**Unit 16 Outline**

**Real Estate Financing - Practice**

**Outline**

I. The Real Estate Financing Market

A. The Federal Reserve System

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

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

a. As a principle, when the money available for lending decreases, interest rates rise.

b. By decreasing reserve requirements, the amount of money circulated in the marketplace rises, causing interest rates to drop.

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

a. The prime rate is strongly influenced by the Fed’s discount rate.

4. Additional practices

B. The Primary Mortgage Market—The primary mortgage market is made up of the lenders that originate mortgage loans. For a lender, a loan must generate enough income to be attractive as an investment.

1. Thrifts, savings associations, and commercial banks

2. Insurance companies

3. Credit unions

4. Pension funds

5. Endowment funds

6. Investment group financing

7. Mortgage banking companies

8. Mortgage brokers

IN ILLINOIS . . . *Illinois requires the licensing of loan originators. Both pre- and post-educational requirements are mandated as well as licensing examinations.*

C. The Secondary Mortgage Market—Here, loans are bought and sold after they have been funded.

1. Fannie Mae or Federal National Mortgage Association (FNMA) is now a government-owned agency that provides a secondary market for mortgage loans.

a. Fannie Mae buys a block or pool of mortgages from a lender in exchange for mortgage-backed securities.

2. Ginnie Mae or Government National Mortgage Association (GNMA) is a division of HUD organized as a corporation without capital stock.

b. Ginnie Mae administers special-assistance programs and guarantees MBSs using FHA and VA loans as collateral.

3. Freddie Mac or Federal Home Loan Mortgage Corporation (FHLMC) also is now a government-owned enterprise, similar to Fannie Mae

c. Freddie Mac provides a secondary market for the sale conventional loans.

II. Financing Techniques

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

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

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

C. Adjustable-Rate Mortgages (ARMs)—A loan originated at one rate of interest that fluctuates up or down during the loan term based on some objective economic indicator is called an adjustable-rate mortgage.

1. Rate caps limit the amount the interest rate may change.

2. Rate is tied to an index.

3. Payment caps set a maximum amount for payments.

4. Adjustment periods establish how often the rate may be changed.

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

E. Growing-Equity Mortgage (GEM)—Uses a fixed interest rate, but payments of principal are increased according to an index or a schedule.

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

F. Reverse Mortgage—Loan is based on the equity the homeowner has invested in the property.

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

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

III. Loan Programs

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

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

1. Importance of credit scores

2. Importance of credit history

C. Private Mortgage Insurance (PMI)—If lenders are giving a loan for greater than 80% of value, they will require the borrower to secure insurance from a private mortgage insurance company as additional security to insure the lender against borrower default.

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

D. FHA-Insured Loans—FHA operates under HUD and has primary responsibility for administering the government home loan insurance program.

1. Title II, Section 203(b), fixed-interest rate loans for 10- to 30- year loans on one- to four-family residences -- most popular FHA program.

2. Certain technical requirements must be met before FHA will insure a loan:

a. Prepayment privileges

b. Assumption rules

c. Discount points

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

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

1. Certificate of eligibility

2. Certificate of reasonable value (CRV)

3. Reasonable discount points

4. No prepayment penalty

5. Assumption rules

6. Income qualification is only back end of 41%

F. Agricultural Loan Programs

1. Farm Service Agency (FSA)—Formerly Farmers Home Administration

a. It is a federal agency of the Department of Agriculture that offers programs to help low- and moderate-income families purchase or operate family farms or purchase or improve single-family homes in rural areas.

2. Farm Credit System provides loans to farmers, ranchers, rural homeowners, agricultural cooperatives, rural utility systems and agribusinesses.

3. Farmer Mac is another government-based enterprise that operates similarly to Fannie Mae and Freddie Mac in the context of agriculture.

IV. Other Financing Techniques

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

B. Package Loan—A package loan includes personal property as security for the loan in addition to the actual real estate.

C. Blanket Loan—A blanket loan covers more than one parcel or lot; it usually includes a partial release clause that permits the borrower to release any one lot or parcel from the lien by repaying a certain amount of the loan.

D. Wraparound Loan—A wraparound loan enables a borrower with an existing mortgage to obtain additional financing from a second lender without paying off the first loan.

E. Open-End Loan—An open-end loan secures a note plus any future advances of funds.

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

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

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

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

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

2. There are various factors to consider when getting a home equity loan.

V. Financing Legislation

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

1. Creditor

a. A creditor is any person who extends consumer credit more than 25 times each year or more than five times each year if the transactions involve dwellings as security.

b. The credit must be subject to a finance charge or payable in more than four installments by written agreement.

2. Three-day right of rescission—A borrower has three days in which to rescind the transaction by merely notifying the lender.

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

3. Advertising—The annual percentage rate (APR) must be stated.

a. Specific credit terms, such as down payment, monthly payment, dollar amount of the finance charge, or term of the loan, may not be advertised unless the advertisement includes specific information.

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

B. TRID and the Loan Estimate (LE)

1. The Loan Estimate shows the consumer the amount of money borrowed, the interest rate, the amount of interest paid, the number of payments, the individual amount of those payments, any associated costs for the loan, estimate of closing costs, and an estimate of the cash needed to close.

2. The LE must be delivered or placed in the mail no later than the third business day after receiving the consumer’s “application.” “Application” is defined as when the lender has received the following information regarding the loan:

* Address of the property
* Loan amount
* Income of the borrower
* Contract price for the property
* Social Security Number of the borrower

C. Equal Credit Opportunity Act (ECOA)—ECOA prohibits lenders and others who grant or arrange credit to consumers from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age, or dependence on public assistance.

1. Lenders and other creditors must inform all rejected credit applicants of the principal reasons for the denial or termination of credit in writing, within 30 days.

2. Borrowers are entitled to a copy of the appraisal report if the borrower paid for it.

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

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

E. Real Estate Settlement Procedures Act (RESPA)—RESPA is designed to ensure that buyer and seller are both fully informed of all settlement costs.