct answer.

1. APR, as used under Regulation Z, stands for:
   (a) Annual Property Return
   (b) Annual Percentage Rate
   (c) Annuity Percentage Rate
   (d) Amortized Property Return

2. The most important information sought by lenders for a potential borrower is the:
   (a) age and sex of the borrower
   (b) need for a loan
   (c) credit history of the applicant
   (d) racial makeup of the area in which the property is located.

3. Processing an application for a real estate loan includes verifying:
   (a) employment
   (b) deposits
   (c) debts
   (d) all of the above

4. Under the Fair Credit Reporting Act, an applicant who has been denied credit is entitled to receive the following information from the credit reporting agency:
   (a) sources of the information
   (b) the financial standing of the reporting agency
   (c) reason for the denial
   (d) only the data which the agency provided the lender that rejected the loan

5. The final step in the loan procedure is:
   (a) servicing
   (b) qualifying the borrower
   (c) processing
   (d) qualifying the property

6. A federal law that prohibits discrimination in lending solely on the basis of sex or marital status is the:
   (a) Equality in Sex and Marital Status Act
   (b) Equal Credit Opportunity Act
   (c) Truth in Lending Act
   (d) Fair Credit Reporting Act

7. Credit reports on which of the following types of loans may be accomplished by telephone?
   (a) government-backed loans
   (b) loans to be sold in the secondary market
   (c) all conventional loans
   (d) none of the above
8. Which of the following is a recurring closing cost?
   (a) Property taxes
   (b) Property insurance
   (c) Loan interest
   (d) All of the above

9. A document issued by a title company which contains the legal description, status of liens, taxes, conditions and restrictions, but which does not insure the title to the property is labeled:
   (a) title policy
   (b) property disclosure statement
   (c) preliminary title report
   (d) statement of information

10. "Non-recurring closing costs" include:
    (a) prepaid taxes
    (b) tax service fee
    (c) tax reserve
    (d) capital gains taxes

11. Since most lenders are subject to the Equal Credit Opportunity Act, they are allowed to ask applicants about:
    (a) any obligations to pay child support
    (b) their religious affiliation
    (c) current marriage plans
    (d) number of children they plan to have

12. The escrow holder is forbidden to close escrow until there is compliance with the instructions of:
    (a) the lenders involved in the transaction
    (b) the principals
    (c) both lenders and principals
    (d) neither lenders nor principals

13. Except where the lender is automatically approved or endorsed, the completed loan package for FHA or VA loans goes directly to:
    (a) the loan committee
    (b) the screening loan committee
    (c) the appropriate appraisal section
    (d) the mortgage credit section

14. The Real Estate Settlement Procedures Act was designed to:
    (a) reduce settlement costs
    (b) standardize settlement costs
    (c) disclose both a and b
    (d) neither a nor b apply
15. Which of the following loan documents are prepared by the lender?
   (a) Promissory Note
   (b) Deed of Trust
   (c) Regulation Z Disclosure Statement
   (d) All of the above

16. If you borrow $100,000 at 10% for a year and the lender collected 3 points, or $3,000 origination fees, what is the APR?
   (a) 9.8%
   (b) 10.0%
   (c) 13.0%
   (d) 10.37%

17. Which of the following is not classified as a non-recurring closing cost?
   (a) credit report fee
   (b) appraisal fee
   (c) escrow fees
   (d) property insurance premiums

18. A conventional lender allows a 20% prepayment per year. You borrowed $95,000 four years ago at 9% and the loan balance is $90,000. What is the maximum amount that you can prepay without a prepayment penalty?
   (a) $10,450
   (b) $18,000
   (c) $19,000
   (d) none of the above

19. A loan assumption is best described as:
   (a) when a takeover borrower is approved by the lender
   (b) property sold "subject to"
   (c) timely payments on a secured loan
   (d) any of the above

20. The "Truth in Lending" law is designed principally to:
   (a) discourage usurious lending practices
   (b) encourage uniform lending policies
   (c) prohibit wholesale advertising of financing terms
   (d) allow consumers to make more informed borrowing decisions
LOAN PACKAGE

- APPRAISAL REPORT
- BORROWER'S APPLICATION
- VERIFICATION OF EMPLOYMENT
- VERIFICATION OF DEPOSIT
- PURCHASE CONTRACT & RECEIPT FOR DEPOSIT
- ESCROW INSTRUCTIONS
- PRELIMINARY TITLE REPORT
- OTHER SUPPORTING DOCUMENTS
NON-RECURRING CLOSING COSTS

- Loan Origination Fee
- Title Policy
- Escrow Fee
- Credit Report
- Appraisal
- Tax Service
- Notary Fee
- Recording Fee
- Pest Control
- Inspection Fee
- Document Preparation Fee
RECURRING CLOSING COSTS

- TAX RESERVE
- TAX PRORATION
- HAZARD INSURANCE RESERVE
- HAZARD INSURANCE PREMIUM
- PREPAID INTEREST
- PRIVATE MORTGAGE INSURANCE RESERVE
- PRIVATE MORTGAGE INSURANCE PREMIUM
LESSON ELEVEN
HOW DO FORECLOSURES AND OTHER LENDING PROBLEMS FIT INTO REAL ESTATE FINANCE?

PREVIEW:
This unit covers a variety of problems connected with repayment of real estate debts. Students are familiarized with some of the provisions contained in a trust deed that lead to default and with the foreclosure procedure. Ways that foreclosure losses can be mitigated and prevented are examined in detail.

PERFORMANCE OBJECTIVES:
After completing this lesson, you should be able to:

1. Explain the collateral provisions of a trust deed.
2. Outline the steps in foreclosure proceedings.
3. Contrast "Power of Sale" with "Deed In Lieu of Foreclosure".
4. Explain how an "Assignment of Rents" clause protects real estate lenders.
5. List five ways that losses through foreclosure can be minimized or mitigated.
6. Explain the use of private mortgage insurance (PMI) in foreclosures.
7. Argue for or against the collecting of confidential data required of lenders under the Community Reinvestment Act.

I. WHAT ARE SOME COLLATERAL PROVISIONS FOUND IN TRUST DEEDS?

A close inspection of a trust deed will disclose a variety of clauses designed to reduce the chance of default and foreclosure. Even if the trustor is current in the payments, the beneficiary can still foreclose should the trustor default in the performance of any of the collateral provisions, especially in the following areas:

A. Maintenance of the Property. The typical trust deed requires the trustor to:
1. Maintain the property in a state of good repair and shall not commit waste, permanent impairment, or deterioration of the property.

2. Pay for labor and materials whenever improvements are made.

3. Comply with local building ordinances and other laws affecting the property.

B. Property Hazard Insurance

1. Trustor (borrower) agrees to maintain basic fire and windstorm insurance. The policy reimburses the lender and homeowner for certain enumerated losses.

2. "Loss payee" clause in favor of the beneficiary is included, allowing the lender to use the insurance proceeds to reduce the loan indebtedness, or to turn the funds over to the owner to rebuild.

3. Failure by the trustor to maintain satisfactory insurance allows the beneficiary to obtain a policy and charge the cost to the trustor. This cost is added to the principal, constituting an "advance" to the trustor.

C. Property Taxes and Other Liens. Trustor agrees to pay for property taxes, assessments, and all other liens.

D. Assignment of Rents. This clause provides that upon default on loans where the security is income-producing, beneficiary (lender) may take possession of the property and collect the rents, applying them to the loan and to the costs and expenses incurred.

II. DEFAULT AND FORECLOSURE

Borrowers default for a variety of reasons: financial reversals, loss of job, death, disability, bankruptcy, divorce, or poor budgeting. Most lenders avoid foreclosure action wherever possible, using it only as a last resort, since lenders are in the business of lending money, not in the business of owning real estate.

Foreclosure may be accomplished through either Trustee's Sale or Court Action.

A. What is a Trustee's Sale?

A "power of sale" clause found in a trust deed empowers the trustee, in case of default by the trustor, to sell the property at public auction. California law prescribes the steps which trustees must follow:
1. Notification by Lender. The beneficiary notifies the trustee that there is a default, and delivers the original note and trust deed along with other evidence of advances (taxes, insurance) made by the beneficiary to protect the security. "Bene" signs a Declaration of Default and requests trustee to start foreclosure.

2. Notice of Default and Election to Sell.

   a. The trustee records this notice in the county where the property is located, at least three months before a notice of sale is advertised. This notice must contain a correct legal description, name of trustor, nature of the breach, and a statement to the effect that the beneficiary has elected to sell the property in order to satisfy the obligation.

   b. A copy of the Notice of Default must be sent by registered or certified mail within one month after its recording to anyone who has recorded a "Request for Notice", and to a number of other parties that are enumerated in Civil Code Section 2924 (such as vendees, successors in interest).

   c. The trustor may reinstate the loan up to five (5) working days prior to the date of sale. In addition to paying all delinquent installments and late charges, the trustor must also pay costs and trustee's fees.

3. Notice of Sale

   a. Three months (not 90 days) after the notice of default (NOD) is recorded, the trustee is instructed by the beneficiary to record a "Notice of Sale" if the default has not been cured by the Trustor.

   b. After first recording the Notice of Sale in the county where the property is located, the Notice must be published in a newspaper of general circulation once a week for three weeks. Each published notice must not be seven days after the previous publication.

   c. It must also be posted in a public place, such as a courthouse. A copy must be attached to some portion of the property, such as a front door, if there are structures on it.

   d. Copies of the Notice of Sale must also be sent to all those entitled to a Notice of Default.
e. The defaulting trustor has up to 5 days preceding the date of sale to bring current all delinquent payments, plus interest and costs. Thereafter the beneficiary could insist on repayment of the entire outstanding obligation in full.

4. Final Sale
   a. The earliest that the sale can occur is three months plus 21 days after the NOD is recorded.
   b. Any party, including the trustor, trustee, or beneficiary, may bid on the property through auction.
   c. The holder of the debt (beneficiary) may offset (called "credit-bid") the amount owing, up to the amount of debt owed the creditor plus interest and costs.
   d. A "Trustee's Deed" is issued to the successful bidder.
   e. After paying off all liens and expenses, any surplus funds are given to the trustor.
   f. There is no right of redemption after a trustee's sale.
   g. The purchaser acquires all rights held by the former owner, and is entitled to immediate possession, subject to those having rights before the trust deed was foreclosed.

B. Judicial Sale

Trust deeds may also be foreclosed as a mortgage, that is, through court action. Called "judicial foreclosures", court-conducted sales usually occur only when the lender seeks a deficiency judgment. Judicial foreclosures are almost non-existent in the case of owner-occupied dwellings, but common for income-producing properties.

1. Procedure:
   a. A complaint is served upon the defaulting debtor.
   b. Trial is held, and judgment entered through a "decree of foreclosure and order of sale".
   c. The debtor has the right to reinstate by paying all delinquent installments plus costs and attorney's
2. Sale
   a. The trial court conducts a public auction.
   b. The highest bidder receives a Certificate of Sale conveying title, but not possession.
   c. The debtor may have a right of redemption for up to one year thereafter. If no redemption is made within this time, a Commissioner's or Sheriff's Deed is issued to the successful bidder. The deciding factor as to the length of time the debtor will remain in the property after the sale will depend on whether there has been a deficiency judgment given to the creditor.

3. Deficiency Judgments
   a. In the event a sale does not bring in enough funds to satisfy the debt, a deficiency judgment could be obtained by the creditor.
   b. Certain types of transactions do not permit deficiency judgments. The most important exception is that of a "purchase money" loan or dwellings up to four units. Where a couple purchases a home for their own occupancy, for instance, and thereafter lose it through foreclosure action, no deficiency judgment is allowed.

4. Deed in Lieu of Foreclosure
   a. To avoid costly and time-consuming foreclosure proceedings, lenders may accept a voluntary conveyance from the defaulting borrower. This is usually accomplished by a quitclaim deed, used as an alternative to foreclosure.
   b. Such an action eliminates the stigma of a foreclosure suit, so that debtor's credit is not severely impaired.
   c. Acceptance of deed in lieu of foreclosure is not automatic. Lenders may want to satisfy themselves that there is adequate collateral, and that there are no unknown, hidden liens against the property.
5. Request for Notice of Delinquency.

a. Reason for its use. Holders of senior loans frequently let many months go by before recording a Notice of Default. Usually motivated by a desire to help defaulting borrowers, this practice invariably hurts those holding junior instruments, especially sellers who carry back paper. One solution is to insert a Notice of Delinquency provision (as provided by Civil Code Section 2924e) into the trust deed by holders of secondary financing.

b. Effect. Once recorded, the Notice of Delinquency clause requires that creditors of underlying liens, including the first trust deed holder, notify the junior holder when payments on the underlying lien are late.

III. WHAT ARE SOME OF THE WAYS TO MITIGATE DEFAULT?

Where a loan is marginal due to a borrower's questionable or "tight" credit rating, the borrower is more likely to default. Result: lender ends up with a sour loan, followed by foreclosure and loss of property.

The following are ways to minimize, or mitigate, the chance of loss to borrowers and lenders: establishing impound accounts, lender forbearance, insuring the loan, automatic payment plans and consumer protection legislation.

A. Impound Accounts

1. Pro rata portion of the annual property taxes and insurance is paid each month. This forces debtors to budget each month amounts that would fall due in large sums if paid only once or twice a year.

2. Spreading the payments equally over twelve months reduces the chance of default.

3. Other names. Some lenders and agents refer to the impound account as an "escrow account" or "loan trust fund."

B. Forbearance.

Lenders often make special arrangements to help defaulting debtors retain their properties. Such arrangements to forestall foreclosure action is referred
1. Moratorium.
This is a temporary suspension or waiver of payments. It acts to delay or defer action for collection of a debt, with five variations.

a. Waiver of Principal. This is a suspension of principal payments, so that delinquent borrowers can regain their financial equilibrium. Only interest is paid.

b. Waiver of Interest. Interest is not forgiven, but added to the principal indebtedness, similar to negative amortization. In VA loans, interest which accrues during a period of forbearance becomes a part of the guaranteed indebtedness. VA lenders, or those who have bought mortgages that have since gone sour, can therefore assist veterans through forbearance without suffering loss.

c. Waiver of Principal and Interest. A moratorium of the entire loan may be negotiated where the interests of both creditor and debtor are concerned. For instance, a debtor who has become unemployed may need some time to find a new job.

d. Partial Payments. Lenders may agree to accept partial payments. VA encourages holders of GI loans to extend such privileges so that veterans may be given every opportunity to retain their homes while awaiting financial recovery.

e. Prepayments. Payments made in advance may have been credited to principal in the past. These may now be reapplied for the purpose of curing a default or preventing a subsequent default.

2. Recasting.
In order to assist delinquent borrowers, lenders may agree to modify or re-arrange the loan in at least three ways:

a. Extended Term. Extending an existing loan that has, say, 10 years remaining of the original 25-year term will result in lower monthly payments.
b. Increasing the Loan. Where the debtor's financial reversals appear to be temporary in nature, lenders may increase the debt. The interest rate may also be increased. By extending the term, the payments can be held down.

Under VA-backed loans, advances may be made for maintenance, repairs, taxes, assessments, and hazard insurance.

c. Reduction of Interest. Lenders might reduce the interest rate if the market reflects a lower rate than stated in the contract. For example, an existing 101/2% rate might be reduced to 10% when the market is at, say, 91/2%

C. Insurance of Loans

Financial interests of lenders can be most effectively protected through insurance of loans.


Lenders are much more willing to extend high loan-to-value ratios that are supported by government insurance or guarantee.

a. Federal Housing Administration

i. Lender risks are eliminated through the federal insurance plan dubbed MIP, for Mortgage Insurance Premium. FHA is not the lender, but insures the loan made by a qualified lender, such as a savings bank.

ii. The borrower pays for the MIP. The premium is approximately 1.50% of the loan amount plus 1/2% of the loan amount as a monthly charge, as discussed in Lesson 6.

b. U.S. Department of Veterans Affairs

i. Guarantee. The VA guarantees up to $60,000 of the balance of a loan, or the amount of actual loss, whichever is less.

ii. Example. A property goes on the auction block for $79,000 at a time when there is $85,000 owing. The maximum liability is the lesser of the $85,000 loan balance or $6,000, the actual loss (ignoring foreclosure costs).
iii. Actual practice. The VA will either take the property and pay off the loan balance, or let the lender keep the property and pay the lender up to the maximum $60,000.

iv. Subrogation. Unlike the FHA-insured program, there is no charge to the veteran for the guarantee. However, should the DVA be required to make good on a loan, the DVA would have right of subrogation for the amount paid.

v. Release. If the veteran sells the property secured by a DVA loan, the vet may pay off the existing loan in full or secure a written release from the DVA. To qualify for a release, the:

(a) loan must be current

(b) purchaser-transferee must be acceptable to the DVA

(c) purchaser must agree to assume both the loan and the original indemnity agreement.

vi. The DVA does employ a charge like FHA's MIP. It is called a funding fee. The amount will vary from 1.25% to 2%, depending on the amount of down payment, the status of the veteran, and whether he is a first or second time user.

c. California Veterans Farm and Home Purchase Act

i. Requires life and disability insurance on the borrower. This "Home Protection Plan" insures the debtor's life for the amount of the unpaid loan balance.

ii. Permanent total disability benefits are included for veterans under age 62 and employed full-time, including housewives. Disability payments are made monthly after the first three months of total disability, continuing until the contract is paid off or terminated.

2. Private Mortgage Insurance (PMI)

Designed especially for low down payment home loans, PMI plans help reduce or eliminate loss on conventional mortgage loans with down payments of less than 20%. PMI has the following features:
a. Down payment. Buyers can acquire a property with less than 20% down.

b. Interest rates. Due to the insurance feature, buyer can get a standard interest rate even though the low down payment is riskier to lender.

c. Insurance account. PMI insures only the upper portion of the loan, measured by the difference between buyer's down payment and up to 25% of the house price. (By contrast, FHA insures the entire loan amount.)

d. Loan amount. Mortgage insurance companies typically insure up to the maximum loan repurchase via the Fannie Mae/Freddie Mac secondary market. This was $300,700, effective 1/1/2002, and is adjusted with changes in median home prices. (By contrast, FHA insures only up to its maximum loan amount, $251,609 in 2002.)

If less than 20% down payment is made, PMI companies require that at least 2% of the down come from buyer's own resources, and not from gifts.

e. Losses. PMI pays lender's loss if borrower fails to pay, regardless of cause. (By contrast, "mortgage insurance" sold by life insurance companies pay the mortgage balance only if the insured debtor dies.)

f. Premiums paid by the insured borrower include a one-time up-front payment plus two months at closing plus annual installments paid monthly thereafter. The amount of the premium will depend on the loan-to-value, loan program, and the lender's desired coverage.

g. PMI can be avoided, as shown above, by insuring that the down payment is 20% or more. However, the best way to avoid PMI is to break up your loan amount into two separate loans. Known as an 180-10-101 or an 180-15-54 this means that you would obtain an 80% first trust deed and a 10% or 15% second trust deed. You would then put down either 10% or 5% in cash. Since the first trust deed is limited to 80%, PMI is not charged.

D. Automatic Payment Plans.
1. Many lenders offer automatic mortgage pay plans. A system of pre-authorized monthly mortgage payments is set up, relieving the homeowner of the chore of writing checks and protects debtors who might otherwise forget to make payments. Debtors simply authorize their banks to make an automatic monthly deduction from their accounts and to forward the monthly installment to the lender.

2. "Transmatic" is the term used by many lenders. By whatever name, this pre-authorization plan is a precursor of the so called Electronics Fund Transfer System (which may someday usher in the "checkless society").

E. Consumer Protection

Other ways to mitigate or reduce the chance of loss is through consumer laws and regulations, and through contract.

1. Public

a. Federal. Truth-in-Lending, covered in Lesson 9, is one of the Federal laws that protects real estate buyers. This requires full disclosure of all borrowing charges, along with the "effective" or "Annual Percentage Rate" (APR) so that prospective borrowers are in a better position to shop wisely for loans.

b. State. California protects consumers by providing rights to cancel home improvement contracts within three business days from date of solicitation by door-to-door salesmen. Too often homeowners, especially first-time buyers, exceed their ability to repay debts, resulting in default and foreclosure. This also applies to refinance loans.

2. Private

a. Defects. Though no statistics are available on how many defaults have resulted from defects in housing, costly repairs do contribute to lender risk.
b. Warranty programs are available for buyer protection. Usually effective for one year, they normally cover the major components of the house, including plumbing, electrical system, heating system, hot water heaters, garage door openers, limited pest control work and most built-in appliances. Optional coverage is available for items like dryers, washers, refrigerators, air conditioners, limited roof leaks, pool and spa equipment at additional cost.

F. Charging Higher Interest

1. Shifting losses. One way that lenders may offset potential loss is to charge higher interest rates. They reason that they can better absorb delinquencies by shifting losses to the higher interest rates paid, in effect, by non-delinquent borrowers.

2. Private lenders. Sellers who are dissatisfied with yields from other investment sources, may increase the sale price of the property, effectively increasing the loan amount and thereby the risk of loss.

   a. Example. Owners are selling their property to buyers who have only a small down payment. Sellers are asked to carry back a relatively large "second". As a trade-off, they increase the price by, say, 5% or more. Even if the second is carried back at only a nominal 10% interest rate, the yield is effectively increased by the additional amount of money included in the junior loan.

G. Short Payoffs

A significant decline in home values took place throughout California, especially in Los Angeles County, from 1990-1994. In some cases home values fell below the loan balance. As a result lenders have been forced in many cases to work out what is termed short payoffs or short sales. Rather than foreclosing on defaulting sellers who cannot sell their homes at prices sufficient to cover the loan plus normal selling costs, lenders compromise the debt, accepting less than what is owed, especially where the costs of foreclosing would likely exceed the loss taken through a short payoff. The reduction, however, is considered profit which the trustor must report as profit in his or her income tax forms.
A. Definition. Blanket refusal to lend money in high-risk areas, usually older urban neighborhoods containing high minority concentrations. No consideration is given to the credit worthiness of the individual applicant for the real estate loan.

B. It is a prohibited practice as specified in the Housing and Financial Discrimination Act of 1977.

C. Rationale. By refusing credit, the lender hopes to reduce exposure to defaults. But in the process decay of the "closed" neighborhoods appears to be hastened. Those homes that are financed often end up abandoned and foreclosed.

D. Disclosures. Major federally-regulated mortgage lenders are now required to disclose publicly exactly where they make their loans. Similarly, in the case of state-chartered lenders, California law prohibits denying credit or altering the terms of a loan solely because of neighborhood factors. Lenders must notify rejected applicants reasons for denial within 21 days of the application.

E. Evaluation. Lenders must qualify houses on the merits of the individual houses, not on the neighborhoods in which the housing is located.

F. Community Reinvestment Act (CRA). To stop redlining practices, Congress passed the CRA that requires federally-supervised financial institutions to disclose lending data in their lobbies and elsewhere. The Financial Institutions Reform, Recovery and Enforcement Act requires lenders to report data on the race, gender, income, and census tract of loans they make. Purpose: "to assist in identifying discriminatory practices and enforcing anti discrimination statutes".

The law encourages offering mortgages for low and moderately-priced housing and other credit needs for low and moderate-income families.
LESSON ELEVEN MULTIPLE-CHOICE QUESTIONS

Directions: Underline the letter representing the correct answer.

1. Reasons for defaulting on the repayment of a real estate debt are many and varied, including all but one of the following:
   (a) dissolution of marriage
   (b) loss of earnings
   (c) low loan to value ratio
   (d) disability

2. Following foreclosure sale, surplus funds remaining after paying off all costs, fees, expenses and liens are given to:
   (a) successful bidder
   (b) trustee
   (c) beneficiary
   (d) trustor

3. "Forbearance" helps defaulting borrowers in a variety of ways. Which of the following illustrates forbearance?
   (a) Imposing a moratorium on principal payments.
   (b) Extending the term of the loan.
   (c) Reducing the contract interest rate.
   (d) Any of the foregoing.

4. A temporary suspension or waiver of payments on a debt is termed:
   (a) moratorium
   (b) forestallment
   (c) prepayments
   (d) recasting

5. The premium rate charged a buyer on an FHA-insured loan is expressed as:
   (a) 2.250%
   (b) 2.025%
   (c) 0.225%
   (d) 2.05%

6. In event of non-payment of property taxes, the beneficiary may pay for the obligation directly and:
   (a) bill the trustor directly
   (b) add the advances to the principal indebtedness
   (c) do both a and b
   (d) do neither a nor b

7. Which of the following parties is not permitted to bid on a property offered at a foreclosure auction?
   (a) Trustor
   (b) Beneficiary
   (c) Other lenders
   (d) Trustee
8. The right of redemption following a trustee's sale is good for:
   (a) one year
   (b) 90 days
   (c) three months
   (d) none of the above

9. A home with a $90,000 DVA loan sells for $70,000 at foreclosure. There is $75,000 owing at time of sale. Ignoring costs, the VA will reimburse the lender:
   (a) $ 5,000
   (b) $10,000
   (c) $15,000
   (d) $36,000

10. Trustors under a deed of trust became delinquent in their monthly payments, thereafter abandoning the premises and moving to another city. Which of the following actions is NOT part of the foreclosure procedure?
   (a) Notify trustors of default
   (b) Issue a Reconveyance Deed
   (c) Publish Notice of Sale
   (d) Record Notice of Sale

11. Notice of a trust deed sale must be published in a newspaper of general circulation for a period of at least:
   (a) 15 days
   (b) 20 days
   (c) 30 days
   (d) 60 days

12. Following the statutory redemption period, the successful bidder at a judicial sale of real property receives a:
   (a) Trustee's Deed
   (b) Commissioner's or Sheriff's Deed
   (c) Judicial Deed
   (d) Deed in Lieu of Foreclosure

13. In the event the trustor fails to maintain satisfactory insurance, the beneficiary may:
   (a) cancel the contract
   (b) obtain a policy and charge the premium to the trustor
   (c) waive the insurance until the next anniversary date
   (d) do any of the above

14. Borrowers default for a variety of reasons, including:
   (a) bankruptcy
   (b) poor budgeting
   (c) long-term illness
   (d) any of the above
15. A copy of a notice of default must be sent by registered or certified mail to anyone who has a recorded "request for notice" within how long after it is recorded?
   (a) 10 days
   (b) 15 days
   (c) 1 month
   (d) 3 months

16. The mailing of copies of the notice of default is the responsibility of the:
   (a) trustee
   (b) county recorder
   (c) beneficiary
   (d) superior court

17. To protect themselves against late payments of underlying loans, holders of secondary financing should insert a clause in trust deeds they hold. Such a clause is known as a:
   (a) Notice of Default
   (b) Notice of Delinquency
   (c) Notice of Secondary Financing
   (d) Notice of Late Payments

18. The purchaser of a property through a trustee's sale receives a:
   (a) Quit claim deed
   (b) Certificate of sale
   (c) Sheriff's deed
   (d) Trustee's deed

19. When a foreclosure on a deed of trust is through a trustee's sale, the lender should receive the proceeds from the sale, following recordation of the Notice of Default, in approximately:
   (a) 3 months
   (b) 4 months
   (c) 1 year
   (d) none of the above

20. A federal law whose purpose is to encourage lenders to offer mortgages for low and moderately-priced housing is the:
   (a) Truth in Lending law
   (b) Community Reinvestment Act
   (c) Equal Credit Opportunity Act
   (d) Fair Credit Reporting Act
COLLATERAL PROVISIONS
OF
TRUST DEEDS

- Maintenance of the Property
- Hazard Insurance
- Property Taxes and Other Liens
- Assignment of Rents
FORBEARANCE TO FORESTALL FORECLOSURE ACTION

- WAIVER OF PRINCIPAL
- WAIVER OF INTEREST
- WAIVER OF PRINCIPAL AND INTEREST
- PARTIAL PAYMENTS
- PREPAYMENTS
LESSON TWELVE

WHO ARE THE MAJOR PLAYERS IN CONSTRUCTION FINANCING?

PREVIEW:
In this lesson we define the vocabulary that is used in construction lending, discuss types of properties and sources of financing for each, and describe the various kinds of loans and their costs. How construction loans are disbursed is detailed, and the lesson concludes with mechanics' liens.

PERFORMANCE OBJECTIVES:
After completing this lesson, you should be able to:

1. Explain the basic principles of construction lending.
2. Learn the technical vocabulary associated with construction lending.
3. List five sources of construction loans.
4. Contrast differences between take-out and interim loans.
5. Enumerate those items that determine the cost of a construction loan.
6. Outline the steps taken in filing a mechanic's lien.
7. Spot why construction loans are self-contained, self-servicing loans.

I. TECHNICAL VOCABULARY

A. Wide variety of words, terms and phrases exist that are peculiar to the field of construction lending. The most common:

1. Building Loan Agreement. Contract between borrower and lender establishing the obligations and duties of both parties during the period of construction.

2. Construction Contract. Agreement executed by owner and contractor specifying project to be built, cost, method of disbursement, and other limiting conditions.
3. Cost breakdown. Listing of individual project's component costs, including the building contractor's overhead and profit.

4. Feasibility Study. A study as to whether the proposed project is practical, financially sound, and can be built at the projected cost.

5. Floor Commitment. A commitment specifying a higher amount upon the performance of conditions (ceiling), but guarantees a specified amount upon satisfactory completion (floor).

6. Loss of Priority. Loss of first lien position by the construction loan to potential mechanic's lien claimants due to either (a) prior commencement of work or (b) optional loan advances. Since lenders must have first position, no materials can be placed on the site, and no work done prior to recordation of the first trust deed.

7. Mechanic's Lien. Lien filed by contractors, subcontractors, or materialmen due to failure of obligated party to pay as agreed.

8. Obligatory Advance. A construction fund advanced in accordance with the schedule of disbursement.

9. Optional Advance. Advances of construction funds that are not in accordance with the schedule of disbursement.

10. Plans. Detailed schematic of the proposed project, including both the structure and components.


12. Source of Repayment. Source of payoff for the construction upon completion, normally a takeout commitment.

13. Specifications. Detailed listing of materials or equivalent to be used in performing the construction project. The list is specific as to size, shape, manufacturers, quality and quantity.

14. Subordination Agreement. This is an agreement under which a prior trust deed loan is made inferior or in lesser position to an otherwise junior loan, typically used where a loan on raw land is subordinated to a new construction loan.
15. **Takeout Commitment.** A commitment to make a permanent loan by a financially responsible lender upon completion in accordance with previously submitted plans and specifications after complying with commitment conditions. This loan will pay off the construction loan and, if so identified, subordinated to a previous trust deed loan.

16. **Tri-Party Agreement.** Also called a *Buy-Sell Agreement.* This is an agreement between borrower, construction lender, and permanent lender relative to future delivery of the construction loan upon completion.

**B. Why Study Technical Vocabulary peculiar to construction lending?**

1. Real estate agents are involved in the sale of vacant lots that are or will be the subject of proposed improvements.

2. Buyers of homes as well as existing homeowners inquire about home improvements that they need to finance from outside sources.

**II. TYPES OF PROPERTIES**

A. **Wide scope.** Every conceivable man-made improvement made to land may be used as collateral for a construction loan. Basic lending principles apply to all types of property, whether owner-occupied or income-producing. However, our discussions will be centered around single-family dwellings, condominium projects, and planned unit developments (PUDs).

B. **Financial analysis.** Apartments, office buildings, shopping centers, industrial buildings, and other income producing properties require an analysis of the projected income and expenses.

**III. SOURCES OF FINANCING**

Lenders involved in the financing of construction projects can be classified into one of five categories. It is said that lenders will finance the "right" project. Consequently successful developers match their projects with the "right" lenders.

A. **Commercial Banks.** These account for the largest number and volume of construction loans.
B. Savings and Loan Associations. Since savings and loans are engaged principally in residential loans, their construction activities are designed primarily to support their single-family and apartment house programs.

C. Real Estate Mortgage Trusts. REMTs are increasing their influence in the construction lending field.

D. Life Insurance Companies. This source limits its lending primarily to very large projects.

E. Others. Consists mainly of private and corporate sources. Includes pension funds, labor unions, mortgage companies, and to a very limited degree, FNMA, GNMA, and even some credit unions.

IV. KINDS OF LOANS

There are two basic kinds of construction loans:

A. Construction-Permanent Combination. Under this type of loan, both the construction and permanent loans are originated in advance of construction and secured under one instrument. Hence it is also referred to as a "package" loan. The construction money is disbursed in installments as construction progresses. The permanent loan begins upon the completion of construction. Two variations are common:

1. Firm commitment. The lender approves the ultimate borrowers on the permanent mortgage, has them sign the loan instruments, and makes construction advances directly to the borrowers for payments to the builder. Frequently found in the financing of single-family homes built for an owner under contract with a builder.

2. Contingent commitment. Lender approves the project in advance of construction to make both the construction and permanent loans, but retains the right to approve the ultimate borrower. The legal instruments are prepared so that the permanent loan can be assumed by the ultimate borrower. Found in large-scale projects where lenders provide builders with construction money and the builders refer the buyers to the lender for permanent financing.

B. Short-term. The interim, short-term, straight construction loan is made by a lender other than the lender making the permanent loan. After a construction loan is arranged, it is tied to a take-out loan to pay off construction funds and subordinated funds with a long-term or so-called permanent loan.
VI. LOAN COSTS.

A. Loan tie-in. The costs of a construction loan to the borrower consist of several items.

Lenders may charge a flat fee, usually a percentage of the amount of the loan, at the time the loan originates, increasing the effective rate of return on the loan to the lender.

B. Expenses. Charges may also be made to cover the necessary expenses in the origination and underwriting of the loan, including costs of the appraisal report, credit report, survey, title policy, lawyer's fee, accrued interest, escrows, hazard insurance coverage, and performance bond premiums.

C. Prepaid Interest. Generally interest charges are included in loan costs. Some lenders charge "dutch interest", that is, interest paid on the full amount of the loan and for the full term of construction. The usual practice, however, is to charge interest on funds as they are disbursed.

VI. STAGES IN THE PROCESSING OF A CONSTRUCTION LOAN

The steps normally found in the financing of a construction project include:

A. Preliminary Interview Stage. To properly assess the construction loan request, it is important to conduct an in-depth interview with the applicant in order to gather data relative to the project and collect supporting documentation. The purposes of the interview are to:

1. Determine the nature and scope of the project: is it a single-family, owner-occupied residence, or is it a tract project?

2. Ascertain the location of the subject property, along with its strengths and weaknesses, such as:

   a. Extent and nature of development of the neighborhood.

   b. Supportive facilities, including schools, churches, recreation facilities, available shopping and other services essential to a residential area.
3. Gather biographical data on the owner-builder or contractor. It is essential to determine the experience of the parties involved and their track record in previous projects. The parties should have experience in the type of project under consideration, be it single-family or high-rise apartment house.

4. Determine the extent of equity investment in the project. Whether it be a detached single-family residence or a tract project, normally a 15% to 20% equity position would be required, with the exception of FHA or VA projects involving strong credit-worthy developers.

5. Obtain supportive documentation, including:
   a. Loan application—Outlining project in detail
   b. Financial statements, including a Balance Sheet and Income Statement, for all parties having a financial interest in the project
   c. Plans and specifications
   d. Cost breakdown
   e. Summary of salient features of the project and previous experience of the principals
   f. Construction contract, if applicable
   g. Environmental impact or Coastal Commission report, as applicable
   h. Building Permit
   i. Takeout commitment (permanent financing) or other source of repayment

B. Feasibility Stage. In order to determine the feasibility of a given project, a survey of the area is made to ascertain the following:

1. Nature and extent of competition in the area to be developed.

2. Absorption rate of existing tracts to determine expected length of marketing period.

3. Price range of competitive projects.

4. Determination that supportive facilities are sufficient to meet the needs of the area.
5. Establish that the price ranges are competitive and realistic in terms of cost factors.

6. Relate floor plan and bedroom profile to needs of the area. If the contemplated project is composed of two and three bedroom plans where the need is definitely established for three- and four-bedroom residences, this would affect the marketability of the project.

C. Formal Processing Stage. Upon completion of the feasibility stage and determination that the project is viable, formal processing begins.

1. Appraisal.

   a. Through the use of replacement cost and market data or comparison approaches, a thorough analysis is made of the projected sales prices to determine that they are in conformance with the market place. From the data compiled, values for each unit are established.

   b. A thorough analysis of the cost break-down is performed by a qualified cost estimator to reflect current construction costs in the marketplace, with proper contingency allowance for overruns. The method of construction disbursement is also established at this point.


   a. The following items are normally taken into account to determine what additional funds are required for a building project:

   Required funds:
   - Land acquisition/trust deed payoff
   - Off-site improvements
   - Construction Costs (estimate or contract)
   - Architect's fees
   - Additional costs (marketing, supervision)

   Financing costs:
   - Title charges
   - Loan fees
   - Interest ((estimated)

   Total Financing Costs
   - Construction Loan Amount
   - Funds Required for Completion
b. Credit Investigation of the Principals

i. Reliance on the builder's past performance and payments record is one of the most important parts of administrating construction loans. Hence a thorough credit investigation is made of the principal.

ii. A thorough analysis is performed on all appropriate financial statements with proper verification of assets and their valuation, as well as extent of liabilities. The chief objectives of financial analysis is to determine ability to perform and to determine willingness as well as staying power in case of adversity. Bond requirements for performance and completion are established at this stage.

3. What is the Source for Repaying the Loan?

In the case of single-family residences the examination may not only involve a takeout commitment, but also the commitment of a governmental agency such as VA, FHA, or private mortgage insurer. Important items to consider:

a. Ability of takeout lender to perform, both on the basis of financial strength and past performance. Many construction lenders are required either legally or by lender policy to obtain a loan commitment from a permanent lender so as to determine that the source of repayment is legitimate.

b. Assessment of commitment risk. In a residential housing project, a construction lender assumes the risk that the project is marketable and that it will sell.

i. Reliability of loan terms. Both the rate committed and amount of points required (in FHA or VA projects) will effect the financial success of a construction project.

ii. Conditions for qualifying applicants. Are there realistic standards for income-to-debt service ratio?
Questionable provisions. Some commitments are written "subject to the ability to fund." This is not acceptable as a firm source of repayment. In the case of income property, a "floor" or bottom commitment figure is established for funding purposes, which is approximately 20% to 25% lower than the "ceiling" or eventual loan amount. The ceiling is usually obtainable upon the completion of a certain percentage of occupancy at an established rental rate, together with installation of appropriate tenant improvements.

iv. Realistic expiration date. The date of expiration of the permanent lender's commitment as well as any FHA or VA commitments should realistically coincide with the construction schedule and projected marketing period.

v. Title requirements. Determine that the necessary title insurance policy, approved general plan restrictions, maintenance agreements for common areas, and any required endorsements are obtainable.

vi. Insurance requirements. In addition to the normal fire coverage, flood or earthquake insurance may be required. If the property is in a high fire area, insurers are extremely limited and requirements are more stringent. A geological report may also be required if it is a multi-family project (under California's Alquist-Priolo Specific Hazard Zone).

vii. Tri-Party Agreement. This is the recording of a construction loan on the documents of the permanent lender.

4. Presentation to Loan Committee.

Upon completion of analysis and supportive valuations, a formal presentation is made to the loan committee with specific recommendations:

a. Loan amount. This is generally limited to a maximum of 80% to 85% of value of the improvements.

b. Required documentation, including:

i. Building loan agreement and supporting loan documentation.
ii. Completion guaranty and bond requirements to protect lenders against non-completion of the construction project.

iii. Approved plan of disbursement.

c. Many times the loan committee will impose further requirements, such as additional collateral, revised terms, lower loan amount or cash deposit requirements as safeguards.

D. Closing and Follow-up. Upon satisfactory disposition by the loan committee, the file is transferred to loan closing for assembly and documentation.

1. File Composition. The following items are normally included in a construction loan package:

   Appraisal and Cost Estimate
   Bonds
   Borrower's Note
   Building Loan Agreement
   Building Permit
   Completion Guaranty
   Construction Contract
   Cost Breakdown
   Deed of Trust
   Environmental Impact or Coastal Commission Report
   Financial and Credit Data
   FHA or VA Commitment (FHA conditional on VA Master CRV (if appropriate)
   Geological Report: Alquist-Priolo Zones Inspection Reports
   Insurance: Fire, public liability and property damage, Worker's Compensation, contractor
   Plans and Specifications
   Preliminary Notices
   Soil Report (may be required to determine if ground is stable)
   Takeout Commitment Policy of Title Insurance
2. Closing.

After preparing the documents, disposing various title and permanent lender requirements, the project is ready to record. It is extremely important that no work be performed prior to recordation. If the priority of a trust deed is lost due to prior commencement of work, a reassessment of all financial aspects of the transaction is required to determine the indemnification ability of the applicants, as well as title company requirements.

All disbursements must be in strict adherence to the disbursement schedule. If any deviation of disbursement occurs, all subsequent advances may lack priority due to the optional nature of the advance. Proper construction loan administration should assure lender disbursement to be obligatory in nature, and not optional, in accordance with the disbursement schedule.

3. Follow-up Inspections.

a. Schedule of Payments. A qualified inspector is assigned to the project to substantiate percentages of construction progress in accordance with the disbursement schedule.

While there is no perfect method of construction disbursement, the three most commonly used are:

i. Stage of Completion. Payments on the construction loan are made as construction progresses. For instance, 20% might be paid after the foundation is laid, another 25% after framing is in place, 20% upon enclosure of the structure, 25% following completion, and the balance, 10% after the lien period has expired.

ii. Percentage of Progress. This is an incremental disbursement of funds with the largest portion paid out after the job is substantially completed.

iii. Voucher. Payments are made upon presentation of receipted bills and with appropriate releases by those involved on the job.

b. Supervision. During the construction stage, the project is carefully monitored to assure that potential problems are detected at an early stage as well as the evaluation and disbursement of construction funds.
4. **Completion.**

   a. **Notice of Completion.** A determination is made by inspection that improvements are substantially completed and that a valid "Notice of Completion" is recorded.

   b. **Title insurance.** The title insurer is instructed to issue a title policy to the ultimate purchaser and lender.

   c. **Permanent lender.** Financial information is sent to prospective purchasers for qualification and preparation of loan documents.

   d. **Funding.** Upon execution of permanent loan documentation (take-out commitment) and deposit of equity funds by the purchaser in escrow, the construction loan is paid off and the transaction closed.

**VII. NATURE OF MECHANICS' LIENS**

Mechanics' liens are a major concern to the construction lender and to the builder and ultimate purchaser of the property. California statutes governing liens provide that certain persons, including contractors, subcontractors, materialmen, and laborers, are given a statutory lien upon property which has been improved by their material and work.

These mechanics and materialmen may, upon meeting statutory requirements, file a lien on the property for unpaid bills and file a lawsuit to enforce the lien.

A. **Lien Priorities.** The main concern of the construction lender is to protect itself against liens emanating from a mechanic or materialman that may take priority over the construction loan, or that may intervene in priority between some of the loan advances.

B. **Protections.** Construction lenders could protect themselves against mechanic's liens in several ways.

1. After the trust deed is recorded, and prior to the start of construction, the lender should inspect the site to determine that no materials have been delivered or work performed.

2. During the course of construction, the lender should verify invoices received for labor and materials.
3. Prior to disbursement of the final loan proceeds, the title company and lender should obtain a mechanic's lien affidavit from the builder certifying that all materials and labor have been listed and paid.

4. The lender may withhold final payout until the expiration of the statutory lien-filing period.

5. As additional precaution for the lender, the borrower may be required to secure a completion bond from an insurance company. The lender will be named as the primary beneficiary, in case of borrower default.
1. Completion bonds are used in construction loans to protect:
   (a) the builder
   (b) the owner
   (c) the lender
   (d) each of the above parties

2. The source of repayment of a construction loan is normally accomplished through:
   (a) a takeout loan
   (b) cash flow generated from income-producing property
   (c) sale of the completed project
   (d) bonded indebtedness

3. The determination of the extent of equity investment in a proposed construction project is ascertained in the:
   (a) preliminary interview stage
   (b) feasibility stage
   (c) formal processing stage
   (d) closing and follow-up stage

4. System of disbursements of construction funds upon presentation of receipted bills by contractors:
   (a) Percentage of Progress
   (b) Voucher
   (c) Stage of Completion
   (d) Proof of Billings

5. An agreement between borrower, interim lender, and permanent lender relative to future delivery of a construction loan upon completion:
   (a) Construction Contract
   (b) Building Loan Agreement
   (c) Takeout Commitment
   (d) Tri-Party Agreement

6. Insurance requirements must be met in order to proceed with a construction loan. What type of insurance is usually required?
   (a) fire
   (b) flood
   (c) liability
   (d) each of the above

7. A construction loan may lose its first lien position to mechanic's lien claimants by:
   (a) prior commencement of work
   (b) optional loan advances
   (c) both (a) and (b)
(d) neither (a) nor (b)
8. The largest number and volume of construction loans are made by:
   (a) Commercial banks
   (b) Savings and loan associations
   (c) Real Estate Investment Trusts
   (d) Insurance Companies

9. The document that is filed after a project is substantially finished:
   (a) Notice of Cessation of Labor
   (b) Mechanic's Lien
   (c) Notice of Non-Responsibility
   (d) Notice of Completion

10. Mechanic's liens may be filed against:
    (a) lenders
    (b) contractors
    (c) owners
    (d) any of the foregoing parties

11. Long-term loans to be issued by a lender upon the completion of a construction project are known as:
    (a) redemption loans
    (b) take-out loans
    (c) discount loans
    (d) renewal loans

12. A lien filed by contractors due to failure of obligated party to pay for work of improvement is called a:
    (a) contractor's lien
    (b) improvements lien
    (c) mechanic's lien
    (d) construction lien

13. A construction fund advance made in accordance with the schedule of disbursements is known as:
    (a) optional advance
    (b) priority commitment
    (c) prepayment advance
    (d) obligatory advance

14. An agreement under which a prior trust deed is made inferior or in lesser position to an otherwise junior loan is called an:
    (a) subordination agreement
    (b) junior agreement
    (c) priority agreement
    (d) inferior agreement
15. A detailed schematic of a proposed construction project including the structure and components:
   (a) Cost breakdown
   (b) Plans
   (c) Specifications
   (d) Feasibility studies

16. Another name for an interim loan is:
   (a) take-out loan
   (b) short-term loan
   (c) advance loan
   (d) progress loan

17. Supporting documentation for a construction loan includes:
   (a) cost breakdown
   (b) environmental impact
   (c) plans and specifications
   (d) each of the above

18. The area survey used as part of a feasibility study involves all but one of the following:
   (a) nature and extent of competition
   (b) price range of competition
   (c) historical background
   (d) determination of supportive facilities

19. Which of these items are normally taken into consideration in determining need for additional building project funds?
   (a) Offsite improvements
   (b) Additional market costs
   (c) Both (a) and (b)
   (d) Neither (a) nor (b)

20. A contract between borrower and lender establishing the obligations and duties of both parties during the period of construction:
   (a) Construction Contract
   (b) Building Loan Agreement
   (c) Takeout Commitment
   (d) Bilateral Agreement
STAGES IN THE PROCESSING OF A CONSTRUCTION LOAN

- PRELIMINARY INTERVIEW STAGE
- FEASIBILITY STAGE
- FORMAL PROCESSING STAGE
- CLOSING AND FOLLOW-UP
PREVIEW:
In this unit various types of promissory notes are discussed, along with the methods of arriving at interest, principal reduction, and use of amortization tables. The effect of points on interest rates is probed. The question of refinancing is answered in depth.

PERFORMANCE OBJECTIVES:
After completing this lesson, you should be able to:

1. Differentiate between the "straight note" and the "amortized note".
2. Apply the formula, \( I = PRT \), to compute interest amount, interest Rate, Principal, and Time factor.
3. Calculate mortgage payments and mortgage balances.
4. Discuss some of the ways in which amortization tables can be used.
5. Compute effective yields when points are charged, with and without the time value of money considered.
6. Make a judgment as to whether it is profitable to refinance an existing loan.

I. WHAT IS INTEREST, AND HOW DO I FIGURE IT?

A. Interest. Interest is the charge or price paid for the use or forbearance of money. This "rent" may be paid either at the end of the period, the maturity date, or more commonly at periodic intervals, usually in monthly installments.

B. Calculation. One of the most common problems found in the area of real estate finance is calculating the amount of interest. This is accomplished by the formula, Interest = Principal x Rate x Time, or \( I = PRT \). Called the simple interest rate formula, it was initially demonstrated in Lesson One. Now we go into much more detail.
You can compute the interest on a monthly basis by one of three methods:

1. **Divide the annual interest rate by 12.**
   For quarterly payments the annual interest rate would be divided by 4, for semi-annual payments divide rate by 2.

2. **Divide the annual interest amount by 12.**
   For quarterly payments the annual interest amount is divided by 4, for semi-annual divide amount of interest by 2

3. **Multiply the principal by the interest rate, then multiply the result by 1/12.**
   For quarterly payments multiply the result by 1/4, for semi-annual payments by 1/2, and by the whole number 1 if payments are made only once a year. This is the approach that we will use in all our examples.

C. **Principal** is the amount of money borrowed. It is the face value of the promissory note upon which interest is paid.

D. **Rate** is the percent of interest charged on the principal and is usually expressed on an annual basis.

E. **Time** denotes the interval between payments of principal and/or interest. It is expressed as a fraction of a year. The terms of a loan may call for interest only payments, with the principal repaid at maturity (straight note calculation). Most real estate loans require repayment of principal and interest through monthly installments.

Before seeing how the I = PRT formula is applied, let's look at the two broad types of promissory notes and their variations.

**II. WHAT TYPES OF PROMISSORY NOTES ARE THERE?** Notes can be so constructed as to be paid in biweekly, monthly, quarterly, semiannually, annually, or at some other future designated date.

A. **Straight Note**

   The debt is paid in one lump-sum, at maturity. Periodic payments of interest are made, usually semi-annually, quarterly, or monthly.

B. **Amortized Note**

   Installment payments are made at stated intervals, usually every month. Two variations exist:

   1. **Installment Note -- Interest Included**
This is the most common note found in real estate financing transactions. Each installment remains constant, with interest computed on the unpaid balance of the note. Every payment on this fully-amortizing note represents a corresponding increase in the principal portion.

2. Installment Note -- Interest Included, Balance Due Date.

This is a partially-amortized note. Payments remain constant until a stated date, at which time a balloon is due. A balloon payment is one that calls for an unusually large outlay at the end of the loan term. It is defined by law as any payment that is at least twice the size of the normal payments being made on the note. Commonly, the last payment made at term with a fully amortized note differs from all the other payments made during the life of the loan, due to round-off factors. By definition, this does not represent a balloon payment.

3. Installment Note - Interest Extra

Level principal payments are made over the term of the loan with interest charged on the initial and reducing loan balances as the monthly principal payments are being made. This type of promissory note is normally used in bank commercial financing on personal property which depreciates value rapidly.

By example, assume you have a $100,000 loan at 12% per annum for a 30-year term. The principal payment per month will be $277.78 (100,000 / 360 months). The first month's interest payment will be $1,000.00 (100,000 x 12% / 12 months). The payment for the first month will be $1,277.78. Each month, the interest will be recalculated on the new loan balance and again divided by 12 months.

III. HOW DO I CALCULATE PAYMENTS ON AN AMORTIZED LOAN?

A. Amortization is the periodic reduction of the principal balance through installment payments of principal and interest. The basic formula, I = PRT, takes into account that interest is computed on the unpaid principal balance, regardless of the variation in the amortized note. Only the Level Payment Plan, also called a "Periodic Loan Reduction Plan" that includes both principal and interest, will be discussed here.
C. Determining Periodic Payments. To determine the required payments on a loan, we need to consult amortization booklets available at any financial institution. On the other hand, you can use much faster and efficient financial calculators. The book is full of tables that show the amount needed to pay off (a) varying amounts of loans, at (b) specified rates of interest, for (c) specified terms.

D. How is the Interest Portion of Periodic Payments Computed?

Each of the above types of loans lend themselves to the basic formula, \( I = PRT \).

1. Example. Assume a $100,000 home loan at an interest rate of 10% per annum, payable quarterly:

\[
\begin{align*}
I &= \text{Principal} \times \text{Rate} \times \text{Time} \\
I &= \$100,000 \times 10\% \times \text{\[12\] months / 3 months = four payments per year, or 4th of a year} \\
I &= \$2,500
\end{align*}
\]

Since the rate of interest is always expressed on an annualized basis, and we're asked to calculate for payments every 3 months, the time factor, \( T \), is \( \frac{12}{3} = 4 \).

2. Application. If payments of principal and interest were $3,000 per quarter, $2,500 would represent the interest portion, and the $500 balance is the principal portion. For the next three-month period a slightly reduced amount will apply toward interest and a corresponding increase to principal reduction, since the $100,000 loan after the $3,000 payment is now $99,500. Let's look at the second quarterly installment:

\[
\begin{align*}
I &= \$99,500 \times .10 \times \text{\[12\] months / 3 months = four payments per year, or 4th of a year} \\
I &= \$9,950 \times \text{\[12\] months / 3 months = four payments per year, or 4th of a year} \\
I &= \$2,487.50
\end{align*}
\]

The principal portion is the difference between the regular (level) quarterly payment of $3,000 and the $2,487.50 interest portion, or $512.50.
E. Calculating Term of Loan. Suppose you are given the interest rate on a loan and the amount of "annual mortgage constant". This is the amount necessary to liquidate a loan, expressed as a percentage of the original balance.

1. Example. Assume that the annual constant is 9.66. This means that the yearly payment on the loan is 9.66% of the original loan amount. What was the original term of the loan?

Solution: Since the annual constant of 9.66 is actually 9.66% of the original note, it is first multiplied by $1,000 to find the annual payment for each $1,000 loan. 9.66% x $1,000 = $96.60.

The yearly payment is divided by 12 to calculate the monthly installment. Thus $96.60 / 12 = $8.05. Since we were given the rate of interest, 9%, we look for a figure approximately $8.05 in the 9% table. Amortization tables will show that this figure is lined up under the 30 year column.

F. Determining Rate of Interest. Given the amount of payment and the length of loan, what is the interest rate?

One way to solve is to simply look up the term given under various rates of interest, until the amount of payment is located. Once found, the interest rate under which it is located is the rate which we are seeking.

1. Example. Assume that payments of $805 per month are made on a 30-year basis. Checking amortization tables shows a 9% interest rate.

A simpler procedure is to divide the payments by the number of thousands of dollars originally borrowed. For instance, if a loan of $100,000 is made under a fully-amortized plan, the payments remain level throughout the life of the loan. Thus, $805 / 100 = $8.05. Armed with this monthly factor per thousand, one can easily scan the various interest schedules across from the number of years column, until $8.05 is arrived at under the 9% column.
2. **Mortgage Constant Tables.** A mortgage constant table can be used to compute the monthly payment for any amortized loan. The table is based on one dollar. To use the table, such as the abbreviated one reproduced below, you choose either the 15-year (180 months) loan or the 30-year (360 months) loan, then go down the column to the appropriate interest rate. This is the monthly mortgage constant. To find the monthly payment multiply the loan amount by the mortgage constant:

\[
\text{Monthly payment} = \text{Loan amount} \times \text{Mortgage constant}
\]

<table>
<thead>
<tr>
<th>Percentage</th>
<th>180 months</th>
<th>360 months</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>0.01075</td>
<td>0.00878</td>
</tr>
<tr>
<td>11</td>
<td>0.01137</td>
<td>0.00952</td>
</tr>
<tr>
<td>12</td>
<td>0.01200</td>
<td>0.01029</td>
</tr>
<tr>
<td>13</td>
<td>0.01265</td>
<td>0.01106</td>
</tr>
<tr>
<td>14</td>
<td>0.01332</td>
<td>0.01185</td>
</tr>
<tr>
<td>15</td>
<td>0.01400</td>
<td>0.01264</td>
</tr>
</tbody>
</table>

3. **Example.**

Ms. Homebuyer purchased a property for $125,000 with a $25,000 down payment. She financed the balance of $100,000 at 10% interest, amortized over 30 years. Her monthly payments are calculated as follows:

\[
\text{Mortgage payment} = \text{Loan} \times \text{Mortgage constant}
\]

\[
\text{Mortgage payment} = 100,000 \times 0.00878
\]

\[
\text{Mortgage payment} = 878
\]

(Financial calculators extend loan constants to many more decimal places than the five shown above. Thus the actual monthly payments would be $877.57, but we've rounded to the next higher dollar amount.)

**IV. HOW DO I CALCULATE THE REMAINING BALANCE OF A LOAN?**

A. **Remaining Balance Tables.** Mortgage balance tables can be used to compute balances on an amortized loan for any period during the life of the loan. To find the mortgage balance, multiply the original loan amount by the mortgage balance constant:

\[
\text{Mortgage balance} = \text{Original loan} \times \text{Mortgage balance constant}
\]
Pay-back Rates.

To calculate the pay-back rate, divide the periodic payment by the face amount of the note.

<table>
<thead>
<tr>
<th>Year</th>
<th>10%</th>
<th>11%</th>
<th>12%</th>
<th>13%</th>
<th>14%</th>
<th>15%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.99438</td>
<td>.99559</td>
<td>.99637</td>
<td>.99711</td>
<td>.99765</td>
<td>.99814</td>
</tr>
<tr>
<td>2</td>
<td>.98818</td>
<td>.99052</td>
<td>.99228</td>
<td>.99382</td>
<td>.99495</td>
<td>.99599</td>
</tr>
<tr>
<td>3</td>
<td>.98133</td>
<td>.98497</td>
<td>.98767</td>
<td>.99008</td>
<td>.99148</td>
<td>.99355</td>
</tr>
<tr>
<td>4</td>
<td>.97377</td>
<td>.97878</td>
<td>.98248</td>
<td>.98582</td>
<td>.98826</td>
<td>.99072</td>
</tr>
<tr>
<td>5</td>
<td>.96540</td>
<td>.97187</td>
<td>.97663</td>
<td>.98082</td>
<td>.98416</td>
<td>.98742</td>
</tr>
<tr>
<td>6</td>
<td>.95616</td>
<td>.96415</td>
<td>.97004</td>
<td>.98098</td>
<td>.97945</td>
<td>.98360</td>
</tr>
<tr>
<td>7</td>
<td>.94596</td>
<td>.95555</td>
<td>.96261</td>
<td>.97546</td>
<td>.97405</td>
<td>.97916</td>
</tr>
<tr>
<td>8</td>
<td>.93470</td>
<td>.94595</td>
<td>.95424</td>
<td>.96919</td>
<td>.96782</td>
<td>.97400</td>
</tr>
<tr>
<td>9</td>
<td>.92224</td>
<td>.93524</td>
<td>.94481</td>
<td>.96205</td>
<td>.96066</td>
<td>.96803</td>
</tr>
<tr>
<td>10</td>
<td>.90850</td>
<td>.92328</td>
<td>.93418</td>
<td>.95392</td>
<td>.95244</td>
<td>.96109</td>
</tr>
</tbody>
</table>

1. Example. Ms. Homebuyer wants to know how much she still owes on that $100,000 that she borrowed at 10% three years ago.

Step 1. Find the mortgage balance constant for 10% loans from the above 30 year table. Looking under the 10% column, and across from 3 years, we find .98133, the mortgage loan balance. This means that Ms. Homebuyer's loan balance over the three-year term has only decreased by 1.867% or .01867.

Step 2. Multiply the original loan amount by the mortgage loan balance:

Mortgage balance = Original loan x mortgage balance
Mortgage balance = $100,000 x .98133
Mortgage balance = $98,133

Can the above table be used for non-amortized loans? A no answer may be obvious, since the table is used only for fully-amortized loans. But there is a solution in the form of another set of tables, designed for balloon payments. This is our next topic.

B Balloon Payment Tables

1. Definition. A balloon payment is, as the name implies, a large remaining balance due before the loan would mature if it were fully amortized. Monthly payments in many junior mortgages are expressed as a percent of the face value of the note, referred to as pay-back rate, pay-back percentage, pay-off rate, or payment rate.

2. Pay-back Rates. To calculate the pay-back rate, divide
a. **Example**

Monthly payments are $1,000 on a $100,000 promissory note. The payback rate is 1%, calculated as follows:

Payback rate = Monthly payment / Original loan balance
Payback rate = $1,000 / $100,000
Payback rate = 1%

Stated differently, a 1% payback rate means that the monthly payment on a $100,000 note is $1,000.
(Incidentally, investors prefer higher payback rates because they increase cash flow and accelerate recovery of their investment.)

3. **Calculating the balloon payment.** This is a three-step process:

**Step 1.** Calculate the pay-back rate. This is demonstrated in the above example.

**Step 2.** Use balloon payment tables to find the balloon payment factor. The table reproduced below is for loans at 10% interest rates, with monthly payback rates varying from .8% to 2.20%. Charts will vary according to the promissory note interest rate that is charged.

**Step 3.** Multiply the balloon payment constant by the original loan amount.

a. **Balloon Table for 10% interest rate loans, due in one year increments from 2 to 10 years, with payback ratios of from .80% to 2.20%**

<table>
<thead>
<tr>
<th>Rate</th>
<th>Due date in years</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2</td>
</tr>
<tr>
<td>0.80</td>
<td>100.88</td>
</tr>
<tr>
<td>0.90</td>
<td>98.24</td>
</tr>
<tr>
<td>1.00</td>
<td>95.59</td>
</tr>
<tr>
<td>1.10</td>
<td>92.95</td>
</tr>
<tr>
<td>1.20</td>
<td>90.30</td>
</tr>
<tr>
<td>1.25</td>
<td>88.98</td>
</tr>
<tr>
<td>1.30</td>
<td>87.66</td>
</tr>
<tr>
<td>1.40</td>
<td>85.01</td>
</tr>
<tr>
<td>1.50</td>
<td>82.37</td>
</tr>
<tr>
<td>1.60</td>
<td>79.72</td>
</tr>
<tr>
<td>1.70</td>
<td>77.08</td>
</tr>
<tr>
<td>1.75</td>
<td>75.76</td>
</tr>
<tr>
<td>1.80</td>
<td>74.43</td>
</tr>
<tr>
<td>1.90</td>
<td>71.79</td>
</tr>
<tr>
<td>2.00</td>
<td>69.15</td>
</tr>
</tbody>
</table>
### Payback Rate

<table>
<thead>
<tr>
<th>Rate</th>
<th>2.10</th>
<th>2.20</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>66.50</td>
<td>63.86</td>
</tr>
<tr>
<td>3</td>
<td>47.08</td>
<td>42.90</td>
</tr>
<tr>
<td>4</td>
<td>25.60</td>
<td>19.75</td>
</tr>
<tr>
<td>5</td>
<td>1.91</td>
<td>0.0</td>
</tr>
<tr>
<td>7</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>9</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>10</td>
<td>0.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Due date in years</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
</tr>
<tr>
<td>3</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>5</td>
</tr>
<tr>
<td>7</td>
</tr>
<tr>
<td>9</td>
</tr>
<tr>
<td>10</td>
</tr>
</tbody>
</table>

---

**Example 1.** You are paying back a second trust deed loan that is due and payable in 5 years, as follows:

Original amount of the note: $15,000
Interest rate: 10%
Monthly payment: $300

**Step 1.** Calculate the pay-back rate:
Rate = Payment / Original note
Rate = $300 / $15,000
Rate = 2%

**Step 2.** Locate the balloon payment factor from the table: in the first column are the payback rates. Run your finger across the 2.00 payback rate until you reach the 5 year column for the due date. The factor shown in that cell is 9.66%

**Step 3.** Calculate the balloon payment:
Balloon payment = Original note x Factor
Balloon payment = $15,000 x 9.66%
Balloon payment = $1,449

---

**Example 2.** Our task in this problem will be to calculate how long it will take to pay off a loan. We use the same table, and again a three-step process is involved. Assume your loan is for $50,000 and payable at $750 per month, including interest at 10% per annum.

**Step 1.** Calculate the pay-back rate:
Payback rate = Payment / Original note
Payback rate = $750 / $50,000
Payback rate = 1.50

**Step 2.** Locate the balloon payment factor, using the same procedure that you did in Example 1, but with one very important exception: go across from the 1.50 payback rate (calculated in Step 1) until you reach 0.
Step 3. Calculate the balloon payment:

Looking up from the cell in which 0.0 appears, we find that it corresponds to year 9. Thus we know that a loan of $50,000 payable at the rate of $750 per month, including interest at 10%, will be zeroed out during the 9th year. To know exactly when, we would need more detailed tables or resort to financial calculators or computers. Use of the HP 12C calculator yields the term of 8 years, 2 months.

{Question: Looking at the same table, can you tell how long it will take to retire that same loan if the monthly payback rate was 2.2%?}

{Answer: 5 years, or about half the time when compared to the smaller 1.5% payback rate.}

V. CALCULATING TOTAL AMOUNT OF PRINCIPAL AND INTEREST PAID

How do you determine the amounts of principal and interest that were paid over a given period of time?

A. Principal paid. To calculate the principal paid to date, subtract the mortgage balance after X years from the original loan amount:

\[ \text{Principal paid} = \text{Loan} - \text{Mortgage balance} \]

1. Example. Three years ago you obtained a 30 year loan for $100,000, payable $877.57 monthly, including annual interest of 10%. The latest statement received from your lender shows a balance of $98,133. How much of your monthly payments of $877.57 during the past 36 months represent principal?

\[ \text{Principal paid} = \text{Loan amount} - \text{Mortgage balance} \]
\[ \text{Principal paid} = \$100,000 - \$98,133 \]
\[ \text{Principal paid} = \$1,867 \]

B. Interest paid. To calculate the interest paid to date involves a two-step process: (1) Multiply the total payments made. (2) Deduct the principal paid.

1. Example: same facts as above, except that we're now asked to determine how much of our total payments made to date represents interest.

\[ \text{Step 1.} \quad \$877.57 \text{ monthly payments of principal and interest} \times 36 \text{ monthly payments made} \]
\[ \$31,593 \text{ total payments made to date} \]
VI. WHAT IS THE EFFECT OF POINTS ON INTEREST RATES?

A. Definition. Points represent a premium paid for the privilege of borrowing money, thereby increasing the effective rate paid on borrowed funds. One point represents 1% of the principal amount of loan. Points are expressed in two ways:

1. Mortgage discount. Mortgage discounts are used as equalization factors for certain loans (discussed in Lesson Seven). They represent prepaid interest, and must therefore be included in the calculation of APR. Regulations may prohibit lenders from charging more than a specified amount of interest. Discounts are determined by numerous factors, such as comparative yields on other investments, economic conditions, size of the loan, nature and location of the property, the borrower's payment history, age of the loan, and money market conditions.

2. Origination fees. Also called "service fees", these are a form of points charged by lenders to cover costs of issuing a loan.

B. What Effect Do Points Have On Nominal Interest Rates (the rates actually stated in the contract)?

Where points are charged for the use or forbearance of money, the effective interest rate is always higher than the nominal, or stated, rate. To compute this higher yield, we need to calculate the total interest charged on the loan, and add this to the points charged, in dollar amount. Since each point represents 1% of the loan, the dollar value is readily computed by multiplying the loan amount by the percentage corresponding to the number of points.

(Instructor: Because of the complex math and rare exposure by most licensees to the material below, you may jump from here to Section VII on page 13-13 without loss of continuity. Or Use the HP calculator, after studying the Appendix at the end of this lesson.)
1. Example.
Assume a 30-year loan for $100,000, payable $877.57 per month, including 10% interest per annum. Assume that it will cost 4 points to obtain the loan. You would pay 4% x $100,000 or $4,000 at the outset. Total interest to be paid over the 30 years is computed through a three-step process: (1) Multiply the monthly payment by the total number of months for loan repayment. (2) Add the points, converted into dollars. (3) Subtract the principal borrowed.

Step 1. $ \ 877.57 \ \times 360 \ \text{monthly payments of principal & interest} \\
$315,925 \ \text{number of months in thirty years} \\
$315,925 \ \text{total payments of P&I over life of loan}

Step 2. $315,925 \ \text{total payments of P&I over life of loan} \\
+ \ 4,000 \ \text{points paid "up front"} \\
$319,925 \ \text{combined payments of P&I plus points}

Step 3. $319,925 \ \text{combined payments of P&I plus points} \\
-100,000 \ \text{principal loan amount} \\
$219,925 \ \text{total financing costs}

2. Computing the effective interest rate (the percentage rate of interest actually being paid by the borrower, which includes the costs associated with obtaining the loan) – the APB). Now that we've determined total financing costs for the projected 30 years of payments, we can calculate the effective rate, or APR. There are other "up front" charges that go into the calculation, but we'll keep the process simpler by ignoring these.

\[
\text{APR} = \frac{(2N \times F)}{[P \times (T + 1)]}
\]

Where \( \text{APR} = \text{Annual percentage rate, or effective interest rate} \)

\( N = \text{Number of payments per year (12)} \)
\( F = \text{Total finance costs + charges ($4,000)} \)
\( P = \text{Principal amount borrowed} \)
\( T = \text{Total number of payments over the life of the loan (360)} \)
\( \text{PMT} = \$877.57 \)

Substituting:

\[
\text{APR} = 2 \frac{(12 \times 219,925)}{$100,000 \times (360 + 1)$}
\]

\[
\text{APR} = 24 \frac{X \times 219,925}{100,000 \times 361}
\]
APR = 5,278,200 / 36,100,000

APR = 14.6%

Summary:
The $219,925 in the numerator represents the combined totals of the $215,925 interest at 10% over 360 months, plus the one-time initial charge of $4,000 or 4 points. By spreading this one-time fee of $4,000 over the life of the loan, our formula reveals an effective rate that is much higher than the nominal rate. IT ALSO TAKES INTO ACCOUNT THE TIME VALUE OF MONEY, i.e., the $4,000 paid up-front could, at 10% per annum, aggregate almost over $80,000 when accumulated monthly over the 30-year mortgage. IF WE WERE TO IGNORE THE TIME VALUE OF MONEY, THE EFFECTIVE RATE OR APR WOULD BE 10.4919%.

APR = 10.4919% (ignoring the time value of money).

C. How Does the Discount Rate Affect APR?

What if a borrower is able to have the lender deduct the points from the loan proceeds? The effective rate will be higher than that computed through the constant ratio method. This is because the net proceeds received is smaller.

1. Example. Same facts as in the previous example. Though the payment remains at $877.57 for a $100,000 loan at 10% interest for 30 years, only $96,000 is actually advanced after a 4 point charge. Notice that the identical formula is used, but with only $96,000 shown in the denominator instead of $100,000.

\[
\begin{align*}
\text{Amount of payback, } & \$877.57 \times 360 \quad \$315,925 \\
\text{Principal loan advanced} & - \quad 96,000 \\
\text{Total finance charge, including points} & \quad \$219,925 \\
\text{Substituting} & \\
R & = \quad 2(12) \times 219,925 \\
& \quad 96,000 \times (360 +1) \\
R & = \quad 24 \times 219,925 \\
& \quad 96,000 \times 361 \\
R & = 5,278,200 / 34,656,000 \\
R & = 15.2%
\end{align*}
\]
VII. WHEN MIGHT IT PAY TO REFINANCE?

A. Analysis

Before deciding to refinance, one should take into consideration income taxes and economic consequences. Borrowers should analyze the relative values of current financing costs, and compare these costs and interest rates charged for new financing.

1. Example.

Assume you have an existing loan of $100,000 at 9% interest per annum. The property has an appraised value of $176,000. The loan balance represents approximately 56% of the property value ($100,000 / $176,000 = .56, or 56%)

You have an opportunity to obtain new financing for $140,000, or roughly 80% of the property's value, at 10% rate of interest for 30 years. You are confronted with three choices:

(1) Should I continue with the lower 9% rate and borrow the additional $40,000 needed at a higher rate as a junior lien?

(2) Borrow the $40,000 through a high-cost personal loan?

(3) Pick up the additional $40,000 by refinancing the property and paying 10% on the entire new balance of $140,000, and not just on the net increase of $40,000?

B. Calculation.

Since the existing loan of $100,000 represents 57% of the property's value of $176,000, it can be seen that by refinancing for $140,000 you are increasing the loan by only 23%, the difference between an 80% and a 57% loan. Ignoring costs to obtain the loan (title search, prepayment penalties, credit check, appraisal, reconveyance fees, points), what is the true cost of the new 10% First Mortgage?

Solution:'

\[
80\% \times 10\% = 8\% \text{ (projected loan)}
- 57\% \times 9\% = 5\% \text{ (existing loan)}
23\% \times ??\% = 3\%
\]
What does the question mark represent? It stands for an unknown that we must solve before making the all-important decision as to whether or not to refinance at the higher interest rate. The effective rate on the new loan is actually much greater than 10%, as we'll demonstrate below.

Using 100% as a base and applying weighted averages to the relative values of each of the loans, you can see that a new 80% loan at 10% interest corresponds to 8% on a $140,000 loan. The present loan of 57% of current market value, at the existing 9% rate, is equal to a 5% rate in relation to the overall weights. The difference between these two, 8% less 5%, is equal to 3%.

If this corresponds to a scale where the differences in loan amounts is 23%, what is the effective cost for borrowing this additional 23% of the remaining equity?

The question mark in our formula represents the unknown, solved by simple division. Dividing 3% by 23%, the answer is 13%. What the borrower doesn't realize is that the new 10% rate applies not just to the additional $40,000 proceeds, but on the old $100,000 loan as well, which carries the favorable 9% rate. Thus the property owner is really paying an effective rate of 13%, and not 10%, to refinance.

C. Secondary Financing as an Alternative

As an alternative, the property owner may want to consider a second trust deed loan for the difference of $40,000. Let's do this by comparing the results of the analysis just worked out above, which we'll call Alternative A, to Alternative B shown below. Alternative B leaves the existing loan as is, but adds a second to it for the additional $40,000, at 12% interest. To simplify the arithmetic, we calculate interest as if paid at the end of the year.

<table>
<thead>
<tr>
<th>Alternative A</th>
<th>Alternative B</th>
</tr>
</thead>
<tbody>
<tr>
<td>$140,000 New loan (80% LTV)  x 10% Interest rate</td>
<td>$100,000 Existing loan (56% LTV) x 9% Interest rate</td>
</tr>
<tr>
<td>$ 14,000 Interest cost</td>
<td>$ 9,000 Interest on 1st loan</td>
</tr>
<tr>
<td></td>
<td>$ 40,000 New 2nd loan (24% LTV) x 12% Interest rate</td>
</tr>
<tr>
<td></td>
<td>$ 4,800 Interest on 2nd loan</td>
</tr>
</tbody>
</table>
Conclusion. Alternative B adds up to $13,800 interest charges for both loans. If we subtract this from the $14,000 interest to be paid on all new financing (Alternative A), the property owner saves $200 interest during the first year.

Even more dramatic is the difference in effective rate between alternatives A and B. Assuming the borrower could obtain a $40,000 junior loan representing 24% of the property's valuation at 12% interest rate, the effective cost is:

\[
\begin{align*}
56\% \times 9\% & = 5.0\% \\
+ 24\% \times 12\% & = +2.9\% \\
80\% \times (?) & = 7.9\%
\end{align*}
\]

Again the unknown, indicated by question mark, is solved by dividing the third column by the first. In other words, 7.9% is 80% of what figure? 7.9 / .80 = 9.88, or 9.9%

The property owner is further ahead by staying with the existing $100,000 loan and tacking on a new second for the difference (Alternative B). Contrast an average rate of 9.9% for Alternative B with the 13% for all new financing under Alternative A.

What we have demonstrated is selecting among three different choices, all based on mathematics only. To fully appreciate the consequences of refinancing, borrowers need to take into account other factors such as income taxes, economic effects, and specific loan provisions.

{INSTRUCTOR: THE USUAL 20 MULTIPLE CHOICE QUESTIONS APPEAR ON THE NEXT THREE PAGES, 13-17 THROUGH 13-19. IMMEDIATELY FOLLOWING THESE IS THE APPENDIX CONSISTING OF 23 PAGES, 13-20 THROUGH 13-43. AS STATED IN THE INTRODUCTION, THIS ADDITION TO THE REVISED GUIDE IS IN RESPONSE TO THE MANY REQUESTS FOR HANDS-ON APPLICATIONS OF REAL LIFE FINANCE PROBLEMS USING A FINANCIAL CALCULATOR. IF TIME DOES NOT PERMIT, OR YOU ARE NOT COMFORTABLE WITH USE OF THE TI-112-C, IT MAY BE OMITTED WITHOUT LOSS OF CONTINUITY. BUT FOR STUDENTS DESIRING ANSWERS, THESE ARE INCLUDED IN THE INSTRUCTOR GUIDE ONLY.}
LESSON THIRTEEN MULTIPLE-CHOICE QUESTIONS

Directions: Underline the letter representing the correct answer. The charts specified in the chapter will be used in your calculations. With the charts can distort the answer.

1. The amount of interest is calculated by the formula:
   (a) \[ I = \frac{P}{R \times T} \]
   (b) \[ I = P + R + T \]
   (c) \[ I = P \times R \times T \]
   (d) \[ I = P - R - T \]

2. To find rate, the correct formula to use is:
   (a) \[ R = \frac{I}{P \times T} \]
   (b) \[ R = \frac{I \times T}{P} \]
   (c) \[ R = I + T \times P \]
   (d) \[ R = I - T + P \]

3. You borrow \$120,000 for 30 years payable \$966 per month, including interest at 9% per annum. The first month's interest will be:
   (a) \$966
   (b) \$900
   (c) \$1,080
   (d) none of the above

4. Using the same data from question 3, the unpaid balance remaining at the end of the first month's payment is:
   (a) \$120,000
   (b) \$119,886
   (c) \$120,066
   (d) \$119,934

5. Assuming you stayed with the property for the entire 30 years, total interest charged over the life of the loan described in question 3 will be:
   (a) \$324,000
   (b) \$227,760
   (c) \$120,000
   (d) \$347,760

6. The act of a creditor who refrains from enforcing a debt when it falls due is an example of:
   (a) forgiveness
   (b) forbearance
   (c) patience
   (d) non-enforcement

7. A partially-amortized note calling for a balloon payment is a(n):  
   (a) Straight Note - Interest Extra  
   (b) Installment Note - Interest Included, Balance Due Date  
   (c) Installment Note - Interest Included  
   (d) Straight Note - Interest Included
9. The amount of points, or discount, is determined by such factors as:
   (a) general economic condition
   (b) size of the loan
   (c) nature and location of property
   (d) all of the foregoing

10. Payments on a 30-year loan for a $90,000 loan are $789.03 per month, including interest at 10% per annum. The first year's equity build-up is approximately:
   (a) $505
   (b) $764
   (c) $692
   (d) $638

11. You are paying $350 per month on a $25,000 second trust deed, with an interest rate of 10%. What is your payback rate?
   (a) 1.7%
   (b) 1.0%
   (c) 1.4%
   (d) 10%

12. A second trust deed straight note loan for $15,000 at 10% interest calls for monthly payments of $125. What will the loan balance be at the end of 7 years?
   (a) $0
   (b) $840
   (c) $15,000
   (d) $2,538

13. You purchased a home for $150,000 and plan to keep it for 5 years. You borrowed $125,000 at 10%, fully amortized over 30 years. What is your monthly payment?
   (a) $1,096.96
   (b) $1,041.67
   (c) $1,250.00
   (d) $1,097.50

14. Using the information in question 13, what will be your approximate payoff in 5 years?
   (a) $120,675
   (b) $121,975
   (c) $125,000
   (d) $150,000
15. You borrow $10,000 secured by a junior trust deed at 10% and are going to pay it back at 2.2% a month, including principal and interest. Approximately how long it will take to pay it off? {Hint: Chart on page 13-8}
   (a) 2 years
   (b) 4 years
   (c) 5 years
   (d) 8 years

16. Using the information from question 15, approximately how much interest will be paid during that time?
   (a) $3,200
   (b) $5,000
   (c) $13,200
   (d) $10,000

17. You are purchasing a home for $125,000 and will get a first trust deed for 80% LTV at 10%, fully amortized over 30 years. The lender is charging 4 points. What are the points expressed in monetary terms?
   (a) $5,000
   (b) $4,000
   (c) $8,000
   (d) $3,000

18. Which of the following would most likely involve the lowest monthly payment initially?
   (a) straight note
   (b) fully amortized note
   (c) partially amortized note with a balloon
   (d) negative amortization note

19. Miss Calculation purchased a home and gets a first mortgage for $125,000 at 11%, fully amortized over 30 years. What are her monthly payments?
   (a) $1,000
   (b) $1,190
   (c) $1,600
   (d) $1,690

20. Using the information in question 19, approximately how much interest will she pay over a 10-year period?
   (a) $115,330
   (b) $27,390
   (c) $133,210
   (d) $142,800
APPENDIX

HOW TO USE THE HP12-C TO SIMPLIFY REAL ESTATE MATH

(This section on the use and application of the HP12-C is adopted from THE HP-12C IN ACTION!, with permission of the author, Robert J. Bond and Financial Publishing House, Sherman Oaks, California.) Designed for advanced students interested in further understanding real estate financial calculations.

UNIT ONE - THE HP-12C IN ACTION!

This material is designed to achieve two objectives for you:

1. Saving time

   Securing knowledge of the HP-12C, and applying it to real life real estate problems, will gain valuable time. Hastening problem-solving frees up time to accomplish other things. Truly, "time is money"!

2. Understanding complex computations

   This means correct application of the financial calculator to real estate math that would ordinarily laborious and counter-productive. Need proof? Recall times when your manual calculations led to incorrect answers, even with a fairly strong math background.

   The financial calculator is a tool, a way to simplify and, yes, a way to reduce incorrect answers. You do not need to be expert in math. You do not need to be concerned with complex formulas and computations since the calculator does the formulations and computations for you. For those concerned with making incorrect entries, you cannot hurt the calculator by "pushing the wrong button".

   Too many words only detract from our mission of getting a good working handle on the financial calculator, so there is very little narrative. Instead, we go directly into the step-by-step operations to solve problems, requiring you to get involved by doing. Practice makes perfect. You will want to continue practicing, repeating as necessary, in order to become proficient at solving financial problems relating to real estate. To this end "self-tests" appear throughout, offering additional opportunities to master the calculator. The correct answers are available from your instructor, so you can verify your responses. If your answers don't match the correct ones given, you'll need to go over the model problem again, then substitute the self-test data until your answers match the correct one.
This guidebook doesn't pretend to cover all of the problems found in real estate practice and investing. Some problems are very easy, others difficult. Indeed the sequence of the exercises proceed from solving the simple, most frequently encountered problems to the complex, less frequently encountered problems. Fortunately the easy ones, like the calculation of mortgage payments, are the most commonly experienced in the business of "real estate". The difficult problems, such as buy-down loans, are much less experienced, hence you go to these only when confronted with situations in which the need arises.

Don't try to memorize steps or formulas. Unless you work with the kinds of problems discussed in here on a regular, systematic basis, the calculating steps are not likely to stay with you. Refer to this manual whenever needed. It does not become outdated.

FUNCTIONS OF THE KEYS

Most of the 39 keys in the HP-12C have more than one use, so let's briefly acquaint ourselves with the ones most often encountered in real estate problems. We'll expand on their meanings through a series of NOTES located throughout the material.

:ON: This is both the on and off key. The calculator has built-in memory, so it will retain information for as long as you wish: if you enter the number 12, that number reappears on your screen even if you don't turn it back to ON until next year (or Century, if your battery doesn't sour).

:ENTER: Enters numbers into the calculator, displayed on the screen, for doing calculations.

The Financial Keys

In the top row of your HP-12C the five financial keys that we will be using most of the time: InI I IPVI IPMTI IPVI - Here is a brief description of what the letters generally mean:

\[
\begin{array}{cccc}
\text{InI} & \text{IPVI} & \text{IPMTI} & \text{IPVI} \\
\text{PV} & \text{PMT} & \text{FV} & \text{FV} \\
\text{(number of payments)} & \text{(rate per period)} & \text{(amount of loan)} & \text{(amount of payments)} & \text{(remaining balance)} \\
\end{array}
\]

----------- DATA keys and QUESTION keys -----------
The arrows indicate that these five keys in essence are data and questions keys. Why? Because we enter data into four of the keys, the known, and compute the fifth key ("cell"), the unknown. So if you know how long a loan is to run (n), its interest rate (i), the amount of loan (PV), and amortization provision (FV) - balloon vs no balloon - you push the PMT button to determine the amount of payments.

The Inl represents number of monthly payments, or it may be quarterly, semi-annual, annual, or any other payment form. The 0.1 is always the rate of interest or yield. The three remaining keys, IPVI, IPMTI, and IFVI are always expressed in monetary terms, though the monetary symbols never show up on the screen, such as the $ or pound sign.

To summarize the financial keys:

- **Inl** Registers the number of periods, or term.
- **IiI** Registers the interest rate per period.
- **IPVI** Registers the Present Value, or initial cash flow, of a loan or investment amount.
- **IPMTI** Registers Payments for money paid out or received.
- **IFVI** Registers the Future Value, or final cash flow, of a loan or investment.

Let's now examine some less frequently used, but equally important keys, to help round out our knowledge of the keyboard:

- **Ifl** Gold-colored key to the right of Inl, used to answer questions for the 16 keys where the gold appears at the top.
- **Ig** Blue-colored key to the right of Ifl, used to answer questions for the 30 keys where the blue appears at the bottom.
- **ICHSI** Changes a number from positive to negative, or from negative to a positive.
- **1%** Computes the ratio, or percentage (%).
- **IR/SI** Runs and Stops programs, similar to a full-fledged computer.
- **ISSTI** Single step in a series of steps used when the calculator is in the program mode.
- **IRI** Rolls down data stored within the calculator.
IX  YI Exchanges stored data, in its so-called X and Y registers.

ICLXI Clears the data displayed in the X register.

11/x1 Reciprocal key, used to change whole or mixed numbers to fractions, or fractions to whole numbers.

1%  Calculated % of difference between two numbers (stored in the calculator's X and Y registers).

1%T  Calculated % that one number represents of a total.

ISTOI Stores numbers into each of the cells labeled 1 through 9 for later use through recall.

IRCLI Recalls stored numbers by pressing RCL and the numerical cell (0 through 9) into which the data was stored.

0, 1, 2, 3, 4, 5, 6, 7, 8, 9 keys on right side of calculator. Used for calculating the numerical or arithmetic functions: addition, subtraction, multiplication, division. When STO key is pressed at the same time as one of the cells, data can be stored in that cell.

- x - Keys used to calculate the four basic arithmetic functions: addition, subtraction, multiplication, division.

**Unit Two HOW DO I CALCULATE TRUST DEED PAYMENTS?**

**DATA:**

<table>
<thead>
<tr>
<th>1st Trust Deed</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rate</td>
<td>10%</td>
</tr>
<tr>
<td>Term</td>
<td>30 years</td>
</tr>
<tr>
<td>Balloon payments</td>
<td>none</td>
</tr>
</tbody>
</table>

**QUESTION:**

How much are the monthly payments

**SOLUTION:**

<table>
<thead>
<tr>
<th>Key</th>
<th>Screen</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 30 :g; :12x:</td>
<td>360</td>
</tr>
<tr>
<td>2. 10 ;g1 :12+:</td>
<td>0.83</td>
</tr>
<tr>
<td>3. 100000 :FV:</td>
<td>100,000</td>
</tr>
<tr>
<td>4. 0 1FV:</td>
<td>0.00</td>
</tr>
<tr>
<td>5. :PMT:</td>
<td></td>
</tr>
</tbody>
</table>
NOTES: In step 1 we enter the number of years, 30, followed by the blue-colored g key that converts 30 years into months. (The blue key is described in the Footnote at the end of this exercise.) In step 2 the annual interest rate of 10% is automatically converted into the monthly rate by using the blue key. Enter the loan amount into the PV cell for step 3. The number 0 is entered for step 4 to reflect that there is no balloon payment, which means that the loan is fully amortized with equal monthly installments for the full term. In step 5 the negative figure showing on your screen reflects money paid out. You would read the monthly payments as shown in the answer below.

ANSWER: $ 877.57

SELF-HELP: To help you master certain financial calculations, throughout this manual we offer a series of test questions. See how well you understand the calculation of mortgage payments by doing the self-test questions that are found on the next page. After you finish, compare your answers to the correct ones given at the end of the test.

Test Yourself

Self-Test 1: Trust deed: $200,000
Interest rate: 10%
Term: 30 years

Question: How much are the monthly payments?

Self-Test 2: Trust deed: $200,000
Interest rate: 10%
Term: 15 years

Question: How much are the monthly payments?

Self-Test 3: Trust deed: $100,000
Interest rate: 5%
Term: 30 years

Question: How much are the monthly payments?

Self-Test 4: Trust deed: $100,000
Interest rate: 10%
Term: 30 years

Question: How much are the annual payments?

Note: When calculating annually, do not convert years into months, and do not convert annual interest into monthly interest.
Answers:
Self-Test 1: $1,755.14  Self-Test 2: $2,149.21  Self-Test 3: $ 536.82  Self-Test 4: $10,607.93

FOOTNOTE concerning the gold and blue keys:
To the right of the ON button at the lowest rung of keys are the so-called prefix keys, which are secondary to the primary keys that you have been dealing with up to this point.

The IfI key is colored gold. The Igl key is colored blue. These have no meanings per se, but they offer a second and third level of calculations, so that each of the keys in the top three rows to the left of the ENTER key, including the enter key itself, can perform three separate functions. Thus if you wanted to calculate the amortization of a mortgage loan, you would press the gold f key before pressing in the AMORT that shows up above the n key. This will be demonstrated in a later unit, so don't be concerned at this stage. All you need to know now is that the HP-12C is a very versatile instrument, allowing you to perform zillions of calculations, combinations and permutations, offering added meanings when the two specially-colored keys are used in conjunction with most of the other keys.

III, the gold key, is used for solving problems above the key.

Example: The AMORT above the n key computes the loan payments attributable to principal reduction, called amortization, as well as remaining balances.

Igl, the blue key, is used for solving problems below the key.

Example: The 12x below the n key is used to multiply the years by 12.

Unit Three  HOW DO I CALCULATE MORTGAGE INTEREST RATES?

DATA:  1st Trust Deed $100,000
        Monthly Payments $ 877.57
        Term 30 years

QUESTION:  What is the interest rate
SOLUTION: 

<table>
<thead>
<tr>
<th>Key</th>
<th>Screen</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 30 Igl:</td>
<td>12x:</td>
</tr>
<tr>
<td>2. 100000;</td>
<td>FV;</td>
</tr>
<tr>
<td>3. 0 :FV:</td>
<td></td>
</tr>
<tr>
<td>4. 877.57 ;</td>
<td>CHSI ;</td>
</tr>
<tr>
<td>5.</td>
<td></td>
</tr>
</tbody>
</table>

NOTES: In step 6 we are converting the monthly interest rate to an annual rate by simply multiplying the step 5 result by twelve, the number of months in a year. There is another way to calculate step 6. In our model we entered the digits 12 followed by the multiplier sign, x. You could instead simply take the answer to step 5 and enter the blue key Igl, then press the 112x1 key.

ANSWER: 0.83% monthly interest rate (step 5), or annual rate of 10.00% (step 6).

Test Yourself

Self Test 1: Trust deed: $200,000
Term: 30 years
Monthly payments: $1,755.14
Questions: What is the monthly interest rate? What is the annual rate?

Self Test 2: Trust deed: $200,000
Term: 15 years
Monthly payments: $2,149.21
Questions: Monthly interest rate? Annual rate?

Self Test 3: Trust deed: $100,000
Term: 30 years
Monthly payments: $536.82
Questions: Monthly interest rate? Annual rate?

Self Test 4: Trust deed: $100,000
Term: 30 years
Annual payments: $10,607.93 Question:
Interest rate?

Careful: This asks you for annual interest rate, so do not convert annual payments to monthly payments. Thus you'll have the annual rate instantly calculated when you hit the button.

Answers:
Self-Test 1: 0.83% monthly interest rate, or 10% annual rate
Self-Test 2: 0.83% monthly interest rate, or 10% annual rate
Self-Test 3: 0.42% monthly interest rate, or 5% annual rate
Self-Test 4: 10% annual interest rate. (The loan is paid once annually, so no need to convert from monthly.)

Unit Four - HOW DO I CALCULATE ANNUAL PERCENTAGE RATES (APR) ADJUSTED FOR A FLAT LOAN FEE?

The calculation for APR is very similar to deriving the so-called nominal, or stated, rate that was performed in the previous unit. What is the difference? In computing an APR, loan costs, called "prepaid interest", must be deducted from the face amount of loan.

What constitutes prepaid interest? It includes the familiar "points" paid by the borrower; origination fee; pro-rata interest, since there usually are interest charges accumulated from close of escrow to date of the initial mortgage payment; first year's mortgage insurance premium (MIP); and a few smaller items. Prepaid interest does not include fees paid for an appraisal, credit report, title insurance, and other forms of insurance and costs that are independent of the loan, such as a homeowner's policy or homeowners association (HOA) fees.

In this example, we'll assume the same facts as before, except that the borrowers are charged $5000 loan costs.

DATA:  
1st Trust Deed $100,000  
Prepaid interest/Loan costs $ 5,000  
Nominal Interest Rate 10%  
Term 30 years
QUESTION: What is the Annual Percentage Rate (APR) ?

SOLUTION:

<table>
<thead>
<tr>
<th>Key</th>
<th>Screen</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 30 ;g1 :12x:</td>
<td>360</td>
</tr>
<tr>
<td>2. 10 1g: :12+1</td>
<td>0.83</td>
</tr>
<tr>
<td>3. 1 00000 ;P:</td>
<td>100,000</td>
</tr>
<tr>
<td>4. 0 1F:</td>
<td>0.00</td>
</tr>
<tr>
<td>5. ;PMT:</td>
<td>-877.57</td>
</tr>
<tr>
<td>6. ;RCL: 5000 ;P:</td>
<td>95,000</td>
</tr>
<tr>
<td>7.</td>
<td></td>
</tr>
<tr>
<td>8. 12 12x: (or :12x:1)</td>
<td></td>
</tr>
</tbody>
</table>

Note: In step 8 we convert the monthly rate to an annual rate by multiplying step 7 result by twelve, the number of months in a year. Step 8 could also be computed by pressing the blue 1g1 button followed by 112x1.

ANSWER: 0.89% monthly rate (step 7), or 10.62% annual (step 8)

Bottom Line: With interest prepayments the effective rate, or APR, increased by .62% when compared to the nominal rate. This is equivalent to an increase of 62 "basis points", with each basis point the same as 1/100th of a percent.

Test Yourself

Data: 1st Trust Deed $150,000
Prepaid interest/Loan costs $7,000
Nominal Interest Rate 10%
Term 30 years

Question: What is the Annual Percentage Rate (APR)?

Answer: 0.88% monthly, or 10.58% APR
### Unit Five - HOW DO I CALCULATE WHICH LOAN IS BEST BASED UPON COSTS AND HOLDING PERIOD?

**DATA:**

<table>
<thead>
<tr>
<th></th>
<th>Option A</th>
<th>Option B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original 1st Trust Deed</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Interest Rate</td>
<td>11%</td>
<td>10%</td>
</tr>
<tr>
<td>Term</td>
<td>360 months</td>
<td>360 months</td>
</tr>
<tr>
<td>Loan Fees</td>
<td>None</td>
<td>3 points + $300</td>
</tr>
<tr>
<td>Expected Holding Period</td>
<td>30 years</td>
<td>3 years</td>
</tr>
</tbody>
</table>

**QUESTION:** Which is better, Option (A), the "no cost loan", or Option (B), which costs 3 points plus $300 in loan fees, based upon the holding period or occupancy?

**SOLUTION for Option A:**

<table>
<thead>
<tr>
<th>Key</th>
<th>Screen</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 30 11</td>
<td>112x1</td>
</tr>
<tr>
<td>2. 11Ig1</td>
<td>112+1</td>
</tr>
<tr>
<td>3. 100000</td>
<td>IPV1</td>
</tr>
<tr>
<td>4. 0 IFV1</td>
<td>0.00</td>
</tr>
<tr>
<td>5. IPMT1</td>
<td></td>
</tr>
<tr>
<td>6. 11I</td>
<td>0.92</td>
</tr>
<tr>
<td>7. 12 ix1</td>
<td>11.00</td>
</tr>
</tbody>
</table>

**ANSWER:** 0.92% per month (step 6), or 11% per annum (step 7).

**NOTE:** The 11% APR is the same as the nominal rate given in the data. This is because there are no loan costs. Let's see how this compares to Option B.

**SOLUTION FOR Option B:**

<table>
<thead>
<tr>
<th>Key</th>
<th>Screen</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 30 11</td>
<td>112x1</td>
</tr>
<tr>
<td>2. 10 11</td>
<td>112+1</td>
</tr>
<tr>
<td>3. 100000</td>
<td>IPV1</td>
</tr>
<tr>
<td>4. 0 IFV1</td>
<td>0.00</td>
</tr>
<tr>
<td>5. IPMT1</td>
<td></td>
</tr>
</tbody>
</table>

13-29
ANSWER: 0.87% per month (step 9), or 10.40% APR annually (step 10)

NOTES: The 10.40% APR is higher than the nominal rate of 10% because there are $3,300 in loan costs, calculated in step 7, and thus results in only $96,700 in net loan proceeds to the borrower. Step 8 is necessary in order to lock in the $96,700 into the calculator's memory.

On the surface it appears as if Option B is the better choice because its APR is 10.40%, in contrast to the 11% APR in Option A. But remember, we need to deal with the holding period, which will have an impact on the real cost of the loan to us, beyond the required APR disclosure. So let's continue with additional steps needed to compute the APR adjusted for the holding period, when the loan is to be paid off.

NOTE: It is necessary to re-enter the original loan amount, $100,000, in step 11 because that's the amount the borrowers will repay to the lender, and not the $96,700 that they actually received after discounting by the loan fees of $3,300. For the same reason we restore the nominal interest rate, 10%, in step 12.
In step 13 we enter the period that the borrowers expect to stay with the loan, three years or 36 months. Step 14 displays the loan balance at the end of the three-year period. Step 15 calculates the net proceeds, while step 16 locks the figure into the memory. Step 17 recomputes the true rate based upon the three-year holding period, and not the original 30 years.

**BOTTOM LINE:** Though the APR in Option B, the 10% loan, was still lower (10.4%) than the 11% loan in Option A, it is higher when adjusted for the holding period. The APR for Option B rises to 11.31% in three years because of the much shorter period for recovery of the one-time up-front fees. (Recall the time value of money from the introductory chapters.)

### Unit Six  HOW DO I DETERMINE THE UNPAID BALANCE OF A LOAN?

**DATA:**
- 1st Trust Deed $100,000
- Interest Rate 10%
- Term 30 years

**QUESTION:** What is the unpaid balance after five years?

**SOLUTION:**

<table>
<thead>
<tr>
<th>Key</th>
<th>Screen</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 30</td>
<td>360</td>
</tr>
<tr>
<td>2. 10</td>
<td>0.83</td>
</tr>
<tr>
<td>3. 100000 :PV:</td>
<td>100,000</td>
</tr>
<tr>
<td>4. 0IFVI</td>
<td>0.00</td>
</tr>
<tr>
<td>5. IPMT1</td>
<td>-877.57</td>
</tr>
<tr>
<td>6. IPNDI IPMTI</td>
<td>-877.57</td>
</tr>
<tr>
<td>7. 5 112x1</td>
<td>60.00</td>
</tr>
<tr>
<td>8. IFVI</td>
<td></td>
</tr>
</tbody>
</table>

**ANSWER:** $96,574.44

**NOTES:** Step 6 is not absolutely necessary. It simply rounds off the monthly payments to the nearest penny. Remember, the calculator has a continuous memory, hence carries the theoretical payment to fractions of a cent. But since the lowest currency in the U.S. Dollar is a penny, it is impossible to pay in smaller denominations, i.e., $877.5715701 if carried to the seventh decimal place.
All the digits following $877.57 are adjusted up or down (depending on the precise language in the promissory note) in the final monthly installment. Since there are digits that follow the .57, you'd have a larger final installment 360 months from now. If on the other hand the note called for monthly payments of $877.58, your final payment would be less than $877.58.

For those who appreciate precision, without step 6 the unpaid balance at end of 5 years would amount to $96,574.32, or a decrease of 12 cents.

Test Yourself

Self-Test 1:

Data: 1st Trust Deed $120,000
Interest Rate 10%
Term, payable monthly 30 years

Questions: (1) What is the unpaid balance after three years?
(2) What is the unpaid balance after five years?

Answers: (1) $2222.211,28 after three years ($117,781.80 if payments of $1,053.07 are rounded via IfI IRNDI)
(2) $115,888.19 after five years ($115,888.87 if payments are rounded)

Self-Test 2:

Data: 1st Trust Deed $150,000
Interest Rate 10%
Term, payable monthly 30 years

Questions: (1) What is the unpaid balance after three years?
(2) What is the unpaid balance after five years?

Answers: (1) $147,227.47 after three years ($147,227.36 if payments of $1,316.36 are rounded via IfI IRNDI)
(2) $144,861.48 after five years ($144,861.28 if payments are rounded via IfI IRNDI)
Unit Seven - HOW DO I CALCULATE INTEREST AND PRINCIPAL COMPONENTS OF A LOAN?

**DATA:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trust Deed Loan</td>
<td>$100,000</td>
</tr>
<tr>
<td>Interest Rate</td>
<td>10%</td>
</tr>
<tr>
<td>Term, payable monthly, fully amortized</td>
<td>30 years</td>
</tr>
</tbody>
</table>

**QUESTIONS:**

1. How much are the monthly payments at 10%?
2. Of the monthly payments, how much represents interest and how much represent principal during each of the first five years?

**SOLUTION:**

<table>
<thead>
<tr>
<th>Key</th>
<th>Screen</th>
</tr>
</thead>
<tbody>
<tr>
<td>la, 30 :g; 112x1</td>
<td>360</td>
</tr>
<tr>
<td>lb, 10 :g; 112+1</td>
<td>0.83</td>
</tr>
<tr>
<td>lc, 100000 :PV;</td>
<td>100,000</td>
</tr>
<tr>
<td>ld, 0 IFV1</td>
<td>0.00</td>
</tr>
<tr>
<td>le, IPMT1</td>
<td>-877.57</td>
</tr>
<tr>
<td>2a, 12 If1 IAMORTI</td>
<td>-9,974.98</td>
</tr>
<tr>
<td>2b, lx=171</td>
<td>-555.86</td>
</tr>
<tr>
<td>3a, 12 If1 IAMORT1</td>
<td>-9,916.77</td>
</tr>
<tr>
<td>3b, lx=171</td>
<td>-614.07</td>
</tr>
<tr>
<td>4a, 12 If1 IAMORTI</td>
<td>-9,852.46</td>
</tr>
<tr>
<td>4b, lx=y1</td>
<td>-678.38</td>
</tr>
<tr>
<td>5a, 12 If1 AMORT</td>
<td>-9,781.44</td>
</tr>
<tr>
<td>5b, lx=y1</td>
<td>-749.40</td>
</tr>
<tr>
<td>6a, 12 If1 IAMORTI</td>
<td>-9,702.96</td>
</tr>
<tr>
<td>6b, lx=y1</td>
<td>-827.88</td>
</tr>
</tbody>
</table>

**ANSWER 1:** $877.57 monthly payments (from step le.)

**NOTES:**

Steps la through le calculate the monthly payments for the thirty-year loan. Steps 2a and 2b compute the (decreasing) interest and (increasing) principal portions of the first year's payments. Steps 3a and 3b compute the interest and principal portions of the second year's payments.
Steps 4a and 4b compute the interest and principal portions of the third year's payments. Steps 5a and 5b compute the interest and principal portions of the fourth year's payments. Steps 6a and 6b compute the interest and principal portions of the fifth year's payments. We can summarize these in simpler tabular form:

<table>
<thead>
<tr>
<th>Year</th>
<th>Interest</th>
<th>Principal</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$9,874.98</td>
<td>$555.86</td>
</tr>
<tr>
<td>2</td>
<td>9,916.77</td>
<td>614.07</td>
</tr>
<tr>
<td>3</td>
<td>9,852.46</td>
<td>678.38</td>
</tr>
<tr>
<td>4</td>
<td>9,781.44</td>
<td>749.40</td>
</tr>
<tr>
<td>5</td>
<td>9,702.96</td>
<td>827.88</td>
</tr>
</tbody>
</table>

**Test Yourself**

Data: Trust Deed Loan $100,000  
Interest Rate 12%  
Term, payable monthly, fully amortized 30 years

Questions: (1) How much are the monthly payments at 12%?

(2) Of the monthly payments, how much represents interest and how much represent principal during each of the first two year?

Answers: (1) $1,028.61

<table>
<thead>
<tr>
<th>Year</th>
<th>Interest</th>
<th>Principal</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$11,980.47</td>
<td>$362.85</td>
</tr>
<tr>
<td>2</td>
<td>11,934.45</td>
<td>408.87</td>
</tr>
</tbody>
</table>

**Unit Eight - HOW DO I CALCULATE AMORTIZATION OF MORTGAGE PAYMENTS?**

DATA: 1st Trust Deed $100,000  
Interest Rate 10%  
Term, payable monthly 30 years

QUESTIONS: What are the interest and principal components of the payments, and how much is the unpaid balance:

A. At the end of the first year (12 months) ?  
B. At the end of the second year (24 months)?  
C. At the end of the fifth year (60 months) ?  
D. At the end of the tenth year (120 months)?
SOLUTION: 

<table>
<thead>
<tr>
<th>Key</th>
<th>Screen</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 30</td>
<td>112d</td>
</tr>
<tr>
<td>2. 10</td>
<td>112H</td>
</tr>
<tr>
<td>3. 100000</td>
<td></td>
</tr>
<tr>
<td>4. 0</td>
<td>IFV1</td>
</tr>
<tr>
<td>5. 1</td>
<td>PMT1</td>
</tr>
</tbody>
</table>

ANSWERS:

<table>
<thead>
<tr>
<th>Step</th>
<th>End of</th>
<th>Interest</th>
<th>Principal</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Key</td>
<td>Key</td>
<td>Reduction</td>
<td>Key</td>
</tr>
<tr>
<td>A.</td>
<td>1st year</td>
<td>12</td>
<td>If1 IAMORT1</td>
<td>1x=y1</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>-9,974.98</td>
<td>-555.86</td>
</tr>
<tr>
<td>B.</td>
<td>2nd year</td>
<td>24</td>
<td>If1 IAMORT1</td>
<td>1x=y1</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>-19,891.75</td>
<td>-1,169.93</td>
</tr>
<tr>
<td>C.</td>
<td>5th year</td>
<td>60</td>
<td>If1 IAMORT1</td>
<td>Ix=yI</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>-49,228.61</td>
<td>-3,425.59</td>
</tr>
<tr>
<td>D.</td>
<td>10th year</td>
<td>120</td>
<td>If1 IAMORT1</td>
<td>1x=yI</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>-96,246.75</td>
<td>-9,061.65</td>
</tr>
</tbody>
</table>

NOTES: The negative figure that shows up in step 5 reflects money paid out. We need to compute this before calculating the principal and interest breakdowns for each of the payments and, thereby, the outstanding principal balance at the end of the 1st, 2nd, 5th, and 10th years.

For each of the periods following the first year, re-enter the original loan amount, $100,000, into PV, and the original number of months, 360, into the n key.

Test Yourself

Self-Test 1: Trust deed: $200,000
Interest rate: 10%
Term: 30 years
Questions
(1) What is the monthly payment?
(2) What is the amount of interest paid out in the 1st year?
(3) What is the amount of principal paid out in the 1st year?
(4) What is the outstanding principal balance owed at the end of the 1st year?

Self-Test 2: Trust deed: $200,000
Interest rate: 10%
Term: 15 years

Questions
(1) What is the monthly payment?
(2) What is the amount of interest paid out in the 1st year?
(3) What is the amount of principal paid out in the 1st year?
(4) What is the outstanding principal balance owed at the end of the 1st year?

Self-Test 3: Trust deed: $100,000
Interest rate: 5%
Term: 30 years, payable monthly

Questions
(1) What is the monthly payment?
(2) What is the amount of interest paid out in the 1st year?
(3) What is the amount of principal paid out in the 1st year?
(4) What is the outstanding principal balance owed at the end of the 1st year?

Answers
Self-Test 1: (1) Monthly payments: $1,755.14
(2) First year interest, $19,949.98
(3) First year principal, $1,111.70
(4) Balance end of first year, $198,888.30
Self-Test 2: (1) Monthly payments: $2,149.21
(2) First year interest, $19,727.08
(3) First year principal, $6,063.43
(4) Balance end of first year, $193,936.56

Self-Test 3: (1) Monthly payments: $536.82
(2) First year interest, $4,966.50
(3) First year principal, $1,475.34
(4) Balance end of first year, $98,524.66

Unit Nine - HOW DO I CALCULATE NEGATIVE AMORTIZATION?

DATA: 1st Trust Deed $100,000
Interest Rate: 9% the first year, 10%, thereafter
Term, payable monthly 30 years

QUESTION: What will the loan balance be at the end of the first year?

SOLUTION: Key Screen

1. 30 ;(4; 112) (1) 360
2. 9 ;:g; 11241 0.75
3. 100 000 ;PV: 100,000
4. 0 IPMTI 0.00
5. IPMTI -804.62
6. 10 Igl 112+1 0.83
7. 12 InI 12.00
8. IFVI

ANSWER: $100,360.77

NOTES: Step 6 shows the new interest rate, 10%, converted into a monthly rate. Observe also that the $100,361 (enter 1f1 101 to get rid of the pennies) balance is larger than the loan originally secured, $100,000. That's because you paid less than the 10% contract interest rate during the first year, resulting in negative amortization.
Self-Test 1:

**Data:**
- 1st Trust Deed
- $120,000
- Interest Rate: 9%, but at only 8% the first year
- Term, payable monthly
- 30 years

**Question:**
What will be the loan balance at the end of the first year?

**Answer:** $120,243.68

Self-Test 2:

**Data:**
- 1st Trust Deed
- $150,000
- Interest Rate: 5% the first year, 10% thereafter
- Term, payable monthly
- 30 years

**Question:**
What will be the remaining balance at the end of the first year?

**Answer:** $155,588.76

---

**Unit Ten - How Do I Calculate Blended Interest Rates?**

**Data:**
- First Trust Deed
- Second Trust Deed
- $100,000
- Interest rate on 1st TD: 10%
- $25,000
- Interest rate on 1st TD: 12%
- Term of each loan, payable monthly: 30 years

**Question:**
What is the blended or composite interest rate?

**Solution:**

Key

1. \(100000\) ISTOI 10
2. \(10\) 1%1
3. \(25000\) ISTOI 1+1 101 12 1%1
4. \(1x=y1\) IR!1 1+1
5. \(1RCLI\) 101

**Screen**

100,000
10,000
3,000
13,000
125,000

\[
\text{\%}
\]

**Answer:** 0.10, or 10%. (If you want to expand the rate to three decimal places, enter f 3, and your screen will show 0.104, or 10.4%)
NOTES: Step 1 stores the existing 1st loan balance for later recall. Step 2 shows the first year's interest on that loan. Step 3 stores the $25,000 second loan, then adds this amount to the stored first loan and computes the first year's interest on the second loan. Step 4 combines total interest, adding up steps 2 and 3. Step 5 recalls the total amount of loans ($125,000) and divides this into the total interest of $13,000 (step 4) to answer the question asked in step 6 (0.10).

Test Yourself

Self-Test 1:

Data:  
- First Trust Deed $100,000  
- Interest rate on 1st TD 8%  
- Second Trust Deed $20,000  
- Interest rate on 2nd TD 10%  
- Term of each loan, payable monthly 30 years

Question: What is the blended or composite interest rate?
Answer: 0.0833, or 8 1/3%

Self-Test 2:

Data:  
- First Trust Deed $150,000  
- Interest rate on 1st TD 9%  
- Second Trust Deed $50,000  
- Interest rate on 2nd TD 10%  
- Term of each loan, payable monthly 30 years

Question: What is the blended or composite interest rate?
Answer: 0.0925, or 9.25%

Unit Eleven - HOW DO I CALCULATE THE COST OF A TEMPORARY BUY-DOWN LOAN?

DATA:  
- Trust Deed Loan $100,000  
- Term, payable monthly for 30 years  
- Interest Rate:  
  - First five years 7%  
  - Each year thereafter 10%

QUESTION: What is the cost of the buy-down loan?
SOLUTION:

Key

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>30</td>
<td>1/m</td>
</tr>
<tr>
<td>2.</td>
<td>10</td>
<td>1/P</td>
</tr>
<tr>
<td>3.</td>
<td>100000</td>
<td>; PV1</td>
</tr>
<tr>
<td>4.</td>
<td>0</td>
<td>IFV1</td>
</tr>
<tr>
<td>5.</td>
<td>IPMT1</td>
<td></td>
</tr>
<tr>
<td>6.</td>
<td>ISTO1</td>
<td>10</td>
</tr>
<tr>
<td>7.</td>
<td>5</td>
<td>Igl</td>
</tr>
<tr>
<td>8.</td>
<td>30</td>
<td>Igl</td>
</tr>
<tr>
<td>9.</td>
<td>7</td>
<td>Igl</td>
</tr>
<tr>
<td>10.</td>
<td>0</td>
<td>IFV1</td>
</tr>
<tr>
<td>11.</td>
<td>IPMT1</td>
<td></td>
</tr>
<tr>
<td>12.</td>
<td>IRCLI</td>
<td>10</td>
</tr>
<tr>
<td>13.</td>
<td>5</td>
<td>Ix!</td>
</tr>
</tbody>
</table>

Screen

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>360</td>
<td>0.83</td>
</tr>
<tr>
<td>100,000</td>
<td>0.00</td>
</tr>
<tr>
<td>-877.57</td>
<td>877.57</td>
</tr>
<tr>
<td>-96,574.32</td>
<td></td>
</tr>
<tr>
<td>360</td>
<td>0.58</td>
</tr>
<tr>
<td>0.00</td>
<td></td>
</tr>
<tr>
<td>-665.30</td>
<td></td>
</tr>
<tr>
<td>2,547.23</td>
<td></td>
</tr>
<tr>
<td>12,736.14</td>
<td></td>
</tr>
</tbody>
</table>

ANSWER: The cost of the buy-down loan is $12,736.14

NOTES: Step 5 calculates the monthly payments that are due under the 10% loan after the buy-down term. Step 6 stores it, since we'll need to recall that number in order to compute the payment differentials for the first five years. Step 7 computes the loan balance at the end of the fifth year. Steps 8 through 11 computes the buy-down rate, 7%, for the monthly payments for the first five years, shown in step 11 as $665.30. Step 12 computes the annual subsidy simply by multiplying the difference in monthly payments, resulting in the buy-down amount of $2547.23 for each of the first five years. Step 13 computes the total subsidy, the buy-down amount of $12,736.14 over the entire five-year period.

FUTURE VALUE vs PRESENT VALUE

The answer of $12,736.14 is the total buy-down amount, without adjusting for the time value of money. But we know that the difference between what would have been paid under the note rate of 10% and the first five years of subsidy at 7% can be generate additional earnings if put to work.
If therefore we want to be more precise, the $12,736.14 difference ($39,918.15 paid during the first five years vs the $52,654.29 that would have been paid without the buy-down) should reflect what the monthly savings could be realistically earning. If we project this at 6%, the Present Value Factors table in Unit One show .7473 at the intersection where the 6% column meets the 5 year period. Multiplying $12,736.14 by .7473 gives us a present value of $9,517.72 for the five year buy-down.

**Conclusion:** The buy-down is effectively worth $9,517.72, and not $12,736.14, after adjusting for the time value of money.

**Test Yourself**

**Data:**
- Trust Deed Loan: $100,000
- Term, payable monthly for 30 years
- Interest Rate:
  - First ten years: 5%
  - Each year thereafter: 10%

**Question:** What is the cost of the buy-down loan?

**Answer:** $40,890

---

**Unit Twelve**  **HOW DO I CALCULATE A BIWEEKLY MORTGAGE?**

**DATA:**
- 1st Trust Deed: $100,000
- Interest Rate: 10%
- Term, payable every 2 weeks for: 30 years

**QUESTIONS:**
- A. What are the biweekly payments?
- B. How long will it take to pay off the loan?

**SOLUTION:**

<table>
<thead>
<tr>
<th>Key</th>
<th>Screen</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 30 kg: 112x1</td>
<td>360</td>
</tr>
<tr>
<td>2. 10 :g: 112-1</td>
<td>0.83</td>
</tr>
<tr>
<td>3. 100000 :PV:</td>
<td>100,000</td>
</tr>
<tr>
<td>4. 0 IFV1</td>
<td>0.00</td>
</tr>
<tr>
<td>5. PMT</td>
<td>-877.57</td>
</tr>
</tbody>
</table>
NOTES: Don't be confused by the negative figure that shows up in step 5. It simply follows the opposite sign convention, and reflects money paid out. Read the monthly payments as: $877.57 without regard to the negative sign. But our question asks what payments are each two weeks. Without disturbing the data you have in your calculator, proceed to step 6:

6. 2 I-I
7. IPMT I
8. 10 'ENTER! IPVI
9. Ii!
10. InI
11. IPVI I-I

NOTES: Step 7 is required to lock in the payments for each two weeks into the memory of the calculator. In step 8, we divide the annual interest rate by 26, because there are 26 two-week periods, called "biweekly", in a year. In step 9 we lock in the biweekly rate by pressing 3i3. For step 10 we determine the number of two-week periods that it will take to pay off the loan. Step 11 converts this information into periods.

ANSWER A: The payments are $438.79 every biweekly period.

ANSWER B: The loan will be repaid in full in 20.96 years, or a hair under 21 years, which means that the final biweekly payment will be just slightly under $438.79.

Test Yourself

Self-Test 1: Trust deed: $200,000
Interest rate: 10%
Term, payable biweekly for: 30 years
Biweekly payments? Number of years to repay?

Self-Test 2: Trust deed: $200,000
Interest rate: 10%
Term, payable biweekly for: 15 years
Biweekly payments? Number of years to repay?
Self-Test 3: Trust deed: $100,000
Interest rate: 5%
Term: 30 years
Biweekly payments: ?
Number of years to repay?

Answers:

Self-Test 1: $877.57 biweekly payments
545 biweekly periods, or 20.96 years to repay
(Did you observe that this is the identical number of years as in the model problem? That's because the data is exactly the same except for the loan amount, which is doubled here.)

Self-Test 2: $1,074.61 biweekly payments
328 biweekly periods, or 12.62 years to repay

Self-Test 3: $268.41 biweekly payments
657 biweekly periods, or 25.27 years to repay
LESSON FOURTEEN
WHAT ARE SOME CREATIVE FINANCING APPROACHES?

PREVIEW:

In this lesson we discuss the reasons for creative approaches to financing. Why are alternative methods required? What are some of the methods used to finance real estate transactions that go beyond the traditional methods of financing? What instruments are used? A number of alternative approaches to financing are discussed and illustrated.

As you travel through this lesson, you should be aware that creative approaches come and go with changes in economy, law and real estate practices. Since most loans are no longer assumable, some of the approaches, limited only by one's imagination, may have only limited application during "stable" real estate markets. But when interest rates skyrocket, especially when accompanied by stagflation (such as in the early 1980s), some of the ideas and concepts in this lesson will be helpful once again. It should be noted that creative financing schemes are particularly useful in non-housing real estate transactions, regardless of market conditions.

PERFORMANCE OBJECTIVES:

After completing this lesson, you should be able to:

1. Differentiate between traditional and creative financing techniques.

2. Offer reasons for using alternative or creative financing.

3. List five types of creative financing techniques.

4. Describe how junior financing can be creatively structured.

5. Point out the advantages and disadvantages for using installment sales over "straight" sales.

6. Explain the techniques used in exchanging.

7. Interpret the major provisions of the Seller Carryback Financing Disclosure (Civil Code Sections 2956-2967).
I. INTRODUCTION TO CREATIVE FINANCING

A. What Is "Creative Financing"?

1. Non-traditional. Any financing technique not normally found through traditional sources.

2. Novel or unique arrangements in solving real estate financing problems.

3. Demand. The use of traditional sources is not enough to do the job of financing the enormous demand for real estate.

4. Limited by the imaginations of the seller and agent and the investor's willingness to accept such financial arrangements.

5. Bottom line: it is a phrase used to explain any financing alternative to the fixed-rate mortgage that will accomplish the buyer's desire to purchase and the seller's desire to sell.

B. Why "Creative" Financing?

1. Competition. Competitive demand for capital is a constant challenge facing continuous development of California's real estate industry.

2. Capital requirements. California is heavily dependent on out-of-state mortgage funds. Restrictions on the inflow of capital can result in a serious reduction of needed construction and real estate sales activity.

3. Tight money. When shortage of funds is accompanied by high interest rates, inflation, recession, and "stagflation", lenders tend to get nervous about committing to long-term, fixed-interest rate loans.

4. Alternatives. Additional sources of mortgage funds must be tapped through the use of new alternative financing techniques if real estate is to be successfully developed and marketed.

II. TECHNIQUES USED IN SOLVING THE FINANCING DILEMMA

A. What are Some of the Creative Approaches Used to Solve Financing Problems?

Many financing and quasi-financing techniques are used by buyers, sellers, and lenders to solve the dilemma of real estate ownership. The number of alternatives is limited
1. Secondary financing  
2. All-inclusive trust deeds  
3. Land contracts (Installment Sales Contract)  
4. Lender participations  
5. Sale-leasebacks  
6. Share collateral  
7. Open-end trust deed  
8. Divided amortization schedules  
9. Exchanging and trade-ins  
10. Commercial loans  
11. Stock equities  
12. Piggyback loans  
13. Seller carry back of first trust deed loan  
14. Lease-options  
15. Compensating balances  
16. Long escrows  

Time constraints limit discussion to only a few of the more commonly used techniques. Others are designed for advanced real estate finance courses.  

B. What are Some of the Instruments Used in the Creation and Consummation of Such Approaches?  

1. Assignment of Note and Deed of Trust  
2. Installment Note - Collateral Security Agreement  
3. All-Inclusive Note and Trust Deed (A.I.T.D)  
4. Long-Form Security Installment Land Contract with Power of Sale  
5. Sale-Leaseback Agreement  
6. Exchange Agreement  

III. SECONDARY FINANCING (not to be confused with secondary markets)  

A. What is meant by "Sellers Carrying Back Seconds"?  

1. Purchase Money Seconds. Known as owner "carry-back", or "gap financing", purchase money loans represent "paper" that sellers carry as part of their equity in order to help finance a sale.  

2. Amount. The amount that is to be carried back is measured by the difference between sale price and amount of down payment plus first mortgage.  

3. Filling the void. Difference between down payment (buyer's equity) plus loan amount (lender's equity) and sale price leaves a gap, or void, filled by seller "carrying back paper".
4. **Example.** A property sells for $150,000, with $20,000 down and a $100,000 first loan for 30 years at 10% annual interest. Seller agrees to carry back balance of $30,000 (the "gap") at 1% rate of payoff per month, including 10% interest, all due and payable in five years. Buyer's position, ignoring closing costs:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale price</td>
<td>$150,000</td>
</tr>
<tr>
<td>Less: Down payment</td>
<td>$20,000</td>
</tr>
<tr>
<td>Balance</td>
<td>$130,000</td>
</tr>
<tr>
<td>Less: 1st trust deed</td>
<td>$100,000</td>
</tr>
<tr>
<td>Seller carry back (purchase money 2nd)</td>
<td>$30,000</td>
</tr>
<tr>
<td>Monthly payments at 1% [.01 x $30,000]</td>
<td>$300</td>
</tr>
<tr>
<td>Balloon payment, end of 5 years</td>
<td>$26,128</td>
</tr>
</tbody>
</table>

5. **What if buyer is unable to meet the balloon at the end of four years?**

Several choices are available, including:

a. Renegotiate the junior loan
b. Secure new loan from outside sources
c. Refinance balance of first and junior loans
d. Sell the property if refinancing and renegotiation not possible.
e. Do nothing (not reasonable alternative, but nonetheless, it is an alternative).

**B. Collateralizing Junior Trust Deeds Loans**

1. **Pledge.** This is a process by which a secured loan is pledged as security, or collateral, for a loan, usually through private parties, mortgage brokers, and commercial banks for a percentage of the face value.

2. **Purpose.** Used where the seller does not wish to carry back secondary financing.

3. **Receipt of cash.** Seller may prefer to cash out in order to purchase a higher priced replacement dwelling.

4. **Example.**

   Seller takes back a $30,000 note at 10% to be paid at 1% per month, including principal and interest. Seller obtains a loan secured by the carry-back note for two thirds of the note's face amount, or $20,000, at a cost of eight points, payable 1% or more including interest at 10% per annum. Selling beneficiary's position is:
Second trust deed carried back by seller

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$30,000</td>
<td></td>
</tr>
<tr>
<td>Less: Collateral loan [66 2/3% x $30,000]</td>
<td>$20,000</td>
</tr>
<tr>
<td>Deferred portion</td>
<td>$10,000</td>
</tr>
<tr>
<td>Interest received on $30,000 second note</td>
<td>$14,128</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Interest paid on $20,000 collateral loan</td>
<td>$9,419</td>
</tr>
<tr>
<td>Eight points origination fee</td>
<td>$1,600</td>
</tr>
<tr>
<td>Net interest income over interest expense</td>
<td>$3,109</td>
</tr>
<tr>
<td>Balloon receivable end of 5 years</td>
<td>$26,128</td>
</tr>
<tr>
<td>Balloon payable end of 5 years</td>
<td>$17,419</td>
</tr>
<tr>
<td>Net payment to selling beneficiary</td>
<td>$8,709</td>
</tr>
</tbody>
</table>

5. How does collateralizing solve the problem of a seller who does not wish to carry back paper?

a. Control. Collateralizing the note provides a means by which a seller-borrower can obtain immediate cash, $18,400 in this illustration ($20,000 loan less $1,600 in points), yet retain control over an attractive investment.

b. Cash flow. Seller-beneficiary receives interest income of $14,128 over the five-year period, or approximately $2,825 annually, against yearly payments of about $1,884 in interest charges, netting $941 per year. At maturity, seller receives $26,128 from the purchaser of the property and pays out $17,419 on the collateralized note, netting the difference of $8,709.

C. Sale of Carryback Junior Loan

1. Purpose. Used where sellers need to cash-out.

2. Residual interest. Seller retains no residual interest in the property, unlike where seller carries back paper or when seller collateralizes the purchase money note as in previous illustrations.

3. Amount of discount varies according to location of property, buyer's credit, amount of equity, length of time note has been in existence (seasonality), payments schedule, amortization period, interest rate, maturity of loan, and market conditions.
4. Example. An investor buys seller's $30,000 second trust deed note at a 20% discount. The selling beneficiary's position is as follows:

- **Face value, 2nd trust deed note**: $30,000
- **Less: 20% discount (120 discount points)**: $6,000
- **Net proceeds to seller**: $24,000

5. How is the sale of a junior trust deed accomplished?

   a. "Assignment of Deed of Trust" is executed by seller-beneficiary, called assignor, in favor of the purchaser of the note, called assignee.

   b. Sources. Investors (buyers of junior loans) are found through real estate agents, escrow firms, loan brokers, reconveyance deeds recorded at the County Hall of Records, classified ads (in the section advertising loans for sale), and client files of brokers.

D. Broker Participation in Junior Loans

1. Partnership. Broker becomes a partner with the seller in the junior loan by breaking down the note into two component parts: Seller is named beneficiary, but assigns part or all of the commission due the broker through a collateral agreement.

2. Purpose. Used where seller needs more cash than is generated through relatively small down payments.

3. Assignment. The second trust deed is assigned to the broker for part or all of agent's commission.

4. Example. A home sells for $150,000 subject to a first loan of $100,000. Down payment is $20,000. Commission is for 6% of the sales price. Seller agrees to carry the $30,000 balance:

- **Sale price**: $150,000
- **Less: Down payment**: $20,000
- **Balance**: $130,000
- **Less: 1st trust deed loan**: $100,000
- **2nd trust deed loan for balance**: $30,000

Second loan divided as follows:

- **Broker's share, 6% of sales price**: $9,000
- **Seller's share for balance**: $21,000
5. What are the mechanics of such an agreement?

   a. Documents. Promissory note and trust deed are executed by buyer in favor of seller for full amount of second, $30,000.

   b. Contract. An instrument such as the Installment Note - Collateral Security Agreement is executed by sellers to broker for amount of commission, $9,000.

   c. Assignment. The Collateral Security Agreement is an assignment of seller's note and trust deed for the portion representing broker's interest (the commission amount).

   d. Default. In event of default, the instrument provides that broker may foreclose through public or private sale of the secured promissory note.

E. Combination or "Split" Junior Trust Deed Loan

1. Purpose. Used where seller is unwilling to sell or collateralize, and where broker does not wish to participate in any note for the commission.

2. Splitting the note. Secondary financing is split by buyer who executes two or more junior loans in favor of the seller, each carrying the same terms. Instead of one large second, the note is split into a second and third trust deed notes.

3. Example. Using the sales price and terms from the "broker participation" example, the position of the junior loans appear as follows:

   - Sale price: $150,000
   - Less: Down payment: $20,000
   - Balance: $130,000
   - Less: First trust deed: $100,000
   - Junior financing for balance: $30,000

   Divided as:
   - Second trust deed: $20,000
   - Third trust deed: $10,000

4. Advantages over a single junior

   a. Sale of note. Should sellers need cash, they could sell one of the trust deeds and retain
ownership of the other.

Where there is no alienation clause in the underlying note(s), such as commonly found in seller carrybacks.
b. Marketability. While each of the notes carry the same terms, a smaller intervening second is easier to sell in the secondary market.

c. Cash relief is readily available,

d. Compromise. Splitting junior loans offers a compromise to carrying back all of the unrecovered equity by seller.

IV. ALL-INCLUSIVE DEED OF TRUST

A. What is an All-Inclusive Trust Deed (AITD)?

1. Definition. A purchase money junior lien, given back to seller, that includes the amount of the first encumbrances as well as any secondary liens.

2. Other names. AITDs are also referred to as "wraparound", "overriding", "overlapping", or "hold harmless" deeds of trust.

3. AITDs are sometimes used in place of an installment sales contract.

{SHOW T 14.8}

B. What Are Some Characteristics of the AITD?

1. Subject to, yet includes encumbrances to which the AITD is subordinated.

2. Normally contains a provision that seller will pay off underlying loan(s) from moneys paid by buyer.

3. Seller-trustor under existing loan becomes a seller-beneficiary in the AITD, and buyer is the trustor.

4. Legal title is actually conveyed, usually by grant deed, and insurable by a policy of title insurance.

5. In event of default, seller-beneficiary follows the same procedure used to foreclose a standard trust deed. However, the action concerns only seller's net equity, which is $58,000 in our comprehensive example on page 14-10.

C. Under What Circumstances is the AITD Used?
3. Where an existing note contains a lock-in clause.

4. For large real estate projects, as is common in those owned through limited partnerships.

5. Where lenders in underlying notes containing acceleration clauses waive the right to accelerate.


7. Where the seller has overpriced the property to compensate for use of the all-inclusive benefits.

8. When only a small down payment is offered.

9. Where there is a low interest loan in existence, so that if the seller is forced to foreclose, benefits of any underlying loan is retained.

10. Where prospective buyers cannot qualify for required financing under normal sale conditions.

11. Where seller might otherwise need to carry back a substantial junior loan.

12. Where heavy prepayment penalties are contained in the underlying encumbrances.

D. Comprehensive Example. A property sells for $150,000. It has an existing assumable first loan of $50,000, payable $500 per month, including 9% per annum. It also has a $30,000 second loan, payable $350 per month including 10% annual interest. Deducting the $80,000 first from the $150,000 sale price leaves an equity of $70,000. Down payment is 8%, or $12,000. Balance of the purchase price, $58,000, is the seller's remaining equity. \[150,000 - (50,000 + 30,000 + 12,000) = 58,000\]. This $58,000 is added to the existing loans under the all-inclusive deed, payable at $1,500 per month, including interest at 11% per annum. To summarize:
$138,000 AITD payable $1,500 per month at 11% interest

<table>
<thead>
<tr>
<th>Down Payment</th>
<th>First Loan</th>
<th>Second Loan</th>
<th>Seller's Net Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amounts:</td>
<td>$12,000</td>
<td>$50,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Seller's Payments:</td>
<td>$500</td>
<td>$350</td>
<td></td>
</tr>
<tr>
<td>Interest Rate:</td>
<td>9%</td>
<td>10%</td>
<td>11%</td>
</tr>
</tbody>
</table>

Buyers' initial equity is the $12,000 down payment. Buyers execute an AITD note for the balance, $138,000, payable $1,500 per month, including interest of 11% per annum.

E. What Are the Benefits to Seller?

1. It may be the only practical way to dispose of a property where there is a prepayment penalty.

2. It may result in a higher selling price, due to the built-in financing terms.

3. The seller retains the favorable terms of the existing loan(s) in event of foreclosure.

4. During the holding period, the seller is able to increase the net yield on the A.I.T.D. than merely carrying back a junior trust deed.

Interest income, 11% of $138,000 = $15,268

Interest expense:
- 9% x $50,000 = 4,500
- 10% x $30,000 = 3,000
Total interest expenses = 7,500
Net interest income over interest expense = $7,768

Yield = \[
\frac{\text{Seller's net interest income}}{\text{Seller's remaining equity}} = \frac{7,768}{58,000} = 13.4\% \]

If the seller carried back a junior trust deed at 10%, assuming that this was a marketable and acceptable interest rate to the borrower, the seller's yield in that case would be 10%, not 13.4%.

5. A very substantial benefit to sellers under a properly-structured AITD is economic: here the seller charged a nominal interest rate of 11% but is receiving an effective return of 13.4%.
F. What are the Benefits to Buyers?

1. Acquisition of the property for which the buyers would not have otherwise qualified through traditional lending sources.

2. Acquire a larger property for the same low down payment, through the principle of leverage.

3. One monthly installment is required, instead of a series of payments if junior financing was obtained.

4. Greater flexibility may be offered in the structuring of the loan, since it is not subject to the stringent controls imposed by institutional lenders.

5. Buyer receives a deed, unlike such instruments such as land contracts.

6. Buyer saves on points and assumption fees and may request an interest rate lower than available in the general marketplace.

G. Buyers handling payments on this form of obligation should specify the use of a collection agent to assure that payments on senior indebtedness continues to be paid.

If time permits and sufficient interest is generated, you may wish to discuss the procedures used to properly setup an AITD.

H. Bringing us up-to-date.

1. The attractiveness of any investment is largely dependent on the yield potential of that investment.

2. Among the various residential investment alternatives, the wraparound concept stands as one of the most attractive investment potential for the home seller.

3. However, as existing loan cannot be easily assumed or not assumed at all, the use of the wraparound has diminished in recent years.

4. For the benefit and protection of all parties, the AITD should be recorded.

V. INSTALLMENT CONTRACT OF SALE

A. What is an Installment Contract of Sale?

A contract for the sale of property in which the buyer-vendee receives possession of the property, but not a
deed. Legal title is retained by the seller-vendor.

1. **Other names.** Usually called a Land Contract. This does not mean a sale of land only, though it originated with the sale of raw land. Today it is used for all types of properties, from sales of single family dwellings to high rise office buildings. Also referred to as Contract for Deed, Contract to Sell, Agreement of Sale, or Real Property Sales Contract.

2. **Unique feature.** By whatever it is called, a land contract is characterized by the fact that seller does not give up fee title until prescribed terms and conditions are met, such as "payment of no less than 50% of the purchase price" or the purchase price is its entirety.

B. **When Would I Use an Installment Land Contract?**

1. Where there is no due-on-sale or alienation clause. The land contract has the same problem as the AITD since many loans are not assumable.

2. When vendee has only a small down payment, and vendor does not wish to give up legal title.

3. Where favorable trust deed loans exist on the property, which vendor would retain in event of repossession.

C. **What Safeguard Might Be Provided When Licensee Proposes Use of a Land Contract?**

1. Full disclosure is required, as provided under the Creative Financing Disclosure Act (detailed later) alerting principals to the possible danger of enforcement of due-on clause by lender.

2. Execution of a disclosure statement. Sellers and buyers must be made aware of the call provision.

3. Consultation between the seller or buyer and a real estate attorney is advisable.

D. **Comprehensive Example.**

A property has an existing assumable first trust deed loan of $85,000 at 8% and is sold for $150,000. Buyer agrees to a 10% down payment, or $15,000, and agrees to execute a note for the balance, payable $400 per month at 9 1/2%, due and payable in 15 years:

<table>
<thead>
<tr>
<th>Sale price</th>
<th>$150,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Down payment</td>
<td>15,000</td>
</tr>
<tr>
<td>Balance</td>
<td>$135,000</td>
</tr>
</tbody>
</table>
Seller continues to make payments on the $85,000 first trust deed at the favorable 8% rate. Seller could have instead carried back a second trust deed for $50,000 (135,000 - 85,000) at, say, 10%. But the AITD will yield more with a 91/2% rate because it is charged on the entire loan of $135,000, meanwhile continuing to pay 8% on the underlying $85,000 - an increase of 11/2 on the $85,000.

E. It may prove wise for a mutually agreed upon trustee to receive loan payments from the buyer and disburse the appropriate amounts to the underlying lenders and the seller.

VI EXCHANGING (Section 1031 of I.R.S. Code)

A. How is Exchanging Used as a Financing Vehicle?

1. Exchanging is an alternative to financing, by means of which equities of two or more properties are traded.

2. An exchange is essentially a sale and a purchase, except that they are treated as a single transaction.

3. Where the equities are exactly equal, no cash is involved, except for money required to pay for brokerage and other services. But where the equities are not equal, the party with the smaller equity may balance the equities by cash, trust deed, other property, or combination or any of these forms of "boot."

B. What Are Some of the Reasons for Exchanging Property?

1. The exchanging of properties provides a convenient way to exchange equities without substantial cash that non-exchanges require.

2. Allows owners to dispose of an unwanted property for a desirable property.

3. Avoid recognition of capital gain, where the transaction qualifies as a tax-deferred exchange. A taxable event does not occur.

4. Pyramids one's investment into larger holdings for those desiring to build an estate.
6. Need to relocate and an outright sale is not possible because of market conditions.

7. Profit motive.

VII. DIVIDED AMORTIZATION SCHEDULE

A. What is Meant by the Term "Amortization"?

Amortization is the periodic reduction of the principal balance of a loan, usually through monthly installments. Amortization is covered throughout this course, especially in Lessons 5 and 13, but is re-introduced here with a creative twist.

B. What is Meant by "Divided Amortization"?

1. Alternative. It is one of many ways in which a loan may be amortized. We are accustomed to the "fully amortizing" plan in which loans are repaid in equal installments over the life of the debt, with portion of the payment applying to interest and the balance to principal. This was demonstrated with the formula, Interest = Principal \times Rate \times Time in Lessons 1 & 13.

2. Usage. The divided amortization schedule provides a means by which repayment of a loan could be tailor-made to fit the particular circumstances of the borrower.

3. Repayment schedule. Payments can be divided so that there is a faster maturity on one part of the loan and a longer maturity on another part of the loan. Example: a $100,000 loan could be arranged so that the first $25,000 is payable in ten years, and the balance of $75,000 over the following twenty years, allowing debtors to repay the bulk of the loan when their earnings (or the earnings of the property, in the case of income-producing properties) are expected to be greater.

4. Variation. Another repayment method may call for interest only for several years, with a complete amortization schedule developed from that point on.

C. The Annual Constant

1. Definition. The "annual constant" is the sum of twelve monthly payments divided by the loan amount. For example, if the loan amount is $1000 at 12% for 30 years, fully amortized with monthly payments of $10.29 principal and interest required, you then would multiply $10.29 \times 12 \text{ months} = $123.48 / $10,000 = \text{an annual constant of 12.35}

5. Dispose of a larger property in exchange for a smaller property, for which there is a broader market for
2. If expressed on a monthly basis, it would then be called a "monthly constant".

3. Application. The required annual payment is applied first to the interest and the balance to principal. The total amount of the loan, including principal and interest, is divided by the number of years to determine what the amount of equal payments will be. These payments, then, are "constant" for the term of the loan.

D How is the Annual Constant Used as a Creative Financing Technique?

1. Yield vs. Cash flow. The principal and interest portions of the constant may be planned to give the lender a particular rate of return, and at the same time to give borrowers, usually investors or developers, the debt service factor they desire.

2. Example. For a $100,000 loan, amortization tables show monthly payments are $900 for a 20 year loan at 9%. Multiplying this by twelve gives us $10,800. Dividing 10,800 by 100,000 results in an annual constant of 10.8.

   (It should be noted that we don't call it 10.8 percent because that may confuse with the rate of interest charged for the loan. Instead we simply call the annual constant 10.8. Informed investors know that this represents both principal and interest payments as a percentage of the original loan.)

   As demonstrated in Lesson Thirteen, the same $100,000 loan but at higher interest rates require longer repayment periods. At 10%, for instance, the loan would take almost 6 1/2 years longer to equate the same constant of 10.8. If a borrower needed a loan of $1 million and could get a 9% loan for twenty years, the payments would be $107,967 per year. If the lender charged 10%, the payments would increase to $117,459 per year (or 95.5022 x 12 = $115,803 if paid monthly) - almost $1,000 more per month. If the borrower could handle only $107,967 per year, the term would have to be extended another 6 1/2 years.

E. It goes further. There are other uses of the annual constant.

1. To determine the note interest rate.

2. To determine the existing loan balance at any point.

3. To determine the remaining term of a loan.
4. To determine how long it will take a loan with a specified loan amount to amortize.

VIII. **SHARED EQUITY FINANCING**

A. What is Shared Equity Financing? This is a financing arrangement that allows investors to obtain significant tax benefits while helping potential home buyers to acquire housing that they are otherwise unable to afford on their own.

1. Purpose. During periods of high interest rates and escalating home prices, shared equity financing is one way to make a transaction occur. High interest rates and high prices can make it virtually impossible for first-time homebuyers and other would-be homeowners to qualify for loans. By purchasing a home with the aid of an outside investor, buyers can purchase the property with relatively little capital with two parties qualifying for the loan.

2. Variations. While there are many variations, all involve two or more parties pooling resources to purchase a property using a shared equity financing agreement under split ownership. The partners under this financial arrangement are the resident owner and the non-resident owner-investor.

B. **Who Are The Parties?**

1. Resident owner. This can be anyone, but it is often young couple purchasing their first home. This couple could be the son, daughter, or other relative of the investor, or even total strangers. A grown son or daughter could be buying the home for their parents.

2. Non-resident owner. This is the investor, the person wanting one or more of the benefits of property ownership. The investor is often the parent or relative of the resident owner.

C. **What Are Some Advantages to the Resident Owner?**

1. Getting into a property sooner, instead of having to wait until they have the large down payment that is required.

2. Equity build-up through loan payments and appreciation.

3. Easier qualifying because of participation by the co-mortgagor/investor.
D. What Are Some Advantages to the Non-resident Owner-Investor?

1. Lower interest rate because the property will be owner-occupied.

2. At least partial income tax deductions.

3. Little, if any, tenant problems.

4. Share in the appreciation of the property's equity.

5. Shifting of management and maintenance problems to the resident-owner.

E. How Do I Get Started With SEF?

Due to its complex language, buyers and investors should approach shared equity financing arrangements only with competent advice, preferably from a tax attorney or CPA knowledgeable in this area. Different rules, for example, apply to whether the house is to be owner-occupied, percentage of ownership, whether or not fair rental is involved, duration of agreement, relationship of the parties, who is to pay for what, who will be entitled to tax deductions, and a myriad of other issues that should be addressed now rather than by redress through legal action later.

IX. SELLER CARRYBACK FINANCING DISCLOSURE (Civil Code Sections 2956-2967), which includes defining who is responsible for disclosures (the arranger of credit) and to whom it is required that it be given (purchaser and vendor). A "Seller Carryback Disclosure Statement" is illustrated on the following page as T 14-17.

A. Introduction

1. An alternative to traditional institutional financing. The seller provides some or all of the financing of his home to attract a buyer.

2. Disclosures.

   a. Certain disclosures to buyers and sellers involved in seller-financing are mandated by law.

   b. These disclosures are an attempt to better inform prospective sellers and purchasers of the pitfalls of unconventional or "creative" financing.
c. The law is aimed mainly at those who engage in short-term financing on the premise that the buyer will be able to obtain a new loan later at more affordable interest rates.

d. It is hoped that strict compliance with the law will minimize if not eliminate altogether fraud, misrepresentation and deceit in creative financing transactions.

3. Application. The law applies to residential sales in which the seller carries some of the financing. It applies to the purchase of a structure consisting of one to four-family dwellings where the seller extends credit to the buyer, even if the property is not owner-occupied.

4. Extension of credit.

a. The seller "extends credit" any time a buyer is given the right to defer payment of the purchase price as long as there is written agreement that provides either for a finance charge or for payments to be made in more than four installments, whether of principal and interest or of interest only, not including the down payment.

b. "Purchase" includes conveyance of equitable title by use of a land contract, or a lease with option to purchase.

5. Loan Arranger of Credit.

a. The disclosure requirements are imposed on the "arranger of credit". This includes real estate licensees or attorneys who are parties to a transaction.

b. The language is clearly directed at real estate agents even if the only compensation to be earned is the commission on the sale.

c. Where there is more than one arranger of credit, the arranger who obtains the purchase offer from the buyer is the one who must make the disclosure unless another person is designated in writing by the parties.

d. Unless otherwise stated the selling agent is normally the responsible party for disclosure purposes.
B. Timing the disclosures.

1. **Immediacy.** Required disclosures must be made "as soon as practicable", but before execution of any note or security document (trust deed, mortgage, land sale contract, lease option).

2. **Contingency.** If any credit documents, including notes or contracts of sale that spell out the financing terms of the transaction, are signed prior to disclosure, they must be contingent on the purchaser's approval before execution of the security document (trust deed, etc.).

3. **Signatures.** The seller and buyer must sign receipts for the disclosure statements, and the arranger must also sign the statements.

C. What Must Be Disclosed?

1. **Identification** of the note, other credit and security documents, and of the property which is the security for the transaction.

2. **Description** of the terms of the promissory note and other credit documents. A copy of the note or other credit documents is acceptable in lieu of a description.

3. **Terms and conditions** of each recorded encumbrance which constitute a lien upon the property which is senior to the financing being arranged, including: original balance, current balance, periodic payments, balloon payments, interest rate, maturity date, and whether there is any current default in payment on any encumbrance.

4. **Balloon payments.** These are defined as payments due at maturity which are more than twice the amount of the smallest regularly scheduled payment. Where balloons are due, the holder must deliver or send to the trustor or any successor in interest, not less than 60 days nor more than 150 days before the due date, a notice which states:
   a. The name and address of the party to whom payment is due
   b. The due date
   c. The exact amount due (or a good faith estimate),
d. A description of any right to refinance and the terms of the refinancing.

e. A statement that there is no assurance that new financing or loan extension will be available at the time the balloon is due.

5. Warning that if refinancing would be required because full amortization is lacking under the terms of existing or proposed loans, notice must be given that such refinancing might be difficult or impossible in the conventional mortgage marketplace.

6. Negative amortization possibilities as a result of any variable or adjustable rate financing being arranged must be disclosed along with an explanation of its potential effect.

7. All-Inclusive Trust Deeds must indicate who is liable for payment or responsible for defense in the case of an attempted acceleration by a lender under a prior encumbrance, along with the rights and obligations of the parties in event of a loan prepayment that may result in refinancing, prepayment penalty, or prepayment discount.

8. Collecting agent. If the financing involves an all-inclusive trust deed or real property sales contract, the parties may agree to have payments made to a neutral third party who will be responsible for making payments to payee(s) under prior encumbrances.

9. Buyer data. Disclosure on the identify, occupation, employment, income and credit data about the prospective purchaser. Or the disclosure can state that no representation as to the credit-worthiness of the purchaser is being made by the credit arranger.

10. Insurance. A statement that loss payee clauses have been added to property insurance protecting the vendor, or that if such provisions have not been made, that the vendors should protect themselves by securing such loss payee clauses.

11. Default. A statement that a request for notice of default under Civil Code Section 2924(b) has been recorded. If such notice has not been recorded, the vendor should consider recording a request for notice of default.
12. Title policy. Disclosure must be given that a title insurance has been obtained or will be obtained and be furnished to the vendee/purchaser insuring the interest of the purchaser, or that the purchaser should consider obtaining a policy of title insurance.

13. Property taxes. That a tax service has been arranged to report to the vendor whether property taxes have been paid on the property, who will be responsible for its payment, and who is obligated to continue maintaining the tax service.

14. Security documents. The disclosure must state whether the security documents will be recorded (pursuant to section 27280 of the Government Code). If they will not be recorded, the credit arranger must state that the security of the vendor may be subject to intervening liens or judgments that may occur after the note is executed.

15. Cash proceeds. If the purchaser is to receive any cash from the proceeds of the transaction, the disclosure must state the amount, source of funds, and purpose of the disbursement.

16. Requirement for other disclosures. The above disclosures do not limit other disclosures that must be made by law (such as the Federal Home Mortgage Disclosure Act), or in order to avoid "fraud, misrepresentation, or deceit".

X. REPRISE

A. There are many other creative financing techniques than the handful discussed in this lesson, but it would be impossible for instructor and students to discuss all of these in the limited time accorded for each of the lessons (typically three hours).

B. The number of financing alternatives are limited only by the creativity and imagination of real estate practitioners, principals and investors. Among those that were not included in the lesson are:

- Bow tie
- Buy-down loan
- Commercial loan
- Compensating balances
- Equity kickers
- Lease options
- Long escrows
- Open end trust deed
- Piggyback loan
- Profit participations
- Revenue sharing
- Sale-leaseback
- Share collateral
- Silent seconds
- Stock equities
- Zero interest loans
C. Finally, it should be noted that some techniques are not "creative" per se, and therefore not discussed in this lesson.

1. Prime example: The seller carrying back the 1st trust deed when the property is free and clear. The real creativity here is not in the financing vehicle, but in the agent's successfully selling the sellers on the idea of carrying back the 1st T.D.!

2. It may even involve an agent who sells the seller on the idea of carrying back a second trust deed even if the seller needs the cash now! In this case, it obliges the agent to locate an investor willing to purchase the second trust deed. The agent will now have to explain the benefit to the seller who will receive less proceeds because the trust deed must be discounted.
LESSON FOURTEEN MULTIPLE-CHOICE QUESTIONS

Directions: Underline the letter representing the correct answer.

1. Under shared equity financing, who gets the tax deductions?
   (a) Resident-owner exclusively
   (b) Non-resident owner exclusively
   (c) Contract terms generally control
   (d) The party obligated to repay the loan

2. A purchase money junior trust deed, given back to seller, that includes the amount of the first encumbrance as well as any secondary liens, is called a(n):
   (a) "hold-harmful trust deed"
   (b) "all-inclusive trust deed"
   (c) "combination trust deed"
   (d) "collateral trust deed"

3. Legal title is retained by the seller in the financing of property through the use of:
   (a) all-inclusive deed of trust
   (b) mortgage instrument
   (c) installment land contract
   (d) exchange agreements

4. Under Civil Code sections related to seller carryback financing disclosure requirements, the agent or arranger of credit must inform the pitfalls of creative financing to which party?
   (a) Buyer
   (b) Seller
   (c) Sellers and buyers
   (d) Members of the local multiple listing service

5. If a buyer is unable to meet a balloon payment on a junior loan at maturity, the buyer may:
   (a) renegotiate the loan
   (b) secure a new loan from outside sources
   (c) refinance the entire loan
   (d) seek out any of the foregoing remedies

6. You sell your home for $125,000. Buyer gives you $25,000 in cash, and secures a new $80,000 first loan. The amount needed to fill in the gap is:
   (a) $20,000
   (b) $25,000
   (c) $100,000
   (d) $125,000
7. To collateralize a loan means to:
   (a) take back a second trust deed
   (b) carry back a mortgage
   (c) pledge the loan as security
   (d) secure the loan with a new mortgage

8. If the face value of a note is $25,000 and it sells at a 30% discount, the cash proceeds to the seller of the note will amount to:
   (a) $ 7,500
   (b) $17,500
   (c) $25,000
   (d) $ 1,750

9. Broker participation means that the broker:
   (a) will get all cash for the commission
   (b) will take back a note for the commission
   (c) will participate in the net equity upon resale
   (d) will split the proceeds of the sale

10. In using an AITD you must make sure that the underlying loan is:
    (a) not too large
    (b) assumable
    (c) not assumable
    (d) variable in the interest charged

11. Under a land contract of sale, buyers receive what kind of title?
    (a) legal
    (b) equitable
    (c) actual
    (d) constructive

12. Shared equity financing is a vehicle that is most popular during:
    (a) a sluggish economy
    (b) periods of high interest rates
    (c) periods of low interest rates
    (d) times when housing prices decline

13. The following areas need to be address when considering a Shared Equity Financing arrangement:
    (a) Who will be entitled to tax deductions.
    (b) What will be the parties' percentage of ownership
    (c) Is the house to be owner-occupied.
    (d) All of these are issues that need to be resolved.
14. Which of the following characterizes an AITD?
   (a) subject to, yet includes encumbrances to which the AITD
       is subordinated.
   (b) normally contains a provision that seller will pay off
       the underlying loan(s) from moneys paid by the buyer.
   (c) seller -trustor under the existing loan becomes a
       seller-beneficiary in the AITD, and the buyer is the
       trustor.
   (d) all of the above apply

15. A buyer executes a junior trust deed note and deposits it
    into escrow. The seller wishes to sell the note immediately.
    It would be best to sell it:
    (a) before escrow closes
    (b) after the close of escrow
    (c) only by a licensed mortgage broker
    (d) to the escrow company

16. Many of the motives that justify an AITD are also applicable
    to:
    (a) land contracts
    (b) split junior loans
    (c) shared equity financing
    (d) collateralization of junior loans

17. As arranger of real estate loans, Broker must disclose:
    (a) the commission received
    (b) any negative amortization
    (c) terms and conditions of any balloon payments
    (d) all of the above

18. When a buyer receives only equitable title in the purchase of real estate,
    the instrument used would be a:
    (a) a land contract
    (b) equitable contract
    (c) an AITD
    (d) a junior mortgage

19. Which of the following Internal Revenue Code sections deals with tax-
    deferred exchanges for real estate?
    (a) 1031
    (b) 1033
    (c) 1034
    (d) 1035

20. A financing technique that would least likely be
    characterized as "creative" is:
    (a) seller carrying back a third trust deed
    (b) use of an AITD
    (c) broker participating in a junior mortgage
    (d) seller taking back the first trust deed
CHARACTERISTICS OF THE ALL-INCLUSIVE DEED

SUBJECT TO, YET INCLUDES ENCUMBRANCES TO WHICH IT IS SUBORDINATED.

2. NORMALLY CONTAINS A PROVISION THAT SELLER WILL PAY OFF UNDERLYING LOANS) FROM MONIES PAID BY BUYER.

3. SELLER-TRUSTOR UNDER EXISTING LIENS BECOMES A SELLER-BENEFICIARY, WHILE BUYER IS THE TRUSTOR UNDER THE ALL-INCLUSIVE DEED OF TRUST.

4. LEGAL TITLE IS ACTUALLY CONVEYED, USUALLY BY GRANT DEED AND INSURABLE BY POLICY OF TITLE INSURANCE.
PROCEDURES IN SETTING UP AN ALL-INCLUSIVE DEED

1. ARRANGE TO RENEGOTIATE OR PAY OFF EXISTING LOANS THAT RESTRICT ALIENATION.

2. CONSTRUCT A REALISTIC PAYMENT SCHEDULE ON THE ALL-INCLUSIVE TO COVER OUTSTANDING BALANCES, PERIODIC PAYMENTS AND BALLOON PAYMENTS PROVISIONS ON THE EXISTING LIENS.

3. DECIDE WHO IS TO PAY FOR THE COST OF SETTING UP AND ADMINISTERING THE COLLECTION PROCESS.

4. DETERMINE CONDITIONS GIVING RISE TO DEFAULT.

5. HAVE ATTORNEY DRAW UP NECESSARY AGREEMENTS AND DOCUMENTS, USING PHRASEOLOGY ACCEPTABLE TO THE TITLE COMPANY WHICH IS TO INSURE THE TRANSACTION AND ACT AS TRUSTEE UNDER THE ALL-INCLUSIVE DEED OF TRUST.
REASONS FOR EXCHANGING PROPERTY

1. THE EXCHANGE PROVIDES A CONVENIENT VEHICLE BY OFFERING EXCHANGE OF EQUITIES, WITHOUT REQUIRING SUBSTANTIAL CASH OR BOOT TO BALANCE THE EQUITIES.

2. ALLOWS TAXPAYER TO DISPOSE OF AN UNWANTED PROPERTY FOR A DESIRABLE PROPERTY.

3. AVOID RECOGNITION OF CAPITAL GAIN WHERE THE TRANSACTION QUALIFIES AS A TAX-DEFERRING EXCHANGE.

4. PROVIDES A HIGHER, MORE FAVORABLE BASIS FOR DEPRECIATION WRITEOFF IN THE CASE OF DEPRECIABLE PROPERTY.

5. "PYRAMIDS" ONE'S INVESTMENT INTO LARGER HOLDINGS IN CONNECTION WITH TAXPAYER'S DESIRE TO BUILD AN ESTATE.

6. DISPOSES OF A LARGE PROPERTY IN EXCHANGE FOR A SMALLER PROPERTY, FOR WHICH THERE IS A BROADER MARKET FOR ULTIMATE SALE.

7. NEED TO RELOCATE.

8. PROFIT MOTIVE.
SELLER CARRYBACK DISCLOSURE STATEMENT

DISCLOSURES:

1. General information concerning note to be executed by Buyer to Seller:

1.1 Note to be executed by buyer in the original amount of $________ payable in constant monthly ________ installments of $________ to include ____________ percent per annum interest, C until paid C all due and payable with a final/balloon payment on ________________ 19 in the approximate amount of S________.

1.2 The note will be secured by a trust deed on the property__________________________

1.3 If this note contains a FINAL/BALLOON PAYMENT, the debt is not fully amortized. When this remaining balance is due and payable, there can be no assurance that refinancing, modification or extension of the balloon payment will be available to the Buyer.

1.4 Unless stated and explained in an attached addendum, the note contains a fixed rate of interest with no variable or adjustable interest rates which would increase payments or result in a negative amortization of the debt.

1.5 Unless stated, the original amount of the note will be adjusted by __________ endorsement at close of escrow, to reflect differences in the then remaining balance of any underlying trust deed obligation(s) being assumed or obtained. ___________________________________________________________________________

1.6 If an All-Inclusive Note and Trust Deed are carried back by Seller, they will contain provisions holding - Buyer harmless from any failure of Seller to pay all demands of the underlying existing trust deed holder(s) for regular installments or accelerations under due-on-sale clauses and any prepayment penalties or discounts. Any refinancing of the property to meet these demands will require the consent of both Buyer and Seller.

2. Special provisions:

2.1 If an All-Inclusive note and trust deed are carried back by the Seller, they will contain provisions that the Seller will place the note on contract collection with any institutional lender, escrow officer or real estate broker, other than the Seller, and that the collection agent is instructed to first disburse funds on payments due senior encumbrances.

2.2 A part protection CLTA policy of title insurance will be delivered to Buyer and Seller insuring their interests in the close of escrow.

2.3 The trust deeds and grant deeds or land sale Contracts to be executed will be recorded with the county recorder at close of escrow.

2.4 The Seller will be named: through escrow, as a loss payee under the hazard and fire insurance assigned to or obtained by the Buyer.

2.5 No tax reporting service shall be obtained (or the Seller and Seller will execute irrevocable assignments or powers of attorney for the Buyer).

2.6 Requests for Notice of Default and Notice of Delinquency under California Civil Code Sections 2924b and 2924e will be recorded and served on behalf of Seller on encumbrancer senior to the carryback.

2.7 Seller is aware that in the event of a default under the carryback note and trust deed, his sole source of recovery is limited to the net proceeds from foreclosure or his subsequent resale: and he is not entitled to rental value or deficiency money judgment under the note. (CC 580b)

2.8 Unless entered, Buyer shall receive no net proceeds or cash back upon the close of escrow. Amount to be received $ _______.

2.9 The note shall include the following provision: This note is subject to the California Civil Code, which provides that the holder of this note shall give written notice to the trustor, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any balloon payment is due.'

3. Conditions of encumbrances, with priority over the Seller's carryback note and trust deed, which will remain or be placed of record at time of closing are as follows:

<table>
<thead>
<tr>
<th>First Trust Deed</th>
<th>Second Trust Deed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original balance:</td>
<td>$__________________</td>
</tr>
<tr>
<td>Current balance:</td>
<td>$__________________</td>
</tr>
<tr>
<td>Interest rate:</td>
<td>% C VIR ___________ S C VIR</td>
</tr>
<tr>
<td>Type:</td>
<td>Type'</td>
</tr>
<tr>
<td>Monthly payments:</td>
<td>D ue date: 19_________</td>
</tr>
<tr>
<td>Balloon payment:</td>
<td>Current defaults:</td>
</tr>
</tbody>
</table>

4. Buyer credit Information (supplied by Buyer):

Buyer to hand Seller a completed credit application on acceptance. Contingent on Seller terminating the agreement within days of acceptance by delivering to Buyer, Buyer's broker, or escrow written Notice of Cancellation based on disapproval of Buyer's credit.

5. Broker disclosures:

5.1 Credit data is supplied by Buyer. Broker knows of no falsity or omission concerning the Buyer's credit information.

5.2 This statement and its contents, being statutorily required disclosures, do not limit the broker's duties to disclose other facts material to the Buyer or Seller.

5.3 The Buyer and Seller are not to sign this statement until they have read and understood all of the information in it. All parts of the form must be completed before signature.

5.4 This statement, when made a part of the contract, creates no right in either the Buyer or Seller to rescind their contract after acceptance.

5.5 This statement was prepared and presented by the broker or agent, to the party who offers or counteroffers to buy, sell, exchange or option, as part of the offer or counteroffer received by the broker or agent.

A copy of this statement shall also be delivered to the party accepting the offer or counteroffer. The statement is signed by the broker or agent who prepares it. Both buyer and seller sign it acknowledging they have read and received a copy.

Buyer credit Information (supplied by Buyer):

<table>
<thead>
<tr>
<th>First Trust Deed</th>
<th>Second Trust Deed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original balance:</td>
<td>$__________________</td>
</tr>
<tr>
<td>Current balance:</td>
<td>$__________________</td>
</tr>
<tr>
<td>Interest rate:</td>
<td>% C VIR ___________ S C VIR</td>
</tr>
<tr>
<td>Type:</td>
<td>Type'</td>
</tr>
<tr>
<td>Monthly payments:</td>
<td>D ue date: 19_________</td>
</tr>
<tr>
<td>Balloon payment:</td>
<td>Current defaults:</td>
</tr>
</tbody>
</table>

6. Other provisions:

<table>
<thead>
<tr>
<th>Seller's Broker:</th>
<th>Seller's Broker:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Address:</td>
<td>Address:</td>
</tr>
<tr>
<td>Phone:</td>
<td>Phone:</td>
</tr>
<tr>
<td>By:</td>
<td>By:</td>
</tr>
<tr>
<td>Dane:</td>
<td>Dane:</td>
</tr>
<tr>
<td>Buyer:</td>
<td>Buyer:</td>
</tr>
<tr>
<td>Broker's approval:</td>
<td>Broker's approval:</td>
</tr>
</tbody>
</table>

This statement is required by California Civil Code Sections 2924b and 2924e. Seller carries back a note executes: by the buyer as part of the sale once for property containing four or less family units.
LESSON FIFTEEN
HOW DOES ONE FINANCE SMALL INVESTMENT PROPERTIES?

PREVIEW:
An understanding of the characteristics of each type of investment property is necessary so that you can better understand how investor's objectives can be met. In this lesson, we examine the advantages and disadvantages of ownership for each class of residential income, commercial, and industrial properties. The lesson concludes with an introduction to the financing of commercial and industrial properties with comprehensive examples of each.

PERFORMANCE OBJECTIVES:
After completing this lesson, you should be able to:

1. List some of the differences between financing of single family dwellings, commercial, and industrial properties.
2. Explain why interest rates, points and terms of loans for different categories of properties vary so widely.
3. Cite tax shelter opportunities for various classes of property.
4. Describe what financial information should be obtained in listing an apartment project.
5. Compare advantages and disadvantages of investments in residential income-producing properties to commercial and industrial properties.

I. SINGLE-FAMILY DWELLING (SFD) AS INVESTMENTS

A. What Are Some General Characteristics of SFD Rentals?

1. There is usually a substantial and varied supply of such properties from which to choose.

2. Management of single dwellings is less demanding than other types of residential rental properties.

3. A house is generally very salable, offering a high degree of liquidity.

4. One big drawback is the vacancy factor. When the property is unoccupied, it is 100% vacant!
B. What Kinds of Financing is Available For SFDs?

1. Conventional loan of 70% of purchase price is almost always available from savings and loan associations and banks. (This is less than the traditional 80% that an owner-occupied dwelling commands because lenders will not grant a loan that creates negative cash flow that is typical of most house rentals.)

2. Lenders generally requires at least 20% down and allow secondary financing for the balance of purchase price.

3. Assumption of existing loan, with seller carrying back second loan.

4. Care should be taken to insure that the loan is one that can be assumed and by whom.- an owner-occupant or a non-owner occupant.

C. Interest Rate and Other Terms of Loan for Rental Houses

1. Conventional lenders generally ask for 1/4% to 1/2% more interest on a rental home than on owner occupied.

2. Single-family homes almost always command the lowest interest rate and the best overall terms.

3. Term of loan, late charges, and other provisions are generally the same as for owner-occupied, single dwellings.

4. Prepayment privileges and penalties apply differently to single-family rentals. Check the promissory note and deed of trust for clarification on the terms of the prepayment penalty.

D. What Are Some Advantages of Single Dwellings as Rentals?

1. Ample selection of properties available.

2. Ease of management.

3. Liquidity.

4. Tenant usually pays for all utilities, gardening and minor repairs.
6. Vacancy factor in single-family homes is lower than other types of residential properties.

7. Price appreciation has risen more quickly and at a greater rate than for most other types of properties in recent inflationary periods.

E. What Are Some Disadvantages to Single Dwellings as Rentals?

1. Homes tend to have more area than apartments. The larger the unit, the less the rent is per square foot when compared to clustered rentals.

2. When house is vacant, 100% of the rent is lost until re-rented.

3. Investor must personally manage since there is no resident manager or enlistment of a private property management firm or real estate agent who specializes in single-family residence properties.

4. As investor acquires more houses, especially in scattered locations, more capital and time is required for travel than if units were all under one roof.

II. TWO-TO FOUR-UNIT RESIDENTIAL PROPERTIES

A. General Characteristics

1. Duplexes, triplexes and fourplexes are more scarce than single rentals.

2. Management is relatively simple.

3. Demand by investors creates relatively good resale market and liquidity.

B. What Kind of Financing is Available?

1. Conventional loans of 70% of value from savings and loan associations and banks.

2. Most lenders require income from the buyer to be sufficient to meet loan payments without relying too heavily on income from the property.
2. Loan fees run 1/2% to 1-1/2% than on prime owner-occupied houses.

3. Term of loan may be less than for single dwellings.

4. Prepayment penalty generally calls for six months' interest, with 20% payoff allowable in any one calendar year without penalty.

D. What Are Some Advantages of 2 to 4-Unit Rentals?

1. Many such properties can be found in most communities.

2. No resident manager required.

3. Owner may delegate some of management duties such as gardening, cleaning and minor repairs to one of the tenants for a nominal fee or for rent concession, saving time and expense for absentee owner.

4. Tenants usually pay for their own utilities.

5. Two to four-unit rentals are next most popular to single dwellings and will often rent while large apartments complexes go vacant.

6. More privacy, with fewer people above or below tenant's unit.

7. The units are under one roof or in central location, saving management supervisory time and travel.

E. What Are Some Disadvantages of 2 to 4-Unit Rentals?

1. Yields to investors are not usually enough to meet operating costs and debt service, requiring owner to "feed the property" because of negative cash flow.

2. Owners must generally pay the water, outside lights and laundry room utilities, unlike single dwellings where tenant pays all.

3. Owners are often forced to keep rents at lower than break-even point in areas containing an excessive number of such properties.
III. LARGER-SIZED APARTMENT PROPERTIES

A. General Characteristics

1. During periods of oversupply owners must be able to withstand temporary losses by "feeding the property" through their own cash resources.

2. Environmental factors make buildings more expensive to build and maintain. New energy requirements, insulation, reduced land density is reflected in higher prices for new apartments.

B. What Kind of Financing Is Available

1. Most apartment houses are financed by conventional loans of from 70% to 80% of value. The ratio is reduced from 80% to 70% with larger complexes.

2. Interest rates can range from k% to 11/2% higher than for prime single dwellings. Loan fees range from k% to 1% higher than single units.

3. Term of loan can be 30 years, but is usually 25 years on larger complexes.

4. Lenders are generally more concerned about credit of the borrower.

5. Regardless of sale price, lenders make their own evaluation of properties. If present rents are not supportable, they may use average market rents for similar units in the area.

6. For furnished apartments, lenders deduct rental income attributable to the furniture and use capitalized income stream from unfurnished units to determine market value.

7. When conventional loans are not available, one or more of the creative financing techniques covered in Lesson 14 might be used, sometimes on an interim basis only, until conventional financing is again available.

8. Savings and loans associations are viable as a source of financing of large apartment projects, but losing ground to commercial banks, life insurance companies, and pension funds.
C. What Are Some Advantages to Larger Rental Properties?

1. Apartment investments tend to be safer than other real estate options for the average investor.

2. Management is concentrated in one location, rather than diffused over a wide area for the same number of units.

3. Cost of operation is usually less per unit than in scattered properties.

4. Tax relief is available through depreciation write-off. Typically 80% of total value is in improvements. Costs for personal property such as carpets, drapes, appliances, and furnishings are also recoverable over much shorter periods, ranging from 3 to 10 years.

5. Good hedge against inflation, estate builder and possible generator of retirement income

D. What Are Some Disadvantages to Larger Rental Properties?

1. Changing neighborhood patterns and encroachment of heavy business or industrial buildings, may result in declining property values.

2. Rent controls and other consumer ordinances can lead to rent collection problems and legal fees.

3. Many owners do not have the temperament to deal with problems of management involving numerous requests for services from tenants.

IV. MARKETING APARTMENT PROPERTIES: THE BROKER'S ROLE

There are many opportunities for licensees to get involved with the marketing and financing of income-producing properties. A short lesson is offered here for those who plan to specialize in this area of real estate brokerage.

A. What Motivates Owners To Sell Their Apartments?

1. On-going management problems may prompt some to sale.
2. Cash needs. Such sellers may not be in position to carry back a loan.
3. Desire for a larger building. The possibility of an exchange might be considered.
4. Moving from the area. Here the owners may wish to reinvest in the new area, or they may be willing to carry back paper that will generate monthly income.
B. What Financing Information Will I Need to Obtain?

1. Get name of lenders, address, phone number and loan number. Get written authorization from owners to write lenders in order to obtain such vital information as status of existing financing, terms of the note, loan balance, pay-off provisions and assumability, etc.

2. If more than one loan, obtain same information for each. Ascertain whether any of the lenders will permit financing through an AITD or other creative instrument.

3. Ask owners for a copy of the note and deed of trust on each loan. If they do not have copies obtain written authorization for you to obtain from lender.

4. Check each note for monthly payment, interest rate, due dates, prepayment provisions, due-on-sale and acceleration clauses, along with any other information that will help you determine appropriate financing options.

5. Determine whether the loan is held by an institutional investor or by private party.

C. Map Out Probable Financing Strategies For the Sale

1. Confer with existing lender on all loans, preferably with letter in hand from owners of the property.

2. Even if loan has a due-on-sale clause, ask lender how the loan can be assumed. For instance, will there be an increase in interest or points or payments?

3. Is the lender willing to increase the loan to a new buyer?

4. Will lender waive the prepayment penalty for the benefit of the seller? How much will the lender charge? Will lender split the prepayment penalty?

5. What special terms will a new loan likely contain? What will the interest rate be? Will the note be fixed or variable? How long will it run? What about prepayment penalty, acceleration clause, loan fees, other requirements? Will lender allow junior financing?

6. Will new lender require an impound account for taxes, or will this be waived?
7. If a new first loan can be obtained for higher than the existing loan, will holder of second loan require a complete payoff, or will second holder take some payoff and allow a portion of that loan to remain on the property?

D. Conference With Seller

1. If seller does not need cash, will seller carry back a junior loan?
2. Will seller take back an all-inclusive deed of trust?
3. Will sellers finance on installment sales contract?

E. What if the Current Financing Market is Poor?

1. Owner might carry back first loan or all-inclusive loan with provision that when the market improves, buyer will take out a new loan and pay off owner part of all of the seller carryback.
2. Offers buyer time to obtain conventional financing when market is stronger, while allowing owners to sell at a time when poor financing is available to buyer.

F. How Do Financing Conditions Affect Price of the Property?

1. When interest rates go up, net income after interest expenses decrease.
2. Interest rate increases result in decreased yields and lower market values.
3. When interest rates decrease, yields increase, tending to raise property value.
4. Property should be priced so that the capitalization rate equals or exceeds the interest rate. Cap rate is calculated by dividing net operating income (NOI) by the sale price.
   a. Example 1.
   If yield or capitalization rate of building is 9% and buyer must pay 10% interest, buyer is losing 1% on every borrowed dollar. This is labeled "negative leverage".
   b. Example 2.
   If cap rate is 10% and interest rate is only 9% the investor has "positive leverage"
5. In listing and pricing property, agent must review income and expense statements, determine true NOI with proper allowance for vacancy factor, and determine at what price the property should be listed so that yield is at least equal to the interest rate.

6. Existing low-interest assumable loans should be preserved if at all possible. When a loan has been in existence for many years, seller will have large equity. Agent can structure sale so that seller's remaining equity can be split in different ways. For example, $100,000 could be split into a $60,000 second and $40,000 third trust deed. Seller can then sell the second loan at prevailing discount, receive some cash, and hold the $40,000 third loan.

G. Pricing: Sound Economic Principles vs Tax Shelter

1. If property shows a return on investment based only on tax shelter, it may not be good investment for buyer for at least two reasons:

   a. The gain upon sale of property at ordinary income tax rates, including depreciation recapture, can be very costly to sellers in high tax brackets.

   b. Changes in tax laws may eliminate certain tax benefits, as they did with the 1986 Tax Reform Act.

2. Apartments require more management and work than other types of investments, resulting in greater yields.

3. Marketability of apartment houses is enhanced when owners assist in their financing.

V. NON-RESIDENTIAL RENTAL PROPERTIES.

The subject of financing commercial, industrial and special-purpose properties is better left to an advanced course in real estate finance, but we'll at least introduce the subject here.

A. Commercial Properties.

   There are a wide variety of commercial properties, generally classified by use:

   1. Neighborhood stores, or so-called strip stores.

3. Neighborhood shopping centers: cluster of stores surrounding a mini-market such as a 7-Eleven store, usually with some off-street parking.

4. Community shopping centers: larger group of stores surrounding a major supermarket and at least one department store.

5. Service stations and garage buildings.

6. Franchise outlets: fast food, either in free-standing building or as part of a center, automotive franchise buildings, and numerous other franchise outlets.

7. Motels, hotels, mobile home parks.

8. Office buildings, ground floor and multi-story.


10. Rest homes and convalescent hospitals.

11. Special-purpose buildings, such as built-to-order for banks, savings and loan associations, insurance companies.

12. Office parks: large cluster of office buildings master-planned and developed for office use with off-street parking and landscaping to give a park-like setting. Includes restaurants and shops to serve the persons working in the office park.

B. Industrial Properties

Industrial properties are usually classified in one of three ways:

1. Small industrial property: free-standing single building in industrially-zoned area of city. They are from 10,000 to 100,000 square feet, often divided into small individual units that can be rented to different tenants. Some have rail facilities.

2. Larger industrial properties: may be one large industrial building leased to one tenant, and usually leased on long-term basis.

3. Industrial parks: developers buy land and develop individual buildings to the specifications of the master plan. Usually landscaped.

C. What Are Some Advantages of Investing In Commercial and Industrial Properties?
1. May require less management than residential rentals.

2. Cost-of-living clauses or, in the case of a retail establishment, a percentage lease provision allows owner to realize increased rents.

3. City growth creates greater demand for commercial properties, offering opportunities for increased rents.

4. There is little risk of rent control.

D. What Are Some Disadvantages of Investing in Commercial and Industrial Properties?

1. Investment in an older commercial buildings, such as found in urban centers, involve greater risks as tenants move to newer centers, with vacancies taking longer to fill. Subsequent tenants may be of lower quality and not be able to pay as high a rent.

2. Changing neighborhood patterns may result in an entire commercial area becoming less desirable. In many downtown areas blight and decay give rise to urban flight.

3. Tenants may have long-term leases at advantageous rents, thereby freezing owners into low fixed revenues while taxes and other operating expenses rise.

4. City requirements often force owners to add expensive improvements to assure safety of occupants.

5. Commercial banks often will not lend on older commercial or industrial properties unless the investor is a major client of the bank. Most savings and loans shy away from such properties.
E. Financing a Small Commercial Property: a Case History

1. Property Analysis

Visualize a suburb of a major city with a main street of storefronts occupied by offices, businesses, and financial institutions. There are sixteen offices, all at ground level with approximately 500 square feet each. Space is renting at $1.04 per square foot, or $520 per month each. Total rent is $8,320 per month. Tenants pay interior maintenance. Owner pays for roof and exterior maintenance. Offices are rented to small shops, lawyers, small publishers, rental agencies, real estate offices, dress shops, and other typical small town tenants. Most are on one-to-two-year leases. Tenants are individuals, not corporations, with no particularly strong financial statements.

2. Income Data

At $8,330 per month, the property grosses $100,000 per year.

3. Expense Data

Owner's records show annual operating expenses as: taxes $10,000; insurance $4,000; repairs and maintenance $8,400; utilities $4,800; licenses, permits and advertising $750; management $5,000; supplies $750; services $1,200; and miscellaneous expenses $1,000. Vacancy is estimated at 7%.

Total expenses including vacancy are $42,900, leaving net operating income of $57,100. Although expense ratios for office buildings are usually lower than for apartment houses, in this case it is just over 42%.

4. Financing Data

Property is sold for $950,000, the buyer netting 7.25% return on total investment. Bank financing ranges from 60% to 65% of value, or $570,000 to $617,500. Interest rates on store front strip commercial buildings generally range from 11% to 14%. This is about 1% higher than apartment house rates. Term of loan may range from 10 to 25 years, depending upon age of property and length of leases.

The buyer might require 35% to 40% down, or from $332,500 to $380,000 for the down payment. However, sellers of commercial properties often carry back secondary financing, so the down payment may be considerably less.
F. Financing a Small Industrial Property: a Case History

1. Property Data

A free-standing building is leased to a fast-food restaurant. The lot is 7,500 square feet, selling at $20 per foot. A 1,200 square foot building is to be constructed at $100 per foot. Paving and other on-site improvements are projected at $60,000. A developer is able to obtain a 65% loan on the basis of total cost, for 25 years at 13% interest.

2. Income Data

The property is to be leased to a fast-food operator for $2,500 per month, or 5% of gross sales, whichever is less, for the first year. Rent increases in subsequent years is tied to CPI, but not in excess of 5% of gross sales. Sales are $50,000 per month the first year and projected to grow by 15% to $57,500 the second.

3. Expense Data

Property taxes during the first (base) year are projected at $4,000 and insurance $2,500. Lessee pays for all other expenses, as well as tax increases after the first year.

| Land cost, $20 x 7,500 sq. ft. | $150,000 |
| Building cost, $100 x 1,200 sq. ft. | $120,000 |
| Paving and other on-site improvements | $60,000 |
| Total cost | $330,000 |
| Less: 25-year loan at 13% (65% of cost) | |
| Down payment for the balance | $214,500 |
| | $115,500 |
| Annual rent, 12 x $2,500 | |
| Less: Property taxes | $4,000 |
| Property insurance | $2,500 |
| Subtotal | $6,500 |
| Net Income | $23,500 |

4. Financing Data

Developer nets $23,500 the first year, or 7.1% return on the $330,000 investment. This net income translates into 4% of gross sales. At end of the first year, the restaurant has grossed $50,000 per month, or $600,000 for the year. 5% x $600,000 = $30,000, the first year's rent.
At the end of second year, gross income has increased to $57,500 per month, or $690,000 for the year. 5% x $690,000 = $34,500. Assuming 6% CPI, the $30,000 first year’s rent is increased to $31,800 for the second year, since this is the lesser of the two figures. In addition, increases in taxes are paid by the lessee. Net return is now $25,300, which represents a 7.7% yield on the original investment of $330,000.

VI. FINANCIAL RATIOS

NOTE TO INSTRUCTOR: IF TIME PERMITS, YOU MAY WANT TO "GO ADVANCED" IN THIS INTRODUCTORY FINANCING OF INVESTMENT PROPERTIES BY ADDING THE TOPIC OF FINANCIAL RATIOS AND RELATED TOPICS, USUALLY RESERVED FOR ADVANCED FINANCE COURSES. INCLUDED IN SUCH DISCUSSION MIGHT BE THE FOLLOWING SEVEN TOPICS:

1. LOAN-TO-VALUE RATIO

   LOAN AMOUNT DIVIDED BY THE PROJECT VALUE. (IF THE BUILDING IS NOT YET IN PLACE, THEN THE PROJECTED VALUE IS BASED ON PROJECTED CASH FLOWS. PERFORMANCE STATEMENTS NEED TO BE PREPARED IN THESE CASES.)

2. DEBT COVERAGE RATIO

   DIVIDE \( \text{Net Operating Income} \) BY DEBT SERVICE (MONTHLY MORTGAGE LOAN PAYMENT).

3. OPERATING EXPENSE RATIO

   OPERATING EXPENSES/EFFECTIVE GROSS INCOME

4. BREAK-EVEN RATIO

   OPERATING EXPENSES PLUS DEBT SERVICE DIVIDED BY POTENTIAL GROSS

5. INTERNAL RATE OF RETURN (I RR)

   APPLICATIONS TO BEFORE AND AFTER-TAX YIELDS ON COMPOUNDING BASIS

6. PRESENT VALUE AND FUTURE VALUE APPLICATIONS

   USEFUL IN MANY WAYS, BUT CONCENTRATE ON SALE-LEASEBACK ARRANGEMENTS AND OTHER FORMS OF REAL ESTATE INVESTMENTS

7. MORTGAGE CONSTANTS

   THEIR USEFULNESS IN COMPUTING CASH FLOWS IS SIGNIFICANT HERE FOR THIS LESSON.
LESSON FIFTEEN QUESTIONS

DIRECTIONS: Underline the letter representing the correct answer.

1. Single-family dwellings are less desirable than other real estate investments in terms of:
   (a) liquidity
   (b) management
   (c) vacancy
   (d) rent per square foot

2. Which of the following statements concerning the financing of large apartment projects is correct?
   (a) The larger the size of the project, the lower the loan-to-value ratio.
   (b) Loan fees for large complexes are usually lower than for single dwellings.
   (c) Loan terms seldom exceed 20 years.
   (d) Lenders ordinarily ignore debt service in evaluating the loan collateral.

3. Where an owner is required to "feed" the income-producing property to meet operating costs and debt service, this is always due to:
   (a) positive cash flow
   (b) negative cash flow
   (c) poor management
   (d) excess depreciation charges

4. The vast majority of apartment buildings are financed through:
   (a) private sources
   (b) government sources
   (c) conventional financing
   (d) syndicate financing

5. In checking over a note and trust deed that is to be assumed, buyers ought to be aware of:
   (a) how title to the property was taken
   (b) assumption fees
   (c) amount of property taxes
   (d) title insurance required by the lender

6. Buying real estate with as little down payment and with maximum financing is called:
   (a) Equity purchase
   (b) Leverage
   (c) Progression
   (d) Regression
7. California law limits prepayment penalties on certain types of real estate loans to the first 5 years. Which of the following transactions qualify for the limitation?
   (a) Owner-occupied, single-family dwelling
   (b) House converted to a rental
   (c) Houses purchased on speculation
   (d) Vacant lots zoned for housing

8. The maximum FHA loan non-owner occupied duplexes is:
   (a) $114,000
   (b) $138,000
   (c) $160,500
   (d) none of the above

9. If the yield on an income property is 9%, but the buyer must pay 12% interest, the net effect is termed:
   (a) negative leverage
   (b) positive leverage
   (c) neutral leverage
   (d) trading on the equity

10. Which of the following properties is most likely to be subject to rent control ordinances?
    (a) Small commercial buildings
    (b) Medium-sized industrial parks
    (c) Parking lots in downtown areas
    (d) Apartment houses

11. Conventional lenders generally require investors in non-owner occupied single family dwellings to invest at least what percentage of property value as a down payment?
    (a) 10%
    (b) 15%
    (c) 20%
    (d) 25%

12. Commanding the highest interest rates are:
    (a) single-family homes
    (b) duplexes
    (c) triplexes
    (d) high-rise apartment buildings

13. Which of these investments is considered to be safest for the average investor?
    (a) Shoe store
    (b) Apartment house
14. In listing and pricing income property, the agent must:
   (a) determine the net operating income (NOI)
   (b) review income and expense statements
   (c) determine the probable selling price
   (d) do all of the above

15. Small industrial properties typically encompass:
   (a) under 10,000 square feet
   (b) 10,000 to 100,000 square feet
   (c) 100,000 to 1,000,000 square feet
   (d) over 1,000,000 square feet

16. Investing in commercial or industrial property:
   (a) requires more management than a residential property
   (b) allows for use of percentage leases
   (c) is always best for high taxpayers
   (d) requires less down payment than apartment properties

17. Operating expenses include:
   (a) income taxes
   (b) utilities
   (c) interest
   (d) depreciation

18. Financing an investment property is said to start with the:
   (a) listing
   (b) first payment
   (c) purchase
   (d) down payment

19. A resident manager is required by law if the apartment building has units
   (a) fewer than 5
   (b) 5 to 9
   (c) 10 to 15
   (d) over 15

20. Investors interested in 2 to 4 rental units will find that:
    (a) It is impossible to assume the existing loan.
    (b) Lenders impose income standards for both borrower and the property.
    (c) FHA financing is not available.
    (d) If there is negative cash flow lenders will not allow secondary financing.
ADVANTAGES OF THE SINGLE-FAMILY HOME AS AN INVESTMENT VEHICLE

1. AMPLE SELECTION OF PROPERTIES AVAILABLE.
2. EASE OF MANAGEMENT.
3. LIQUIDITY OF INVESTMENT.
4. TENANT USUALLY PAYS ALL UTILITIES, DOES THE GARDENING AND MINOR REPAIRS IN CONTRAST TO LARGER PROPERTIES.

5. TENANTS REMAIN LONGER IN SINGLE-FAMILY HOMES THAN IN APARTMENTS. OFTEN TENANTS WILL REMAIN FROM THREE TO FIVE YEARS AND LONGER.
DISADVANTAGES OF THE SINGLE-FAMILY HOME AS AN INVESTMENT VEHICLE

1. Homes tend to have more area than apartments; the larger the unit, the less the rent per square foot in comparison to compact rentals.
2. When house is vacant, 100% of the rent is lost until re-rented.
3. Investor must personally manage as there is no resident manager.
4. As investor acquires more houses in scattered locations, more money and time is required for travel than if units were all under one roof as in apartment houses.
DISADVANTAGES OF INVESTMENT IN COMMERCIAL OR INDUSTRIAL PROPERTY

III STORES ENTAIL GREAT RISK AS TENANTS MOVE TO NEWER CENTERS.

- CHANGING NEIGHBORHOOD PATTERNS MAY RESULT IN AN ENTIRE COMMERCIAL AREA BECOMING LESS DESIRABLE.

- TENANTS MAY HAVE LONG-TERM LEASES AT ADVANTAGEOUS RENTS, THEREBY FREEZING OWNERS INTO FIXED INCOME WHILE TAXES AND OTHER EXPENSES RISE.

- CITY REQUIREMENTS OFTEN FORCE OWNER TO ADD EXPENSIVE IMPROVEMENTS TO SAFEGUARD SAFETY OF OCCUPANTS.

III BANKS OFTEN WILL NOT LEND ON COMMERCIAL OR INDUSTRIAL PROPERTIES UNLESS THE INVESTOR IS A MAJOR CLIENT OF THE BANK. MANY SAVINGS AND LOANS WILL NOT MAKE LOANS ON SUCH PROPERTIES.
ADVANTAGES OF INVESTING IN COMMERCIAL OR INDUSTRIAL PROPERTY

A. MAY REQUIRE LESS MANAGEMENT THAN A RESIDENTIAL INVESTMENT PROPERTY.
B. A COST-OF-LIVING INCREASE CLAUSE OR, IN THE CASE OF A RETAIL ESTABLISHMENT, A PERCENTAGE LEASE PROVISION ALLOWS OWNER TO REALIZE INCREASE RENTS.
C. GROWTH OF THE CITY CREATES GREATER DEMAND FOR COMMERCIAL PROPERTIES, OFFERING OPPORTUNITIES FOR INCREASED RENTS.
D. THERE IS LITTLE RISK OF RENT CONTROL.
FINANCING OF AN INDUSTRIAL PROPERTY
A CASE HISTORY

- COST DATA
- INCOME DATA

II EXPENSE DATA
- OTHER DATA
INSTRUCTIONS: Do NOT write on this paper. Use your Scantron answer sheet. From each of the following groups of responses, choose the item that most correctly answers the introductory material, or stem of the question. Darken the column, using a #2 pencil, for the letter representing the correct answer, to the right of the question number. Interpret each question literally - that is, make no assumptions, and do not search for exceptions to the general rule or application.

1. The sequence of the five-step financing process is as follows
   (a) Application, Underwriting, Closing, Processing, Servicing
   (b) Application, Processing, Underwriting, Closing, Servicing
   (c) Application, Processing, Underwriting, Closing, Servicing
   (d) Application, Processing, Underwriting, Servicing, Closing

2. The Federal Reserve System consists of __ reserve districts, and ___ board members.
   (a) 12, 7
   (b) 7, 12
   (c) 7, 11
   (d) none of these is correct

3. Share liability represents
   (a) time deposits
   (b) demand deposits
   (c) stock ownership
   (d) bond ownership

4. Another name for a "take-out" loan
   (a) permanent financing
   (b) short-term financing
   (c) combination loan
   (d) package loan

5. Savings and loan associations are permitted to make collateral loans that are secured by the borrower's
   (a) savings accounts
   (b) existing secured notes
   (c) bonds
   (d) any of the above

6. The chief regulator of federally-insured savings associations is the
   (a) Federal Housing Finance Board
   (b) Office of Thrift Supervision
   (c) Resolution Trust Corporation
   (d) Federal Reserve Bank Board

7. Another name for a "swing loan" is the
   (a) junior loan
(b) bridge loan
(c) leasehold loan
(d) replacement loan
8. Trends influencing the way commercial banks are conducting business include all but which of the following
   (a) acquiring savings and loans through mergers and purchases
   (b) franchising
   (c) underwriting mortgage-backed securities
   (d) smaller-sized banks

9. One of the following characterizes lending policies of life insurance companies
   (a) preference for very large projects
   (b) short payback terms
   (c) high point and fee structure
   (d) construction loans preferred over take-out loans

10. Trends affecting the way life insurance companies are financing real estate include
    (a) formation of joint ventures
    (b) participation in the income stream
    (c) sharing in the equity
    (d) each of the above

11. Although mutual savings banks do not exist in California, it is important to understand their functions because
    (a) they are actively involved in second mortgages in California
    (b) they are actively involved in the secondary market in California
    (c) they are actively involved in first mortgages in California
    (d) they are actively involved in the primary market in California

12. Pension and retirement funds play vital roles in the financing of real estate. Lending characteristics of these funds include
    (a) no uniform lending practices are followed
    (b) administration of the funds can be handled only by employers
    (c) such funds only provide interim loans
    (d) retirement funds are not a reliable source of funding for real estate

13. The principal purpose of the Depository Institutions and Monetary Control Act was to
    (a) phase out interest rates that lenders may pay depositors
    (b) control the interest rate that lenders may charge borrowers
    (c) phase out insurance of savings accounts
    (d) restrict lending powers of institutional lenders

14. Trends influencing the way savings and loan associations are doing business include all but one of the following
    (a) selling loans in the secondary market
    (b) increasing consumer services
    (c) reducing real estate lending activity
    (d) movement toward interstate banking
15. The agency responsible for chartering and overseeing the operations of national banks and bank holding companies is the
   (a) Federal Home Loan Mortgage Corporation
   (b) Office of Thrift Supervision
   (c) Bank Insurance Fund
   (d) Controller of the Currency

16. The trade association that consists of the major investors and lenders in the mortgage banking field is the
   (a) American Banking Association
   (b) Independent Bankers Association
   (c) Mortgage Bankers Association
   (d) Savings and Community Bankers of America

17. Unlike institutional lenders, private lenders
   (a) are highly regulated
   (b) are subject to California’s usury statutes
   (c) apply uniform lending policies and practices
   (d) need not be licensed to make loans

18. Concerning private lenders, one of these statements is not true
   (a) By lending directly, private lenders eliminate appraisal and loan screening functions.
   (b) While the lending risks are greater, so is the potential for rewards.
   (c) The role of mortgage broker is to bring borrowers and lenders together.
   (d) Unlike direct lenders, indirect private lenders invest through mortgage brokers.

19. A purchase money loan is best illustrated by
   (a) refinancing one's home
   (b) seller carrying back a first trust deed
   (c) buyer obtaining the down payment through an unsecured loan
   (d) securing a home equity line of credit

20. Lending characteristics of private lenders include
   (a) high degree of sophistication in loan decisions
   (b) making primarily first trust deed loans
   (c) charging relatively low interest rates
   (d) short-term repayment schedules

21. Exempt from California's Mortgage Loan Broker Law are
   (a) first trust deed loans of $30,000 or more
   (b) second trust deed loans of $10,000 or more
   (c) seller carry-back loans on more than 7 transactions per year
   (d) none of the above
22. The maximum commission that may be charged for a $25,000 loan secured by a second trust deed is

   (a) 5%
   (b)
   (c) 15%
   (d) no limit

23. Under the Real Property Loan Law, a balloon payment is prohibited if

   (a) the term is for 6 years or less
   (b) the loan is also secured by the dwelling place of the borrower
   (c) the promissory note is silent on the matter
   (d) all of the above

24. A mortgage banker is differentiated from a mortgage broker in the following ways

   (a) Mortgage bankers service the loans of lenders they represent, while mortgage brokers usually do not.
   (b) Mortgage bankers are usually incorporated, while mortgage brokers are generally unincorporated.
   (c) Mortgage bankers may be mortgage correspondents, while mortgage brokers operate as agents.
   (d) Each of the foregoing is correct.

25. You are a seller carrying back a second trust deed for part of the purchase price. The maximum interest rate that you may charge, without violating California's usury law, is

   (a) above the Federal Reserve Bank discount rate
   (b)
   (c) 15%
   (d) any rate agreed to between you and the borrower

26. Mortgage companies

   (a) reflect the loan policies and practices of their principals
   (b) must be licensed real estate brokers
   (c) are subject to the Real Property Loan Law
   (d) all of the above

27. An association of two or more parties who combine their financial resources for financing or acquiring real estate is best illustrated by a

   (a) real estate investment trust
   (b) syndication
   (c) general partnership
   (d) limited partnership

28. A real estate investment trust that invests in an income-producing property is the

   (a) mortgage trust
   (b) equity trust
   (c) hybrid trust
   (d) income trust
29. The following receive their capital primarily from gifts, and are a good source for sale-leaseback financing
   (a) state-chartered credit unions
   (b) labor unions
   (c) endowment funds
   (d) estate funds

30. Alternative mortgage instruments (AMI) are financing vehicles that
   (a) are universally standardized
   (b) are an alternative to fixed-rate instruments
   (c) call for level payments throughout the life of the loan
   (d) always call for 30 year repayment schedules

31. The principal objective of AMI is to
   (a) transfer the risk of rising interest rates from borrower to lender
   (b) transfer the risk of rising interest rates from lender to borrower
   (c) overcome loss of purchasing power through inflation
   (d) assure a steady flow of funds in gyrating capital markets

32. Among the characteristics of adjustable rate mortgages (ARM) is
   (a) higher initial teaser rates
   (b) stricter qualifying requirements
   (c) provision for a fully-indexed interest rate
   (d) adjustments every month

33. A convertible rate loan
   (a) starts out as a fixed-rate mortgage and allows the borrower to convert to an adjustable rate mortgage
   (b) starts out as an adjustable rate mortgage and allows the borrower to convert to a fixed-rate mortgage
   (c) both (a) and (b) are correct
   (d) neither (a) nor (b) is correct

34. In a negative amortization loan
   (a) initial monthly payments are not sufficient to satisfy interest payment requirements
   (b) initial payments are adequate to satisfy principal payment requirements
   (c) the outstanding loan balance always grows larger, until the note matures
   (d) recasting automatically occurs after the loan balance reaches 125% of the original debt

35. Regulation Z of the Truth-in-Lending law requires lenders who offer ARM loans to disclose to borrowers
   (a) what index is being used
   (b) how rates and margins interact
   (c) payment adjustment periods
   (d) each of the above
36. Disadvantages of ARM loans to borrowers include
   (a) usually larger loan costs than for fixed-rate loans
   (b) more difficulty in qualifying for house purchase
   (c) income may not correspondingly increase with payment increases
   (d) there is no warning to borrowers when interest rates or payments increase

37. Graduated payment mortgages (GPM)
   (a) provide for lower initial payments
   (b) have fixed-interest rates
   (c) appeal to buyers whose income has not caught up with their potential earning ability
   (d) all of the foregoing are true

38. Where a loan contains negative amortization
   (a) monthly payments decrease over time
   (b) equity actually shrinks during the initial years
   (c) the original term of loan is extended
   (d) deferred interest is deducted from principal

39. The graduated payment adjustable rate mortgage (GPARM)
   (a) both interest rate and monthly installments fluctuate
   (b) does not involve negative amortization
   (c) provides for principal reduction during the first five years
   (d) has adjustable interest rates, but fixed payments

40. Options that may be available to borrowers who cannot meet balloon payments include
   (a) obtain an extension agreement
   (b) refinance the outstanding balance due
   (c) obtain a junior loan
   (d) any of the foregoing

41. A loan that offers below-market interest rates in exchange for lender participation in the appreciation of the property is the
   (a) renegotiable rate mortgage
   (b) reverse annuity mortgage
   (c) shared appreciation mortgage
   (d) shared equity mortgage

42. The additional participation by lenders who agree to reduce the interest rate in exchange for a percentage of the growth in the property is labeled
   (a) contingent deferred interest
   (b) contingent deferred principal
   (c) contingent deferred profit
   (b) contingent deferred appreciation
43. The chief benefit to the use of a reverse annuity mortgage is to
   (a) supplement the recipient's income on a tax-free basis
   (b) convert one's equity in a home into a rental property
   (c) exchange the property's value into a lifetime annuity
   (d) build up negative amortization that is forgiven should death occur
       before repayment of the loan

44. Characteristics of the Shared Appreciation Mortgage include:
   (a) Short-term, partially amortized loan program
   (b) Assists buyers who cannot qualify for a loan at market rate
   (c) Lenders does not participate in the property appreciation
   (d) All of the above are characteristics of the SAM loan

45. The renegotiable rate mortgage contains a variety of features that
    differentiate it from other types of loans, including
    (a) guaranteed renewability at predetermined time periods
    (b) more effective matching of sources of funds to their use
    (c) ability to roll over the short-term loan into a new loan
    (d) all of the above

46. Under a two-step mortgage
    (a) a lower fixed-rate of interest is charged initially
    (b) a higher adjustable rate of interest is charged
    (c) amortization is based on five-year payment schedules
    (d) an automatic conversion follows when the loan matures

47. The chief advantage to a 15-year loan over that of a 30 year loan is
    (a) higher interest deductions over the life of the loan
    (b) lower monthly payments
    (c) retiring the loan sooner
    (d) easier loan qualifying

48. For homes priced under $203,000, the highest loan-to-value ratio would
    be found in
    (a) Cal-Vet loans
    (b) Federal Housing Administrations loans
    (c) U.S Department of Veterans Affairs (GI) loans
    (d) conventional loans

49. For most people the most important criteria in selecting a conventional
    lender is likely to be
    (a) the minimum loan that the lender will consider
    (b) the term of loan
    (c) whether the lender will lower its interest rate through a buydown
        arrangement
    (d) the loan fees and points charged for making the loan

50. Under the Community Home Buyer's Program,
    (a) buyers may obtain part of the down payment through a gift
    (b) buyers must meet stricter loan underwriting standards to qualify
    (c) only first-time buyers are eligible for low-interest rate financing
    (d) higher closing costs are charged
51. Under California's Housing Financial Discrimination Act, financial institutions cannot deny or discriminate against in fixing the loan amount, interest rate, or length of loan based upon

(a) income level composition of a neighborhood
(b) borrower's physical hardship
(c) racially mixed neighborhood
(d) any of the above criteria

52. Private mortgage insurance

(a) protects lenders in case of death of the homeowner
(b) protects borrowers in case of insolvency of the lender
(c) protects lenders in event property that is the security for the loan is destroyed
(d) protects borrowers against the possibility of intervening liens

53. A property sells for $150,000, with a $50,000 down payment. Under a 90% PMI loan, the maximum coverage in event of foreclosure would be

(a) $30,000
(b) $25,000
(c) $20,000
(d) none of these is correct

54. FHA loans

(a) are partially amortized
(b) require large down payments in exchange for low interest rates
(c) mandate impound reserves
(d) provide for low qualifying standards

55. The Federal Housing Administration

(a) is a direct lender
(b) guarantees loans
(c) charges MIP
(d) insures the borrower's life

56. Advantages of FHA loans include

(a) origination fees paid by the seller
(b) no prepayment penalties
(c) assumability by borrower
(d) low qualifying ratios for low-income borrowers

57. Among the disadvantages to FHA financing is the

(a) processing time
(b) property standards
(c) prepayment penalty
(d) discount points required of borrowers
58. One of the following statements concerning FHA guidelines is incorrect

(a) The seller normally pays the loan fee.
(b) Secondary financing is allowed under prescribed conditions.
(c) The maximum purchase price cannot exceed the loan amount.
(d) FHA appraisals are good for 24 months.

59. If the FHA appraisal value differs from the sales price, the loan will be based on the lesser of the following:

(a) Loan amount or appraised value
(b) Sales price or loan amount
(c) Sales price or appraised value
(d) based on appraised value only

60. Under the FHA 203(b) program

(a) only those over 21 are eligible
(b) loans are available from one to sixteen units
(c) U.S. citizenship is required
(d) the maximum loan amount varies by area

61. The maximum FHA loan for a home that sells for $150,000, plus allowable closing costs of $5,000, is

(a) $146,600, excluding MIP
(b) $146,250, including MIP
(c) $141,750, excluding MIP
(d) $141,750, including MIP

62. Borrowers under an FHA 203(b) loan need not occupy the property under the following circumstance

(a) if the borrower is a qualified veteran
(b) if the rental exceeds the mortgage payments
(c) if the property exceeds minimum building code standards
(d) none of these

63. Under the FHA-Vet loan program

(a) loans may be obtained on up to four dwelling units
(b) down payments are greater than regular FHA loans
(c) a vet can obtain such a loan only once in her life
(d) the maximum loan is the same as for 203(b) loans

64. Under an FHA Adjustable Rate Loan

the index used is the U.S. Treasury security constant maturity for 1 year
the index is the 11th District Cost of Funds
65. Under the FHA-GPM program

(a) payments may decrease anywhere from 2 1/2% to 7 1/2% depending upon the plan selected
(b) payments may increase anywhere from 2 1/2% to 7 1/2% depending upon the plan selected

66. The maximum guarantee to lenders in case of borrower default on a $150,000 DVA loan is

(a) $46,000
(b) the lesser of $36,000 or 40% of the loan
(c) 50% of the loan amount
(d) none of the above

67. In event of foreclosure, the DVA

(a) can pay the lender the loan balance and take back the property
(b) may give the lender the property and pay the deficiency, up to the maximum guarantee amount
(c) may do either (a) or (b)
(d) may do neither (a) nor (b)

68. Advantages of DVA loans include

(a) automatic assumability by subsequent buyer
(b) small prepayment penalties
(c) very generous appraisals
(d) no down payments

69. Disadvantages of DVA loans include
(a) processing time
(b) low loan-to-value ratio
(c) high down-payment requirements
(d) limitations on qualifying income

70. Eligible for a DVA loan is
(a) any U.S. citizen
(b) those who served in the armed forced for more than 180 days
(c) those who meet qualifying service periods
(d) all active National Guard Reservists

71. A vet originally obtained a DVA loan in 1988 when the entitlement was $36,000. The loan was not paid off. If the entitlement had increased to $46,000 and the home that the vet now wants to purchase is $200,000, what is the maximum loan that the DVA would guarantee?

(a) $160,000
(b) $200,000
(c) $184,000
(d) none of these
72. Had the $100,000 loan from the previous question been made in 1990 instead of 1988, the maximum loan in 1994 would have been

(a) 50% of the loan amount
(b) $10,000
(c) $0
(d) none of these

73. A vet is purchasing a home appraised for $150,000. If the remaining entitlement is $20,000 the maximum GI loan will be

(a) $132,500
(b) $170,000
(c) $184,000
(d) none of these

74. One of the following statements concerning DVA loans is correct

(a) Only 1 to 4 detached dwelling units qualify.
(b) DVA approves new properties only if built under DVA or FHA inspections.
(c) Discount points must be paid by the seller.
(d) Funding fees are limited to 1% of the loan amount.

75. One of the following statements concerning DVA loans is not true

(a) The maximum loan term is 30 years.
(b) A vet may pay more than the appraised value.
(c) The maximum loan amount set by the DVA is $184,000.
(d) Monthly payments include impounds for taxes and insurance.

76. A certificate of reasonable value (CRV) is good for

(a) 3 months
(b) 6 months
(c) 1 year
(d) none of the above

77. Secondary financing for DVA loans

(a) are prohibited
(b) when added to the first loan cannot exceed the CRV
(c) must carry a larger interest rate than the first loan
(d) are used only if the property value exceeds $184,000

78. One of these statements regarding termite reports is correct when securing a DVA loan

(a) The buyer has no voice in whether or not the work is done satisfactorily.
(b) The teLiaite clearance must state that there is no evidence of termites, wet rot, dry rot, or fungus.
(c) Detached structures, such as garages, need not be inspected.
(d) Termite reports include preventive work, but not corrective work.
79. The DVA permit its borrowers to pay for
   (a) termite reports
   (b) escrow fees
   (c) CRV if ordered before vet agreed to buy the home
   (d) non-recurring closing costs

80. Under the DVA-GPM program
   (a) deferred interest is added to the principal balance
   (b) no down payment is required
   (c) a growth of 7 1/2% per year is factored into the property value
   (d) loans are offered only for 1 to 4 dwelling units

81. FHA and DVA loans can be made by
   (a) commercial banks
   (b) mortgage companies
   (c) savings and loan associations
   (d) all of the above

82. Under the Cal-Vet loan program
   (a) the veteran-borrower deals with an institutional lender
   (b) the veteran-borrower deals with California's DVA
   (c) funds come from the U.S. Department of Veteran Affairs
   (d) funding is obtained from sale of state veterans bonds

83. To qualify for a Cal-Vet loan, the applicant
   (a) must be a California veteran
   (b) must be a U.S. citizen
   (c) must have received an honorable discharge
   (d) must apply within 10 years after release from active duty

84. Characteristic of Cal-Vet loans is one of the following
   (a) the maximum loan amount is $170,000
   (b) the down payment is 3% of the purchase price
   (c) interest rates are fixed for the life of the loan
   (d) secondary financing may be allowed

85. The maximum prepayment penalty under a Cal Vet loan may not exceed
   (a) six months of unearned interest
   (b) 2% of the unpaid balance
   (c) 2% of the original loan amount
   (d) none of the above is correct

86. Title to property bought under Cal-Vet financing is held by
   (a) the U.S. Department of Veterans Affairs
   (b) the U.S. Department of Housing and Urban Development
   (c) the buyer
   (d) the California Department of Veterans Affairs
87. The *Land Contract of Sale* is used in the financing of

(a) FHA properties  
(b) DVA properties  
(c) Cal-Vet properties  
(d) seller carry-back loans

88. Interest rates under Cal-Vet

(a) are variable  
(b) are fixed  
(c) cannot exceed 10\%  
(d) may not fall below 3\%6\-

89. The major source of capital brought into the mortgage market is through the operations of two corporations, namely

(a) Fannie Mae and Freddie Mac  
(b) FHA and DVA  
(c) Fannie Mae and Ginnie Mae  
(d) HUD and Ginnie Mae

90. Points charged by lenders are based on the

(a) appraised value of the property  
(b) purchase price of the property  
(c) amount of loan  
(d) the maximum permitted by primary lenders

91. You apply for a $100,000 loan at 8\% interest only for one year, and are charged two points. The effective interest for the loan is

(a) 8.2\%  
(b) 8.9\%  
(c) 10.2\%  
(d) 11.1\%

92. In the sale of loans in the secondary market, price and discount added together always equal

(a) par  
(b) 100\%  
(c) price less charge for points  
(d) two of the above are correct

93. When a junior trust deed is sold on the open market, it usually commands a discount. The amount of discount varies depending upon

(a) note rate  
(b) equity in the property  
(c) due date  
(d) all of the above
94. One of the following statements concerning the discounting of a junior trust deed is correct

(a) As at the risk increases, the discount decreases.
(b) As the risk increases, the discount increases.
(c) Discounts may not exceed the state usury rate.
(d) The lower the discount, the greater the yield.

95. When a mortgage company makes a loan directly to a borrower, that action takes place in the

(a) secondary market
(b) primary market
(c) junior trust deed market
(d) first trust deed market

96. The main purpose of the secondary market is

(a) to shift money from areas where there is a surplus to areas where there is a shortage of funds
(b) to shift money from areas where there is a shortage to areas where there is a surplus of funds
(c) to provide additional deposits for lending institutions
(d) to overcome the problem of disintermediation

97. Mortgage bankers

(a) operate as a conduit between Fannie Mae and the Freddie Mac
(b) operate as a conduit between the primary and secondary markets
(c) like banks, have their own deposits to lend
(d) specialize in short-term loans

98. Mortgage-backed securities were created in order to

(a) make investing in mortgages as simple as buying stocks and bonds
(b) raise capital primarily for government-backed loans
(c) provide for guarantees against borrower defaults
(d) support government-sponsored enterprises

99. The government-sponsored enterprise in which FHA-insured and DVA-guaranteed loans are bought and sold is the

(a) Federal National Mortgage Association
(b) Federal Home Loan Mortgage Association
(c) Housing and Urban Development
(d) Government National Mortgage Association

100. The mortgage-backed security issued by the Federal Home Loan Mortgage Corporation (FHLMC) and designed to limit prepayment risk to investors is the

(a) Pass-through Security
(b) Collateralized Mortgage Obligation
(c) Participating Certificate
(d) Mortgage Revenue Bond
1. b 51. d
2. a 52. a
3. a 53. c
4. a 54. c
5. d 55. c
6. b 56. b
7. b 57. a
8. d 58. b
9. a 59. c
10. d 60. d
11. b 61. a
12. a 62. d
13. a 63. d
14. c 64. a
15. d 65. b
16. c 66. b
17. b 67. c
18. a 68. d
19. b 69. a
20. d 70. c
21. a 71. a
22. d 72. c
23. d 73. a
24. d 74. b
25. d 75. c
26. d 76. c
27. b 77. b
28. c 78. b
29. c 79. d
30. b 80. a
31. b 81. d
32. c 82. b
33. b 83. c
34. a 84. d
35. d 85. c
36. c 86. d
37. d 87. c
38. b 88. a
39. a 89. a
40. d 90. C
41. c 91. c
42. a 92. d
43. a 93. d
44. b 94. b
45. d 95. b
46. a 96. b
47. c 97. b
48. c 98. a
49. d 99. d
50. a 100. b
INSTRUCTIONS: Do NOT write on this paper. Use your Scantron answer sheet. From each of the following groups of responses, choose the item that most correctly answers the introductory material, or stem of the question. Darken the column, using a #2 pencil, for the letter representing the correct answer, to the right of the question number. Interpret each question literally—that is, make no assumptions, and do not search for exceptions to the general rule or application.

1. If a conventional loan is not sold to Fannie Mae or Freddie Mac,
   (a) lenders must still comply with secondary market guidelines
   (b) lenders can establish their own guidelines
   (c) maximum loans permitted for lenders may not exceed $203,150
   (d) lenders will usually stiffen qualifying guidelines

2. "Qualifying the property" for loan purposes means
   (a) determining its value
   (b) determining what ratio of loan-to-value the lender will commit
   (c) determining what interest rate, term, and loan fee should be quoted for a given property
   (d) all of the above

3. In qualifying property for a loan, lenders uniformly agree upon one of the following
   (a) sales price is usually the same as fair market value if there are concessions made in the sale transactions
   (b) sales price is usually the same as fair market value if there are no concessions
   (c) the assessed value is usually interpreted as market value
   (d) under Proposition 13, the property's sales price is always considered the market value

4. Regarding FHA and DVA qualifying property standards
   (a) both agencies apply the same standards as conventional lenders
   (b) both agencies adjust the loan-to-value ratios based on the property's value
   (c) interest rates are increased for properties that do not meet minimum qualifying standards
   (d) all properties must meet minimum qualifying standards

5. During periods of tight money, lenders
   (a) loosen property standards
   (b) are more selective on property standards
   (c) decrease loan-to-value ratios
   (d) do not differentiate, since the loan will be sold in the secondary market

6. After an appraiser has inspected and appraised a property, a "conditional commitment" is issued by the
   (a) Department of Veterans Affairs
   (b) Federal Housing Administration
   (c) conventional lender
   (d) mortgage company
7. In considering neighborhood influence, appraisers consider many questions. Which of the following is not likely to be one of them?

(a) Is the neighborhood heterogeneous?
(b) Is the neighborhood in a state of transitions?
(c) Is the neighborhood well maintained?
(d) What adverse influences exist?

8. The Uniform Residential Appraisal Report (URAR) gives most weight to the

(a) sales comparison approach
(b) income approach
(c) reproduction cost approach
(d) none of the above

9. Referring to the URAR, in analyzing the neighborhood, great weight is given to

(a) demand and supply
(b) price range
(c) predominant use
(d) each of the above

10. A freeway adjacent to a home is an example of

(a) functional obsolescence
(b) economic obsolescence
(c) physical deterioration
(d) social deterioration

11. One of the following additions is likely to increase a home's value by at least the cost of the improvement

(a) swimming pool
(b) elaborate landscaping
(c) bathroom
(d) intercom system

12. In applying the sales comparison approach, before arriving at value appraisers adjust for sales and financing concessions, including

(a) seller carry-back loans
(b) buyer assuming a low-interest loan
(c) seller paying buyers' points
(d) each of the foregoing

13. In arriving at value, the appraiser's best source for obtaining "comparables" would be

(a) neighbors
(b) assessed valuations from the county assessment rolls
(c) multiple listing service of the local realty board
(d) expired listings
14. In using the income approach to value, the formula for the gross rent multiplier (GRM) is

(a) \( GRM = \frac{\text{sales price}}{\text{gross monthly rent}} \)
(b) \( GRM = \frac{\text{gross monthly rent}}{\text{sales price}} \)
(c) \( GRM = \text{gross monthly rent} \times \text{sales price} \)
(d) \( GRM = \text{sales price} \times \text{cap rate} \)

15. A single family dwelling sold for $150,000. The property is rented for $1,000 per month. The GRM is

(a) 1000
(b) 150
(c) 66.7
(d) none of these

16. An apartment property has a $100,000 gross scheduled annual income, a 10% vacancy, and $35,000 in operating expenses. If a cap rate of 10% is used, the indicated value is

(a) $1,000,000
(b) $450,000
(c) $550,000
(d) $650,000

17. A planned unit development (PUD) is

(a) the same as a condominium development
(b) a type of structure
(c) a type of property ownership
(d) a combination of row houses and townhouses

18. In California, a licensed appraiser

(a) is limited to evaluating noncomplex one to four unit residential properties up to $1,000,000
(b) is limited to evaluating complex one to four unit residential properties up to $1,000,000
(c) may appraise any type of residential property
(d) may appraise any type of real estate

19. In dealing with an appraiser, real estate agents should

(a) follow her around the property to be sure the appraiser doesn't overlook anything
(b) distract the appraiser if it will result in a higher valuation
(c) furnish her with low-priced comparables
(d) make it convenient for her to see the property

20. Which of the following statements regarding qualifying borrowers is correct?

(a) The greater the equity, the lesser the incentive to meet timely mortgage payments.
(b) The smaller the equity, the greater the incentive to meet timely mortgage payments.
(c) If a loan is not sound for the borrower, it's not sound for the lender.
(d) Qualifying borrowers is not too important where the lender is able to foreclose and end up owning the property.
21. Qualifying potential borrowers
   (a) is a precisely scientific operation
   (b) is a process where flexibility and judgment are discouraged
   (c) is done on a case by case basis
   (d) involves rules and procedures to which lenders must strictly adhere

22. Where an applicant for a loan falls short of meeting qualifying income ratios, lenders may feel justified in approving a higher ratio if
   (a) the applicant has been making rent payments approximating the proposed mortgage payments
   (b) a larger than normal down payment is made
   (c) compensating factors exist, such as substantial net worth
   (d) in any of the above situations

23. The formula for calculating the "front-end ratio" is
   (a) mortgage payment / gross income
   (b) mortgage payment / net income
   (c) total payments / gross income
   (d) total payments / net income

24. Conventional, Fannie Mae, and Freddie Mac define long-term debts as those extending longer than
   (a) 3 months
   (b) 6 months
   (c) 10 months
   (d) none of the above

25. The front-end and back-end ratios for conventional lenders is ____ and ____ respectively.
   (a) 28%, 33%
   (b) 31%, 36%
   (c) 28%, 36%
   (d) none of the foregoing

26. FHA front-end and back end ratios are
   (a) 28%, 36%
   (b) 29%, 41%
   (c) 29%, 36%
   (d) none of the foregoing

27. To qualify for a GI loan, the Department of Veterans Affairs applies a two-phase procedure, namely
   (a) residual income and qualifying income ratio
   (b) net take-home pay and residual income
   (c) total fixed obligations and borrowers living pattern
   (d) none of the above

28. DVA considers long-term debts as any debt requiring longer than
   (a) 3 months
   (b) 10 months
   (c) 1 year
   (d) none of the above
29. A family has combined gross income of $6,000. Housing payments, including property taxes and insurance, are $1,500. Other fixed obligations total $500 per month. The DVA income to expense ratio is

(a) 40%
(b) 30%
(c) 33.3%
(d) 44.4%

30. In qualifying an applicant for a Cal-Vet loan, total housing expense plus qualifying debts should not exceed ___ of gross income.

(a) 29%
(b) 50%
(c) 41%
(d) none of the above

31. Underwriters generally regard long-term debts as those stretching out beyond

(a) 3 months
(b) 6 months
(c) 10 months
(d) none of the above

32. Which of the following is the least likely to qualify as income for borrower qualifying purposes?

(a) straight commission
(b) self-employment income
(c) income from part-time work
(d) public assistance receipts

33. In assessing stability of income, lenders view such criteria as

(a) length of time on the job
(b) type of job
(c) years before retirement
(d) each of the above

34. Which of the following demonstrates high motivation in measuring borrowers' ability to pay back loans?

(a) buyer coming in with a 10% down payment
(b) house is purchased as investment property
(c) home is purchased for personal use
(d) seller is carrying back part of the purchase money loan

35. In working with lenders, borrowers and agents ought to

(a) suggest that a recent bankruptcy was unavoidable
(b) try to hide credit problems
(c) routinely shop other lenders if declined by the first lender
(d) ask the lender what can be done to qualify

36. Data disclosed on credit reports include

(a) judgments against the applicant
(b) listing of credit accounts in the name of the debtor
(c) a rating of the promptness of repayments by debtor
(d) each of the above
37. An advantage to having the loan officer assist a loan applicant complete the application includes

(a) assurance that the application is properly filled out
(b) ability to answer applicant's questions
(c) pointing out why the applicant may not qualify
(d) each of the above

38. Under the Equal Credit Opportunity Act, lenders may ask loan applicants

(a) whether they are divorced or widowed
(b) whether they are receiving alimony or child support
(c) whether they are married or unmarried
(d) whether they plan to have children

39. Under the Real Estate Settlement Procedures Act, lenders

(a) must give borrowers a written estimate of the closing costs
(b) may collect reserves of up to three years for taxes and insurance
(c) may require borrower to purchase title insurance from a particular company
(d) must furnish a booklet explaining ways to hold title to property

40. All real estate lenders require

(a) character references
(b) properly completed applications
(c) personal interviews with applicants
(d) good-faith deposits

41. Loans secured by junior liens and for refinancing

(a) are typically made only by conventional lenders
(b) involve a three-day right of rescission
(c) are made predominantly by private lenders
(d) may not involve a deficiency judgment

42. Whether paid on the first or any other day of the month, loan payments

(a) include interest paid in arrears
(b) include interest for the following month
(c) are billed either by the voucher or impound method
(d) may not involve late charges if a government-backed loan

43. Lenders may legally file foreclosure

(a) whenever requested by the trustee
(b) only after property taxes become delinquent
(c) even though payments of principal and interest are current
(d) if a property becomes uninhabitable due to severe damage

44. Following a foreclosure sale, a Trustee's Deed is issued under

(a) the Power of Sale contained in the trust deed
(b) the Authority of Foreclosure contained in the trust deed
(c) authority granted under the Real Estate Law
(d) authority granted under the California DRE Code of Conduct
45. Right of redemption following a trustee's sale is permitted within
   (a) three months
   (b) six months
   (c) twelve months
   (d) none of the above

46. In general, California's usury laws apply to
   (a) out-of-state transactions
   (b) seller carryback loans
   (c) unsecured loans
   (d) private lenders only

47. Home Warranty programs generally insure
   (a) all moving components within the dwelling
   (b) roof leaks, if uncovered within three years
   (c) electrical problems, if discovered within five years
   (d) most major components, for up to one year

48. Judicial foreclosures
   (a) are permitted only for non-residential properties
   (b) usually precede trustee sale foreclosures
   (c) always involve court action
   (d) preclude deficiency judgments

49. Mortgage guaranty insurance, such as MIP or PMI,
   (a) protect borrowers against loss due to insolvency of the lender
   (b) protect lenders against loss due to death of the borrower
   (c) protect lenders in event of foreclosure
   (d) is required for all loans with less than 20% down payment

50. The term used to describe situations where a lender defers monthly
    payments to avoid foreclosure is called
    (a) forbearance
    (b) modification
    (c) recasting
    (d) compromise

51. So-called combination loans
    (a) combine real and personal property loans
    (b) combine construction and permanent financing
    (c) combine permanent and personal property loans
    (d) involve two or more lenders

52. Construction loans are usually made
    (a) for less than six months
    (b) by the same lender that will provide permanent financing
    (c) where a take-out loan has been committed
    (d) for only the value of the improvements
53. Payouts under construction financing typically involve
   (a) draws as construction progresses
   (b) lump-sum following the filing of a notice of completion
   (c) installments only after obtaining lien releases from the owner
   (d) fully-amortized repayments

54. Controlling the manner of payments under a construction loan is the
   (a) purchase agreement
   (b) mortgage document
   (c) title insurer
   (d) building and loan agreement

55. Upon discovery of a work of improvement made by a tenant without the
    landlord's permission, the owner should
   (a) record a Notice of Non-Responsibility within 10 days of discovery
   (b) record a Notice of Completion within 90 days of discovery
   (c) record a Notice of Non-Completion within 10 days of discovery
   (d) institute eviction proceedings

56. Partial lien-release clauses, such as those used in the financing of
    housing subdivisions, are most likely to be found in
   (a) construction loans
   (b) blanket trust deeds
   (c) package loans
   (d) all-inclusive trust deeds

57. Once a mechanic's lien has been filed
    (a) action to foreclose must take place within 90 days thereafter
    (b) it constitutes a junior lien
    (c) the owner must pay the debt within 30 days
    (d) it takes precedence over all other liens

58. Another name for construction loan is
    (a) interim loan
    (b) package loan
    (c) bridge loan
    (d) tri-partite loan

59. A provision in a construction loan granting a loan for commercial
    property but that is contingent on the developer-borrower's ability
    to pre-lease a stated amount of space is referred to as
    (a) subordination clause
    (b) pre-lease clause
    (c) rental achievement clause
    (d) holdback clause

60. Prior to the 1930s, lenders generally used
    (a) short-term fully-amortized loans
    (b) long-term fully-amortized loans
    (c) straight notes
    (d) unsecured promissory notes
61. Under a Level Principal Plus Declining Interest plan
   (a) the loan calls for a balloon payment
   (b) the loan is greater than with standard fully-amortized plans
   (c) payments of principal and interest declines with each installment
   (d) payments of principal and interest increases with each installment

62. A home is sold for $200,000, with a down payment of Three points plus $300 is charged for the loan, amounting to
   (a) $5,100
   (b) $6,300
   (c) $4,800
   (d) $4,000

63. The periodic reduction of principal is labeled
   (a) depreciation
   (b) appreciation
   (c) escalation
   (d) amortization

64. The annual percentage rate (APR) is required of any loan under provisions of the
   (a) Truth in Advertising law
   (b) Truth-in-Lending law
   (c) Fair Lending Practices Act
   (d) Equal Credit Opportunity Act

65. Buydowns are most often employed
   (a) to attract buyers
   (b) when market interest rates are high
   (c) for relatively short periods of time
   (d) for all of the above reasons

66. Biweekly loans
   (a) require more interest over the life of the loan
   (b) require less interest over the life of the loan
   (c) are popular during periods of tight money
   (d) are most popular for first-time buyers

67. A disadvantage of biweekly mortgages is
   (a) they are not approved on the secondary market
   (b) their lower loan-to-value ratios
   (c) the higher monthly payments over monthly loans
   (d) the lower total interest charges over the life of the loan

68. A loan for $100,000 fully is amortized over 25 years with payments of $772 per month, including interest of 8% per annum. The first month's interest is, rounded to the nearest dollar
(a) $77$

(b) $66$
69. Using the same data from problem 68, after the first payment has been made the balance of the loan will be, in round numbers

(a) $99,228
(b) $99,333
(c) $99,895
(d) $100,000

70. An installment note, with interest included and a balance due date, illustrates a

(a) straight note with interest included
(b) straight note with interest extra
(c) partially-amortized note calling for a balloon
(d) fully-amortized note calling for a balloon

71. The annual constant is calculated by dividing the annual payments by the original loan amount. If your payments on a $125,000 loan are $965 per month, including interest of 8% per annum, the annual constant is

(a) 8.0%
(b) 9.3%
(c) 7.7%
(d) 9.6%

72. You borrow $100,000 for 15 years with monthly payments of $1,075, including interest of 10% per annum. During the first year you pay only $500 per month. At the end of the first month the approximate loan balance will be

(a) $100,500
(b) $100,167
(c) $99,500
(d) $99,333

73. The facts in question 72 illustrate a condition referred to as

(a) interest-only loan
(b) positive amortization
(c) negative amortization
(d) balloon note

74. The type of interest typically paid on home loans is

(a) amortized interest
(b) simple interest
(c) compound interest
(d) discount interest

75. When the Federal Reserve Board tightens money

(a) conventional lenders are encouraged to make more loans
(b) creative financing techniques increase
(c) housing activity increases
(d) construction activity increases

76. An all-inclusive trust deed is also referred to as a(n)

(a) wrap-around trust deed
(b) hold-harmless trust deed
(c) overriding trust deed
(d) all of the above
77. The all-inclusive trust deed note
   (a) may result in a lower effective yield than the standard trust note
   (b) always produces a higher effective yield than the standard note
   (c) is not desirable for installment sales motivated by income tax savings
   (d) must always be prepared by an attorney

78. A property sells for $300,000, with an existing first note for $125,000 and a second lien for $30,000. Buyers pay 20% down, and sellers carry back the balance under an AITD. The sellers' remaining equity is
   (a) $215,000
   (b) $85,000
   (c) $145,000
   (d) $175,000

79. At maturity of a note calling for a balloon, the borrower may
   (a) force the holder of the note to extend the maturity if the borrower is unable to meet the payment
   (b) add the balloon to the existing first trust deed loan
   (c) obtain a hard-money loan to replace the balloon
   (d) assign the note to another party

80. Where a down payment is not sufficient to pay commissions, the broker may
   (a) take an unsecured promissory note for part or all of the commission
   (b) accept a collateral assignment of a note carried back by sellers
   (c) take anything else of value, such as an automobile
   (d) do any of the above

81. In an otherwise tax-deferred exchange, anything of value that is paid to one of the parties to the exchange is termed
   (a) facilitator
   (b) boot
   (c) equity equalizer
   (d) exchange payment

82. To increase their yields, lenders may resort to a variety of techniques, including
   (a) participation in the income stream
   (b) participation in any profits
   (c) participation in the ownership
   (d) any of the above

83. Imputed interest
   (a) is another term for deferred interest
   (b) is illegal in California
   (c) is governed by the applicable federal rate
   (d) applies to assumptions of existing loans
84. In a sale-leaseback arrangement involving rental properties
   (a) lessors can deduct their lease payments on their tax returns
   (b) lessees can deduct the lease payments on their tax returns •
   (c) the buying lessors give up the right to depreciate the improvements
   (d) the selling lessees deplete their capital

85. Under the Creative Financing Disclosure Act
   (a) negative amortization must be disclosed
   (b) sellers must disclose full selling price to buyers
   (c) balloon payments are not permitted
   (d) credit information on the seller must be furnished to buyers

86. Under a land contract of sale, title to property is held by
   (a) the vendor, until the note is repaid
   (b) the vendee
   (c) the trustee
   (d) the beneficiary

87. Existing junior trust deeds are typically sold
   (a) at a premium
   (b) at a discount
   (c) at par
   (d) at less than prime rates

88. Collateralizing a junior trust deed note involves
   (a) additional liens on the property
   (b) sale of the note
   (c) third-party lending with the note as security
   (d) diluting the interest of the property owner

89. Financing duplexes as compared to single dwellings usually
   (a) require less down payment
   (b) mandate owner occupancy
   (c) necessitate co-signors
   (d) involve higher interest rates

90. A disadvantage to the single-family dwelling as an investment is
   (a) full loss of rent when vacant
   (b) limited number of choices
   (c) low appreciation rate compared to income properties
   (d) the interest that must be paid on any loans

91. The best way to increase the value of a commercial property is
   (a) offer it as an exchange property
   (b) to increase its net operating income
   (c) defer cash flow to time of resale
   (d) to take acceleration depreciation for the value of the improvements

92. Rent control ordinances typically impact
   (a) commercial properties
   (b) industrial properties
   (c) shopping centers
   (d) residential properties
93. A reduction in cash flow for rental properties is generally caused by
(a) careful management
(b) spiraling repair costs
(c) increased demand
(d) poor bookkeeping

94. Experienced apartment house investors realize that
(a) pre-tax cash-flow is the most important criteria to measure a property's worth
(b) net operating income is the most important criteria to determine a property's value
(c) resident managers are not required except for high-rise properties
(d) taxable cash flow should be avoided at all costs

95. When mortgage rates rise for income-producing properties
(a) property values tend to decline
(b) property values tend to increase
(c) net operating income falls
(d) interest rates have no impact on rental properties

96. When mortgage rates exceed capitalization rates on income-producing properties, it gives rise to a condition known as
(a) positive leverage
(b) interest rate leverage
(c) neutral leverage
(d) negative leverage

97. Gross rent for an income-producing property is $100,000. Vacancy losses and operating expenses amount to $35,000, resulting in net operating income of $65,000. If the loan calls for monthly payments of $5000, the debt coverage ratio is
(a) 1.08 to 1
(b) 1.67 to 1
(c) 1.86 to 1
(d) 2.86 to 1

98. Using the same data from question 97, if the capitalization rate is 8%, the indicated value for the property is
(a) $800,000
(b) $650,000
(c) $812,500
(d) $520,000

99. The sale of an existing trust deed loan comprises
(a) secondary financing
(b) secondary mortgage market
(c) primary mortgage market
(d) primary financing

100. The effective yield on an 11%, 30 year loan that is discounted at 5% and prepaid in 12 years will be:
(a) higher than the note rate
(b) lower than the note rate
(c) the effective yield and note rate will be the same
(d) not enough facts to determine an answer
ANSWERS

1. (b) 51. (c)
2. (d) 52. (c)
3. (b) 53. (a)
4. (d) 54. (d)
5. (b) 55. (b)
6. (b) 56. (b)
7. (a) 57. (a)
8. (d) 58. (a)
9. (d) 59. (c)
10. (b) 60. (c)
11. (c) 61. (c)
12. (d) 62. (a)
13. (c) 63. (d)
14. (a) 64. (b)
15. (b) 65. (d)
16. (c) 66. (b)
17. (c) 67. (c)
18. (a) 68. (b)
19. (d) 69. (c)
20. (c) 70. (c)
21. (c) 71. (b)
22. (d) 72. (b)
23. (a) 73. (c)
24. (c) 74. (b)
25. (c) 75. (b)
26. (b) 76. (d)
27. (a) 77. (a)
28. (b) 78. (b)
29. (c) 79. (c)
30. (c) 80. (d)
31. (c) 81. (b)
32. (d) 82. (d)
33. (d) 83. (c)
34. (c) 84. (b)
35. (d) 85. (a)
36. (d) 86. (b)
37. (d) 87. (b)
38. (c) 88. (c)
39. (a) 89. (d)
40. (b) 90. (b)
41. (b) 91. (d)
42. (a) 92. (b)
43. (c) 93. (c)
44. (a) 94. (b)
45. (d) 95. (a)
46. (c) 96. (d)
47. (d) 97. (a)
48. (c) 98. (c)
49. (c) 99. (b)
50. (a) 100. (a)