



FI 1120 – 564002166

Demystifying the Mortgage Process



ILLINOIS REALTORS®
Licensing & Training Center

Real Estate Licensing & Continuing Education

The Illinois REALTORS® Licensing & Training Center is your
TRUSTED SOURCE for state-approved education.



Lin Ewing, Author

Completing Your Homestudy Course:

The student should look through the entire course to get a feel for the format (quizzes, notes, etc.) Highlighted areas and pre-quiz questions have been written to help students recognize key information in the material.

At the end of the course, students will take a proctored exam that will cover the course information. When you have completed the course, and have had time to review, please contact the board from which you purchased the course to schedule your proctored exam.

Instructor Availability

Lin Ewing is the author and instructor for this home study program. As this program is designed to allow you to work at your own pace, it may be necessary for you to contact the instructor at some point if you are struggling with a certain area of the course.

It is the policy of the Illinois REALTORS® and Lin Ewing to make available to you, an email address for a quick response to your questions, concerns, or comments about the home study program.

Always leave a detailed message with specific pages and/or topics you would like to discuss - **Email – lin.ewing@bairdwarner.com**

Maximum Allowable Time:

The maximum allowable time to complete this home study package is **90 days from the date of purchase.**

Any student not achieving a 70% score on the Final Exam must contact IR to prepare for a successful re-take of the Final Exam.

DEMYSTIFYING THE RESIDENTIAL MORTGAGE PROCESS

WHAT IS A MORTGAGE?

A mortgage is a temporary, voluntary lien on a piece of real estate. That real estate is being pledged as security against the mortgagor's repayment of a loan to the mortgagee. The **mortgagor** is the **borrower/buyer/purchaser** and the **mortgagee** is the **lender**.

The mortgagee/lender allows the mortgagor/buyer to purchase and assume ownership of a property with the agreement that the borrower will repay the amount of the loan according to parameters agreed to in the loan agreement between the mortgagee and the mortgagor.

The actual amount that the borrower will need to repay will include:

- The amount of money borrowed, known as the principal;
- The amount of interest accrued over the life of the loan;
- Any other fees that the lender/bank and the borrower have agreed upon.

WHO'S WHO IN THE TRANSACTION?

Loan Officer/Mortgage Broker/Mortgage Banker/Mortgage Originator:

Representatives of banks, credit unions, mortgage brokers, mortgage bankers and other financial institutions who help borrowers in acquiring a loan are generally referred to as **Loan Officers, Loan Originators** or **Mortgage Originators**.

Federal legislation mandates that loan officers must:

- Be licensed;
- Pass a background check;
- Have no felony conviction;
- Fulfill continuing education requirements.

Loan officers usually specialize in one of 3 main types of lending:

- **Commercial Lending**-working with businesses to expand the business, purchase new equipment, etc
- **Consumer Lending**- working with borrowers who are purchasing a car, acquiring a home equity loan, personal loan;
- **Residential Lending**-working with borrowers who are:
 - Purchasing detached homes;
 - Purchasing attached homes (condominiums, townhomes, duplexes, etc.);
 - Purchasing 1-4 unit properties;
 - Purchasing other residential properties;
 - Refinancing an existing mortgage.

A **residential mortgage loan officer** may:

- Work any number of hours;
- Meet clients in his/her office or at their homes;
- Assist as many customers as he/she chooses.

The loan officer/loan originator, whether working for a mortgage broker, a mortgage banker or a retail bank collects the same information or documentation from the borrower.

The mortgage broker and the mortgage banker have access to banks, investors and lenders and are therefore able to "shop" for the best loan program and the best rates for the borrower. Consequently, the mortgage broker and the mortgage banker may offer an advantage to the borrower/customer over the retail bank in that they work on behalf of the borrower, whereas the retail bank loan officer works on behalf of the banking institution by which he/she is employed. The mortgage broker and the mortgage banker are able to explore various sources to find the best or lowest mortgage rates currently available in order to secure the best rate for the borrower.

Differences Between A Mortgage Broker And A Mortgage Banker:

A **Mortgage Broker** is an intermediary, go-between, liaison or middleman who brings a mortgage lender together with a borrower for the purpose of the borrower receiving a mortgage loan from that lender. The mortgage broker works directly with the borrower and directly with the lender, whether the lender is a bank or an end investor. Think of the lender as wholesale and the borrower as retail, who are brought together by the mortgage broker.

The mortgage broker does **not** fund the mortgage, but assists the borrower in collecting the necessary information and completing the necessary paperwork in order to apply for the loan which will allow the mortgage lender to send that loan application to underwriting. The funds for the mortgage loan are from the end lender who is funding the mortgage, purchasing the mortgage and investing in it, **not** from the mortgage broker. The mortgage broker collects an origination fee as payment for the work he/she has completed, thereby earning money by charging the borrower closing costs upfront. The mortgage broker "brokers" a transaction between the borrower and the lender of the mortgage funds. The mortgage broker does **not** service the loan.

The mortgage broker is **not** a mortgage banker, but might facilitate the transaction for a mortgage banker by bringing the mortgage banker and the borrower together.

A **Mortgage Banker**, also an intermediary, is an individual, an institution or a company that originates mortgages and **may use its own funds** to close the mortgage in its own name or **choose to broker the loan out, which will then be funded directly by the end investor**. Once the mortgage is originated, the mortgage banker may choose to hold the mortgage in its own "portfolio" or to sell the mortgage to another investor or to the secondary market, such as Fannie Mae or Freddie Mac. The mortgage banker may opt to service the mortgage or to sell the rights to service the mortgage to a different financial institution. **The primary business for a mortgage banker is receiving the fees from originating the loan.** The majority of mortgage bankers do **not** hold the mortgages in their own portfolios, but sell them into the secondary market.

Mortgage bankers if selling the loan to an end investor, like mortgage brokers, will underwrite the loan to meet an end lender/investor's guidelines and then sell that mortgage loan to that end investor. The mortgage banker's underwriter will underwrite the loan to make sure that the loan meets the criteria necessary for the intended end investor/lender. If the mortgage banker's loan is declined by the end lender/investor, the mortgage banker would simply have its in-house underwriter review the guidelines of other end investors and then sell that loan to that end investor.

The mortgage broker, however, must physically deliver the file to the end investor so that the end investor/lender is the one who will underwrite and approve the loan. If the mortgage broker's loan is declined by the first end investor, the broker must then send the file to another investor to review. Brokers do not have the flexibility in going back to their own underwriting to **quickly** re-submit the loan file to a different end investor as the mortgage broker must submit each loan to a different end lender's underwriter.

Additionally, if a mortgage broker's loan is rejected by the first end investor and the mortgage broker sends the file to a new investor, that new investor might not accept the appraisal that was done for the first investor and might require another appraisal.

Further, because of the perceived higher risk of a brokered loan over those mortgages that go through a mortgage banker, the mortgage broker's loans may have additional underwriting restrictions, also known as "overlay" lending requirements, imposed on them beyond what the usual underwriting requires so that the end lender/investor will feel more secure in purchasing the loan. (Historically, mortgage broker loans default at a higher rate than non-broker loans.)

Traditional **retail banks insured by FDIC** (and credit unions and insurance companies) may also offer mortgages. The mortgage banker in a traditional retail bank is only able to offer the borrower a choice of the loan programs and rates that that particular bank has available. The borrower may not be getting the best program or the lowest rate available because his/her choices have been limited by the bank's limitations.

When a borrower is experiencing "challenges" in having a mortgage approved through a retail banking institution, mortgage bankers and mortgage brokers may be able to assist that borrower in securing the mortgage. This is because mortgage brokers and mortgage bankers typically have relationships established with many banks, credit unions, etc. and are often able to see if a challenging loan scenario will meet the underwriting guidelines of many different end investors. Most residential loans are underwritten to conform to Fannie Mae, Freddie Mac, or FHA guidelines, but many financial institutions impose additional "overlays" on top of the Fannie Mae, Freddie Mac or FHA guidelines.

The Mortgage Broker:

- Is an intermediary or middleman who brings a mortgage lender together with a borrower;
- Facilitates the mortgage origination for a financial institution of which the mortgage broker is **not** a part;
- Works directly with the borrower;
- Works directly with the lender, whether the lender is a bank or an end investor;
- Assists the borrower:
 - In collecting the necessary information;
 - In completing the necessary paperwork in order to apply for the loan.
- Collects an origination fee as payment for the work;
- Earns money by charging the borrower closing costs upfront;
- Does **not** fund the mortgage;
- Does **not** retain a portfolio of mortgages;
- Does **not** service the mortgage;
- Does **not** close mortgages in its own name;
- Brings together a borrower and a lender for the purpose of creating a mortgage.

The Mortgage Banker:

- Is an intermediary, an institution or a company that originates mortgages;
- Funds the mortgage with its own funds, which may have been borrowed at a lower rate of interest than the mortgage banker is charging the borrower or may be the banker's own funds;
- Closes the mortgage in its own name;
- May **choose to broker the loan out, which will be funded directly by the end investor;**
- May **choose to hold the mortgage in its own "portfolio";**
- Typically pools the loan with other loans and sells that pool of loans to large financial institutions. These large financial institutions may be the same financial institutions that are issuing the funds to the mortgage banker, so the funds may be supplied by the same financial institutions who is eventually purchasing the loan;
- May choose to service the mortgage after closing or may sell the right to service the loan to another entity.

Advantages And Disadvantages Of Mortgage Brokers And Mortgage Bankers:

The **advantages** of working with a **mortgage broker**:

- Shops wholesale mortgage rates from various lenders and banks in order to find the best rates for the borrower, thus saving the borrower the effort of researching rates and lenders to find the best scenario;
- Can offer "wholesale" interest rates that can be lower than a retail bank's interest rates;

The **disadvantages** of working with a **mortgage broker**:

- May not have access to programs that the mortgage banker or the retail bank might have.
- May not be able to transfer the appraisal to another end lender if the first lender declines the loan;
- May have more requirements/overlays from the end lender beyond the guidelines imposed by Freddie Mac, Fannie Mae and FHA than mortgage bankers and retail banks have because historically more broker loans are defaulted than non-broker loans;
- Slow turnaround time because it is the end investor who is underwriting the file and not the mortgage broker.

The **advantages** of working with a **mortgage banker**:

- Can offer "wholesale" interest rates that can be lower than a retail bank's interest rates;
- Usually has less conservative parameters on the loan programs he/she can offer;
- Is often more easily accessible to the borrower and works with less "red-tape" than a traditional bank;
- Can redo underwriting in-house if original end lender rejects the loan and the loan must be sent to a different end lender with different criteria;
- Can often finance a difficult loan situation that a mortgage broker or a retail bank cannot finance.

The **advantages** of working with a **retail banker**:

- May be able to offer the borrower incentives because of an already existing relationship via the borrower's account(s) with the bank;
- May be able to add the mortgage to the borrower's existing bank profile and facilitate automatic payments from already existing accounts at the bank.

The **disadvantages** of working with a **retail banker**:

- Usually has more conservative parameters on the loan programs he/she can offer;
- May not be able to offer as many programs to customize the borrower's situation;
- Less likely to be able to work with a loan that is difficult or not "standard";
- More likely not to be able to secure a loan that falls outside of the standard guidelines.

It should be noted that borrowers who agree to pay the loan originator "directly" do not also pay the originator "indirectly" through a higher interest rate, thereby effectively paying more in total compensation than they are aware. By federal law, the loan originator is prohibited from receiving compensation directly from the consumer and then also receiving compensation from the end lender or another party. However, loan originators can continue to receive compensation based on the loan amount via mortgage points.

Portfolio Lender and Temporary Lender

A company that originates mortgage loans and holds its own loans instead of selling them to another institution in the secondary market is called a "**Portfolio Lender**". Portfolio lenders can often offer the borrower more flexibility in the qualifying process if the portfolio lender is intending to keep the loan rather than sell it to the secondary market. In this way, a portfolio lender would be a good choice for a borrower who does not meet the required qualification for a conventional loan that would later be sold to Fannie Mae, Freddie Mac or FHA.

Consider that portfolio lenders are likely to be privately held community banks or savings and loans that are more localized in their decision-making processes rather than a large banking institution that has stockholders. A community bank might be influenced by a long-standing relationship with the borrower in a situation where the borrower did not qualify for a conventional mortgage. Circumstances, such as a period of bad credit for a borrower, might influence the borrower's ability to qualify at a larger banking

Holding the mortgages is riskier for the lender than selling them in to the secondary market. Portfolio lending requires the bank/lender to hold a large amount of reserves in order to cover for any non-performing loans that result in a loss of reserves. This is a reason that the big banks (those deemed too big to fail) can more readily issue portfolio loans because of the massive amount of customer deposits they hold, providing the reserves they would need to compensate for any loans that go into default.

A large mortgage banker usually services the mortgages that it originates, while smaller mortgage bankers tend to sell to another institution their **right to service** the mortgages they originate.

Servicing a loan would generally include:

- Collecting the payment, including PITI (Principal, Interest, Taxes and Insurance);
- Bookkeeping;
- Accounting;
- Preparing and recording the property's taxes;
- Preparing and paying the hazard insurance for the property;
- Processing the tax and insurance payments;
- Monitoring payments;
- Monitoring delinquencies.

A lender that sells the loans it has originated into the secondary market after the real estate transaction is closed is called a "**Temporary Lender**". The lender might sell the closed loans to a securities dealer who might then re-sell the loans to investors, or to another lender who buys debt and holds it in its own portfolio. Further, a temporary lender may opt to sell its loans to its own trust.

The temporary lender earns money by:

- Charging the borrower fees for its funding of the loan;
- Originating loans at interest rates that are above **par value** and then selling the loans into the secondary market at a premium price. Because of the above par interest rate that the lender has charged, the loan is worth more sold into the secondary market than what the actual, principal balance of the loan is. Par value or par pricing is an interest rate where the lender neither makes nor loses money, but simply breaks even;
- Charging the borrower/consumer a higher interest rate than the lender is paying for having borrowed the money in order to fund the loan. The temporary lender earns the difference or "spread" between the consumer's interest rate and the rate the lender is paying out until the lender sells the loan into the secondary market.

Differences Between A Portfolio Lender And A Temporary Lender:

The **portfolio lender originates** mortgage loans and **holds** these loans instead of selling them to another institution in the secondary market. The portfolio lender may have more flexibility in qualifying a borrower for a mortgage because the loan being issued does not need to meet the qualifications to be sold in to the secondary market.

The **temporary lender sells** the loans it has originated into the secondary market after the real estate transaction is closed.

PRIMARY MORTGAGE MARKET AND SECONDARY MORTGAGE MARKET

The Primary Mortgage Market

A **Mortgage Originator** is defined as an individual or an institution working with a borrower in order to complete a mortgage transaction. The mortgage originator may be a mortgage broker or a mortgage banker or a retail banker. **The mortgage originator is the original mortgage lender and is a part of the primary mortgage market.**

The **Primary Mortgage Market originates mortgage loans**. It is made up not only of several large firms that originate a very great percentage of all mortgages, but also of a great number of small firms and individual investors who originate mortgages as well.

The Primary Mortgage Market is where a borrower and the mortgage originator:

- Come together to create a mortgage;
- Negotiate the terms of the loan;
- Participate in the mortgage transaction.

The lenders in the Primary Mortgage Market make money for mortgage loans available directly to the borrowers.

This Primary Mortgage Market is made up of mortgage brokers, mortgage bankers, credit unions and retail banks. After the mortgage is originated, a large percentage of the mortgages are immediately sold into the secondary mortgage market, usually as part of a package of mortgages that make up a Mortgage-Backed Security (MBS).

A **Mortgage-Backed Security (MBS)** is an asset-backed security that is secured by a mortgage or a group/collection of mortgages originated by a regulated, authorized financial institution. MBSs are debt investments in pools of mortgages. An investor holding an MBS receives payments of interest and principal on his/her investment as the borrowers' payments are made on the mortgages held within the pool. The riskiness of the MBS is defined by the type of rating received by an accredited credit rating agency and usually pays a period payment similar to coupon payments. The majority of MBSs are issued by the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

The investment in an MBS (also known as a Mortgage-Related Security or a Mortgage-Pass-Through) allows money to be lent to a home purchaser/borrower or a business. The MBS is a way in which a smaller, regional bank is able to originate mortgages for its borrowers without needing to have the customers supply assets to cover the amounts of the loans. The bank, in this case, acts as a liaison between the borrower and the investor.

The Secondary Mortgage Market

The **Secondary Mortgage Market** assists lenders in raising capital so that the primary mortgage market lenders are able to continue originating mortgage loans. It is here, in the Secondary Mortgage Market, that mortgage loans and the rights to service those loans are bought and sold **after** the mortgages have been funded; that is after the transaction has closed. This type of transaction is between mortgage originators, investors and those who securitize mortgages.

The Secondary Mortgage Market is liquid and very large. A large percentage of newly funded mortgages that are originated by temporary lenders are sold into the Secondary Mortgage Market after they are packaged into MBSs. They can then be sold to other investors who might be pension funds, insurance companies or hedge funds. The Secondary Mortgage Market gives the Primary Mortgage Market the liquidity of money they need to continue issuing new mortgages. It frees up the money of the Primary Mortgage Market so that the Primary Mortgage Market can issue new loans.

FANNIE MAE-The Federal National Mortgage Association-FNMA

Works with Conventional loans, VA guaranteed loans and FHA insured loans.

The Federal National Mortgage Association, aka **FNMA** or most commonly called **Fannie Mae**, does **not offer** loans, but instead, through the Secondary Mortgage Market, purchases and guarantees mortgages which meet its criteria. In doing so, Fannie Mae replenishes the funds of lenders in the Primary Mortgage Market. It was created by Congress in 1938 to purchase loans from mortgage lenders, including local and national banks, credit unions, thrifts, etc., in order to facilitate

their ability to originate new loans by keeping their funds liquid instead of having them "tied up" in home mortgages and to securitize or purchase those issued mortgages. To fund its portfolio, Fannie Mae issues its own MBSs which the market place calls "agency debt". Some of the investors in Fannie Mae's MBSs are foreign governments, insurance companies and pension funds.

Fannie Mae purchases:

- Single-family home mortgages through banks and state housing finance agencies;
- Mortgages secured by manufactured homes;
- Mortgages in rural areas;
- "Blocks" or "pools" of mortgages from lenders which it then uses as collateral for its MBSs which are then sold to investors.

Further, Fannie Mae provides debt financing for the rental housing market and offers specialized mortgage financing solutions to help increase the supply of affordable housing for purchase or for rent.

Fannie Mae is a "government-sponsored enterprise" chartered by Congress to:

- Keep money available to flow to mortgage lenders through a secondary mortgage market;
- Help strengthen the housing market and the mortgage market;
- Facilitate affordable home ownership and rental.

Because of problems in the declining real estate and mortgage industry and because of a concern about increasing losses and the potential bankruptcy of Fannie Mae, the federal government "took over" Fannie Mae on September 6, 2008 and Fannie Mae is now in conservatorship as a "government-sponsored enterprise". Fannie Mae is working with mortgage servicers, housing counselors and others to assist homeowners in distress to find options and good solutions to help them to remain in their homes thereby working to preserve communities and to stabilize property values. Further, Fannie Mae has a foreclosure prevention operation to assist homeowners in difficulty to continue making their mortgage payments and to avoid foreclosure.

Fannie Mae is a national mortgage company that securitizes or purchases mortgage loans from mortgage originators. The mortgage originator may be a local bank, a national bank, a thrift (savings banks or savings and loans), a credit union, etc. These lending institutions originate the loans and Fannie Mae purchases those loans in order to give the money back to them to replenish liquidity to the lending institutions so that they have money available to issue new loans.

Fannie Mae is the largest source of home mortgage funding in the USA as it:

- Purchases mortgages;
- Purchases mortgage-backed securities from financial institutions;
- Guarantees the payments of principal and interest to those who purchase the Fannie Mae-issued mortgage securities.

Fannie Mae creates an MBS in exchange for a lender's delivery of a pool of mortgage loans to Fannie Mae. The lender who delivers the pool of mortgages may choose to hold the mortgage security in its own portfolio or sell it off to other investors. Fannie Mae provides the guarantee to the investor/purchaser of the MBS. Reflected in the interest rate on a residential mortgage is a guarantee fee, also referred to as a "g-fee". Since Fannie Mae guarantees that the investor/purchaser of the loan will receive the principal and interest payments that he/she expects to receive until the loan is fully repaid, Fannie Mae will absorb the credit losses and costs incurred should the loan go into

default and/or foreclosure. The g-fee is to compensate Fannie Mae for absorbing the credit losses and costs should a loan default and/or go in to foreclosure.

Fannie Mae purchases federally insured/ guaranteed mortgages that meet the conforming loan limits that Fannie Mae has established.

Fannie Mae's funds are raised through:

- Issuing common stock;
- The sale of notes and debts;
- Fees charged to lenders.

Fannie Mae's purpose is to:

- Keep funds flowing into the mortgage market by providing mortgage liquidity to lending institutions;
- Aid distressed homeowners by preventing foreclosures and limiting losses where possible;
- Strengthen lending standards to encourage sustainable lending by emphasizing long-term, fixed-rate mortgages to protect homeowners from fluctuating interest rates that may be harmful to them.

Fannie Mae's 2010 Mission Report states that the company provides liquidity, stability and affordability to the US mortgage finance market by facilitating:

- Refinancing of homeowners' existing mortgages into more sustainable loans;
- Enabling borrowers to purchase homes;
- Assisting homeowners in avoiding foreclosure;
- Supporting the rental market through financing multifamily units making these properties affordable for families earning at or below their area's median income;
- Strengthening communities by preventing foreclosures and homelessness.

FREDDIE MAC-The Federal Home Loan Mortgage Corp-FHLMC

Works with Conventional loans.

The **Federal Home Loan Mortgage Corp**, aka **FHLMC** or most commonly called **Freddie Mac**, and sometimes referred to as Fannie Mae's "Little Brother", was chartered by Congress in 1970 in order to keep funds flowing into the mortgage market by providing mortgage liquidity to lending institutions in order to support home ownership and the rental market for middle income Americans. Freddie Mac was created to help the savings and loan associations/thrifts to distribute their loans into the Secondary Mortgage Market. Freddie Mac purchases, guarantees and securitizes mortgages by forming mortgage-backed securities that it issues.

Freddie Mac states that when it was created in 1970, its purpose was to:

- Make sure that financial institutions have mortgage money to lend;
- Make it easier for consumers to afford a decent house or apartment;
- Stabilize residential mortgage markets in times of financial crisis.

Freddie Mac was **not** created to work directly with consumer borrowers, but with the banks and lending institutions that provide mortgages to borrowers, its purpose being to make certain that the

lending institutions and banks in the primary mortgage market have funds available to lend to credit-worthy borrowers.

Like Fannie Mae, Freddie Mac also began as a "government-sponsored enterprise" (GSE). Since September 6, 2008, Freddie Mac has been in "conservatorship" conducting business under the direction of the Federal Housing Finance Agency (FHFA). Fannie Mae is receiving federal support or to help them stay afloat during the economic recovery in order to:

- Support the single family home market;
- Support the multifamily home market;
- Stabilize neighborhoods by working to prevent foreclosures.

If a homeowner stops paying the mortgage Freddie Mac takes over to pay the securities investors who have purchased the loans, thereby managing the credit risk. When Freddie Mac funds a loan, it collects what is called a "credit guarantee fee" from the lender who is selling the loan to Freddie Mac. This fee serves to protect Freddie Mac from loss should the homeowner default on the loan and Freddie Mac needs to make up the loss to the investor.

To further serve and aid the consumer, Freddie Mac:

- Conducts foreclosure prevention workshops;
- Offers free telephone consultation service to help homeowners who are in trouble financially;
- Helps homeowners through the process;
- Give homeowners steps to keep their homes from foreclosure.

Freddie Mac also sponsors a program that allows Freddie Mac to rent the home back to the owner in order to help struggling homeowners to avoid foreclosure and to stay in their homes.

During their conservatorship, Freddie Mac has done and continues to:

- Provide mortgage funding and liquidity to the primary market;
- Insist on responsible lending by putting borrowers into homes they can actually afford and keep for the long term;
- Strengthen credit standards on new, single-family loans;
- Keep people in their homes as long as possible;
- Help homeowners to avoid foreclosure by managing delinquencies;
- Provide financing for rental housing so that the rental market is liquid, affordable and available;
- Stabilize neighborhoods through foreclosure prevention programs;
- Contribute to lower mortgage rates for the 30-year fixed conforming mortgage;
- Provide a reliable, steady purchaser for the mortgages that lenders originate, regardless of what private capital does.

GINNIE MAE-The Government National Mortgage Association-GNMA

Works with Special Assistance loans.

The **Government National Mortgage Association**, aka **GNMA** or most commonly called **Ginnie Mae**, operates within the Department of Housing and Urban Development (HUD). Created in 1968, Ginnie Mae has always been a government-owned agency. Ginnie Mae neither purchases nor sells loans, nor does it issue mortgage-backed securities. It guarantees/insures investment securities

emanating from private banks, mortgage companies, savings and loan associations, etc. backed by pools of VA guaranteed and FHA insured mortgage loans.

Ginnie Mae issues a "pass-through certificate" that is a security interest in a pool of mortgages. This residential mortgage pool is made up of a group of mortgages that have similar terms and interest rates that were originated by private lenders which would include private banks, savings and loans, etc. Ginnie Mae approves the pool and places it into a trust, from which the pool is sold to investors. The funds that Ginnie Mae receives from the sale of the pools of mortgages is then used to make additional credit available for VA guaranteed and FHA insured mortgage loans, particularly aiding lower and moderate-income households to obtain affordable housing more easily.

Ginnie Mae guarantees those pass-through certificates, thereby guaranteeing that the holder of the pass-through certificate receives a timely, monthly "pass-through" of payments of principal and interest. This process allows the approved lenders to receive a better price for their loans when they sell the loans into the secondary mortgage market, which in turn ensures liquidity for the FHA insured and VA guaranteed loans, making investor capital available to issue more of these loans. This allows a lower cost to home mortgage borrowers and also to renters.

Lesson One Review Quiz

- T F** 1. The mortgage broker and the mortgage banker have access to banks, investors and lenders and are therefore able to "shop" for the best loan program and the best rates for the borrower.
- T F** 2. A major difference between a mortgage broker and a mortgage banker is that the mortgage broker does not fund the mortgage while a mortgage banker may use its own funds to close the mortgage in its own name.
- T F** 3. A company that originates mortgage loans and holds its own loans instead of selling them to another institution in the secondary market is called a "Portfolio Lender".
- T F** 4. The Primary Mortgage Market originates mortgage loans and makes money for mortgage loans available directly to the borrowers.
- T F** 5. It is in the Secondary Mortgage Market that mortgage loans and the rights to service those loans are bought and sold after the mortgages have been funded; that is after the transaction has closed.
- T F** 6. Fannie Mae and Freddie Mac originate loans directly to borrowers.

Answers

1. T
2. T
3. T
4. T
5. T
6. F

LOAN ORIGATION, LOAN ORIGATION FEES, DISCOUNT POINTS AND PREPAYMENT PENALTY

Loan Origination refers to the processing of a borrower's mortgage application. When a mortgage lender creates a mortgage, that mortgage is secured by the mortgagor's (borrower's/buyer's) real property. The process of securing that mortgage via the real property is called **Origination** or **Loan Origination**. All purchasers of real property must go through an origination process in order to secure the mortgage for that real property and to legally bind together the parties involved in the mortgage transaction.

In the loan origination, the borrower may be paying "points". There are 2 types of mortgage points: **Origination Points and Discount Points**.

Origination Points:

- Are charged by the lender to pay the cost of originating or processing a new loan;
- May include third-party costs of appraisal, notary public, attorney fees, inspection fees, credit report and the like;
- May be negotiable.

Discount Points:

- Are interest that is pre-paid in order to lower or "buy down" the rate of interest being charged on the loan;
- Are **optional** on the part of the borrower.

Most lenders charge a loan origination fee in order to pay the expenses which they incur in issuing the loan. These expenses include:

- The loan officer's salary or commission;
- The cost of doing the paperwork involved with the mortgage loan (paying people to process the paperwork);
- Any other costs incurred by the lender in order to originate the loan.

The origination process defines the terms of the mortgage agreement: the amount of the loan and interest rate of the loan.

Origination Points (Sometimes Referred To As Mortgage Points)

The fee that the borrower pays to the lender or to the loan officer for originating the loan is the **Origination Fee** or the **Origination Points**. The loan origination fee is paid to the loan officer or mortgage broker who initiates (originates) the loan for the borrower. The origination fee is paid to the lender to cover the lender's expenses in processing the loan once the loan is funded. This is an up-front fee that the lender charges for processing a new loan application. This payment does **not** go toward pre-paid interest.

The lender charges these fees in order to pay for a variety of services, such as:

- Processing;
- Document preparation;
- Copying documents;
- Underwriting.

Third-party fees might also be included in the origination fees. Depending on the norm in the market area, these third-party fees might include:

- Appraisal costs;
- Notary fees;
- Attorney fees;
- Inspection fees;
- The cost of pulling credit reports.

Generally, the lender earns fees from origination points, from origination fees or from both. The loan origination fee is paid to the mortgage broker or mortgage banker who initiates and completes the loan transaction for the borrower and then to the loan originator. The funds are paid to the loan officer who is employed by that lender after the loan is funded or closed.

The loan officer never receives direct payment from the borrower. The employing lender receives the fees and then pays the loan officer in accordance with the employment agreement that they have between them, much as a real estate agent is paid by his/her employing broker. This fee is the loan officer's/loan originator's commission payment for having completed the loan transaction. Origination fees are **not** discount fees and do **not** lower the rate of interest on the loan.

The lender is also considering the number of points being charged on the loan in regards to the loan's ease of sale into the secondary market. Since the originating lender may have to sell the loan at a discount in order to compensate whoever purchases the loan in the secondary market, the lender may make up some of that loss of revenue through the origination fees/points charged to the borrower. Because of a competitive market within the mortgage field, as an incentive, some lenders will offer loans with no origination fees.

Since loan origination fees increase the lender's yield on the loan, the government requires that they be included in the annual percentage rate (APR) of Regulation Z. (Discussed later.)

The loan origination points are calculated as a percentage of the loan amount (the principal). A common amount to pay on an origination fee is 1% of the loan amount, but it can be more than that. This cost is paid at closing/settlement and may be paid by the borrower or by the seller if the parties agree that the seller will pay the points.

For example:

Considering paying only toward the principal, if the loan amount is \$100,000 and the origination fee is 1%, the cost to the borrower is \$1000. ($\$100,000 \times 1\% = \1000 .) If the origination fee on a \$100,000 loan is 5%, the cost to the borrower is \$5000. ($\$100,000 \times 5\% = \5000 .) If the mortgage amount is \$150,000 and the bank or lender is charging 1.5% of the mortgage amount that would be 1.5 origination points or \$2250. ($\$150,000 \times 1.5\% = \2250 .)

The actual amount the borrower will pay is based upon the borrower's credit history as well as other factors, such as:

- Credit score;
- Loan to value ratio;
- Type of property being purchased (single family, condominium, 2-4 unit home);
- Owner occupancy (owner-occupied, second home, investment property);
- Amount of the loan.

The amount of the origination fee is negotiable, although banks are not usually as flexible in negotiating their fees as a mortgage broker or mortgage banker might be. Whether a mortgage broker, mortgage banker or a bank charges loan origination fees is dependent on the terms of the loan. If the loan is a true "no-cost" loan, the origination fees may be waived as they would be an "out-of-pocket" expense for the borrower. Whether the loan has origination fees or not, all fees must be disclosed on the Good Faith Estimate and the Uniform Settlement Statement (HUD-1).

Lenders are required to prepare a Good Faith Estimate (GFE) for the borrower to review before the loan is committed to and before the loan is closed. This is essentially a summary of the loan and a good estimate of the charges the buyer will incur when the transaction is closed and the loan is funded. This GFE provides an itemized list of all of the fees the borrower will be expected to pay. According to the Real Estate Settlement Procedures Act (RESPA), the Uniform Settlement Statement (HUD-1) must itemize all of the charges that the borrower will be required to pay.

The lender is required to provide certain documents to the borrower at the time of the loan application or within 3 days of the application:

- The HUD booklet that appraises the borrower of the closing costs;
- A line-by-line description of the Uniform Settlement Statement (HUD-1).

The Truth In Lending Act, the purpose of which is to inform borrowers of the true cost of borrowing, requires through **Regulation Z**, that in any transaction where a loan is secured by a residence, the borrower must be completely informed of the true interest rate for the loan and all finance charges including:

- Finder's fees;
- Service charges;
- Loan fees;
- Points on the loan;
- Interest;
- Annual Percentage Rate-APR (Rate of interest plus **all** costs associated with processing the loan).

Whether origination points are or are not tax deductible depends on the way the lender presents them. According to the IRS, if the closing documents include the origination points lumped into a single summary charge instead of the origination points being itemized on the settlement statement, they are **not** tax deductible. If the closing documents identify the origination fees separately on the settlement statement as a part of an increased cost of purchasing the property and thereby reducing the profitability of capital gains when the purchaser sells the property, they can be tax deductible. It is advisable for the purchaser to consult a tax attorney or a financial advisor.

Points may be tax-deductible; however, fees typically are not tax-deductible.

Discount Points

Discount points are used to enable the borrower to obtain a lower rate of interest. Discount points are interest that is paid up front on the loan. In this way, the monthly payment on the loan is reduced, although the principal amount of the loan being issued remains the same. Discount points can be paid by the purchaser/borrower or by the seller, whether the seller is a private individual, a builder or a developer.

Discount points, like origination fees/points, are expressed as a percentage of the loan/mortgage amount. The interest rate reduction the borrower will receive as a result of paying discount points will fluctuate with market conditions. The borrower will know the value of the discount point once the rate is about to be locked in. A discount point is pre-paid interest on the loan that is collected at the closing/settlement.

For example:

Because the discount point rate fluctuates with market variations, let us assume for this example that for each discount point paid the rate of interest is reduced by 0.125% or 1/8 of a percentage point.

If the lender were issuing a loan of \$100,000 at 5% interest and the borrower chose to pay 2 discount points in order to reduce or "buy down" the interest rate, the interest rate would drop from 5% to 4.75%. (1 discount point = 1/8 or .0125 of a percentage point. 2 discount points = 1/4 or .25 of a percentage point. 5% - .25% = 4.75%)

With a \$100,000 loan at 6% with the buyer paying 2 discount points, the rate of interest is now reduced by 0.25% or 1/4 of a percentage point. The interest rate will be reduced from 6% to 5.75%. Taking a 30-year fixed rate mortgage of \$100,000 at 6% interest results in a monthly payment of \$599.55. Whereas, at a rate of interest of 5.75%, this same loan amount would result in a monthly payment of \$583.57. The lower monthly payment for the life of the loan (30 years) would amount to the borrower having paid approximately \$9,000 less for the loan.

A "buydown" reduces the monthly payment amount that is paid by the purchaser. This reduction may be for a set number of years or for the entire length of the loan. Typically, the buydown is 1% to 2% or 1 to 2 points of the loan and applies to the first one or two years of the loan, after which the interest rate will go up. A borrower who wanted to have a permanent buydown would pay more interest or points up-front. A borrower can pay up to 3 to 4 points on the loan according to how much he/she would like to reduce the mortgage rate.

For example:

A "2/1 Buydown" would be for a reduction of the interest rate for the first two years of the loan. A "3/2/1 Buydown" for a loan that is at 9% might have a bought down interest rate of 6% for the first year of the loan, an interest rate of 7% for the second year of the loan and an interest rate of 8% for the third year of the loan. At the end of the first 3 years the rate would return to 9%, the original interest rate that was bought down.

Since a buyer may not readily have on hand the amount of cash needed to pay the discount points, a buyer may choose to finance paying the discount point(s), thereby rolling the point payment into the mortgage itself. With such a situation, the amount of money saved by buying down the interest rate may not be significant enough to warrant financing it into the mortgage. Borrowers should always discuss their options with a licensed mortgage broker or banker and/or a personal financial counselor prior to going forward with a financed buy down.

Discount points can be paid by a builder, a developer or by a private seller in order to assist the buyer in purchasing the property or to assist the purchaser in purchasing at a higher purchase price than the buyer otherwise would qualify for.

For example:

John and Janis are getting ready to purchase a new home. If they secure a rate of interest of 5%, they qualify for a loan amount of \$200,000 with a monthly payment, on the principal only, of \$1073.64. But if they can secure a rate of interest of 4%, they qualify for a loan of \$225,000 with a monthly payment, on the principal only, of \$1074.18. Consequently, with the lower rate of interest they can borrow a greater amount of money and pay essentially the same monthly payment. Since the lower rate of interest affords them a higher loan amount, they can purchase a more expensive home without going beyond the monthly payment that they can afford. They have greater buying power with the lower rate of interest.

Remember that the 2 main advantages for a borrower to buy down the interest rate are:

- The borrower's monthly payment on the loan will be lower than without paying the discount points;
- With the lower rate of interest, the borrower will be able to borrow a larger amount of money for the same monthly payment that would be on a smaller loan with a higher rate of interest.

Payment Of Origination Fees Compared To Payment Of Discount Points

It is beneficial for a borrower to compare the offers that different lenders make. Some might offer no origination fees but the borrower must pay discount points to secure a certain rate of interest. Some might charge origination fees but give the same rate of interest to the borrower without the borrower paying discount points.

Let us assume for this scenario that 1 discount point is equal to 1% of the loan amount. Two lenders are each offering the same rate of interest. One of those lenders is offering zero (0) origination points to secure that rate, but the borrower must pay 1 discount point or 1% of the loan up front in order to secure that rate of interest. The other lender is charging the same rate of interest with no discount points, but is charging the borrower 1.5 origination points or 1.5% of the loan amount to originate the loan. The lender who is charging no origination fees, but is charging 1 discount point might be a better choice in the long run than the lender who is charging that same rate of interest with no discount points, but who is charging 1.5 origination points or 1.5% of the loan as an origination fee.

For example:

Lender A is offering a loan of \$100,000 at 7% interest with the buyer paying 1 discount point to secure the loan at 7%, but charging no origination fees. That borrower will pay \$1000 to secure that loan of \$100,000 at 7% interest. ($\$100,000 \times 1\% = \1000 .)

Lender B is offering a loan of \$100,000 at 7% interest with no discount points to secure that rate of interest. However, Lender B is charging 1.5 or 1.5% of the loan

as origination fees. The borrower will pay \$1500 to secure that same loan of \$100,000 at 7% interest. ($\$100,000 \times 1.5\% = \$1500.$)

In this scenario, Lender A is the better choice enabling the borrower to secure the loan at a lower actual cost than the borrower would pay for the same loan with Lender B.

While saving costs is always a good thing for the borrower, service and reliability are also very important. When considering which loan and which lender to select for the loan, the borrower should consider the lender's:

- Interest rate;
- Origination points;
- Possible discount points;
- Experience;
- Ability to explain various loan options;
- Ability to close the loan.

Generally, discount points are tax deductible only when the borrower itemizes his/her deductions during the tax return year in which the discount points were paid. Always seek the advice of a tax attorney or financial planner.

Below is a sample of the differences between 30-year fixed loans varying according to discount points paid and interest rates. Assume for this chart that the loan amount is the same for all loans listed and simply compare how they vary according to rates, points and monthly payments.

Loan	Rate	Points	Fees	Monthly Payment
30 Yr. Fixed	3.375%	1.625	\$1500	\$1,105
30 Yr. Fixed	3.500%	0.875	\$1500	\$1,123
30 Yr. Fixed	3.625%	0.5	\$1500	\$1,140
30 Yr. Fixed	3.750%	0	\$1500	\$1,158

THE LOAN PROCESS BEGINS

The Initial Informational Conversation Between Loan Officer And Borrower

The loan process begins with a conversation between the loan officer and the potential borrower in order for the loan officer/loan originator to:

- Define the borrower's needs;
- Assess the borrower's capability to purchase;
- Determine what amount the borrower can afford to spend on the purchase of a property.

Since it is also a part of the loan officer's duties to help the borrower find the right loan for him/her, this initial conversation helps to find this direction.

The loan officer's purpose is to guide the client through the loan process by:

- Obtaining the borrower's information;
- Completing a loan application;
- Explaining the different types of loans;
- Assisting the client/borrower in selecting the most appropriate type of loan for the client's needs;
- Offering guidance to a borrower who may have difficulties in qualifying for a traditional loan.

Pre-Qualification

Pre-Qualification is a first step in the mortgage process and is a relatively informal process. A potential borrower might meet in person with the loan officer or they might simply talk on the telephone. In a pre-qualification, the borrower only **verbally** provides the loan officer with information concerning his/her assets and liabilities, income and debt in order that the loan officer may ascertain how much the borrower can afford to purchase, as well as to ascertain the borrower's viability in receiving a loan.

With this information, which is **not** verified at this time, the loan officer can estimate how much money the purchaser can borrow and at what rate of interest that can be done. A credit report is not "pulled" and the loan officer's estimates are based solely on what the borrower has said. There should be no fee associated with this service and a pre-qualification is in no way a commitment for a loan. It is simply informational between loan officer and client and allows the buyer to have an idea of his/her financial capabilities.

A pre-qualification serves to let the borrower know the purchase limits and also allows the real estate agent to know the correct price range in which to look for suitable properties. Further, it can signify the potential buyer's seriousness in the purchasing process. It does **not**, however, carry purchasing credibility. A pre-qualification may not give to the seller or to the seller's agent's a sense of credibility in terms of the borrower ultimately securing a loan. It simply places the borrower in a purchase price range, determining what he/she would "likely" qualify for in a mortgage.

At most, a pre-qualification is valuable in that it gives the borrower's real estate agent an indication that the buyer is serious enough in the purchasing process to seek out a lender and it allows both the borrower and the real estate agent to search for properties within realistic price ranges that the borrower can afford to purchase.

Pre-Approval

A **Pre-Approval** is more formal than a pre-qualification. In this process, the lender/loan officer usually, but not always, runs a credit report on the potential borrower to get an idea of the debt level and debt service reliability of the applicant. The loan officer usually verifies the borrower's employment and then issues a letter of pre-approval. Although this is not a commitment to a loan, it gives the purchaser strength in making an offer on a property as the buyer can say that there is a mortgage company ready to give him/her a mortgage and all he/she needs to do is submit the application and the contract on the chosen property.

The pre-approval is a written, conditional commitment from a mortgage lender or from a bank stating that the borrower is pre-approved by them for the financing sited in the approval.

While pre-approvals are usually given **after** the borrower has minimally had a credit report run and may also have completed a loan application, verified income, assets and employment, many mortgage companies will issue a "pre-approval" letter without having done any verification of the borrower's information. So it is important when reading a pre-approval letter or statement to note what qualifications to this approval a loan officer has stated. If the loan officer has not even pulled a credit report or verified the borrower's employment, a pre-approval is no more reliable than a pre-qualification. (For the purposes of this discussion, we will assume that the loan officer has at least run a credit report on the purchaser in order to verify his/her credit worthiness.)

Once the application is complete, the loan officer analyzes and verifies the information that the client/borrower has supplied. This includes the credit history taken from a credit report and nowadays uses underwriting software to determine the borrower's eligibility for a loan.

TO RECAP:

Pre-qualification:

- Usually the initial step in securing a loan;
- Not as much credibility as a pre-approval;
- Is given based on the borrower's "stated", but not verified, employment, income, assets, and debts;
- Generally does not include a credit report being run;
- Gives no purchasing credibility;
- Does not state that the bank or mortgage lender is ready to originate a loan for the borrower

Pre-approval:

- Usually, is given on the verified information about the borrower's income, assets, debts and employment;
- Usually, a credit report has been pulled to verify the borrower's credit history;
- The borrower may have completed a loan application with the lender who is issuing the pre-approval;
- Is a written, conditional commitment that the lender is making to the borrower that the lender is ready to issue a mortgage loan as long as the conditions of the commitment are met by the borrower.

THE CREDIT REPORT AND CREDIT SCORE

THE CREDIT REPORT

A Credit Report is the credit history of an individual. It shows the person's history of borrowing and repaying credit card companies, banks, lenders, etc. The lender uses a credit report to determine if a potential borrower is credit-worthy and reliable. While the FICO score is a significant factor in securing a loan and in determining the interest rate of that loan, in assessing a borrower's credit worthiness, a lender looks at many other factors about the borrower, such as:

- Work history;
- Current job;
- Income;
- Overall debt ratio;
- The type of loan for which the borrower is applying.

The credit report shows:

- The applicant's current and previous addresses;
- The applicant's social security number;
- Employment history;
- Credit history including:
 - The quantity of accounts the borrower has;
 - The types of accounts the borrower has;
 - If these accounts are current or past due;
- Details of the accounts;
- Types of inquiries and the number of inquiries that have been on the applicant's credit report;
- Whether any accounts have been turned over to a collection agency;
- If the applicant has had wages garnished, liens, etc.;
- Judgments against the person, such as bankruptcy or foreclosure.

The credit report includes 3 credit scores or FICO scores from 3 different credit-reporting agencies:

- Experian;
- Equifax;
- TransUnion.

FICO stands for the name of the software used in scoring which was developed by Fair Isaac and Company. The FICO score is computed using an algorithm developed by this company.

The credit reports must be issued by professional consumer-reporting agencies and generally show a history of up to 7 years. (Accurate, negative information can generally remain on a credit report for 7 years from the date that the negative event took place. A negative event might be a delinquent account turned over to a collection agency.) Each of the scores is based on the information that each credit bureau maintains about the purchaser and his/her credit history. A change in this information creates a change in the credit score.

For example:

A borrower is paying off a loan. In March he missed a payment, but in April he made up the missed payment and the currently owed payment. However, in June he missed another payment but once again, made it up by paying the June and July payments in July. Come August he missed the payment again and before he could make up the missed payment, the lender turned his account over to a collection agency. The Fair Credit Reporting Act (FCRA) allows that each late or missed payment may be reported for a total of 7 years.

A good credit score/FICO score is very important when a borrower applies for a loan as lenders use this score to determine whether or not they consider this borrower/applicant credit-worthy, worthy of receiving a loan as well as determining what rate of interest they will charge the borrower.

The data used to determine a FICO score are:

- The borrower's **payment history** (accounting for approximately 35% of the score);
- The **amount of money the borrower already owes** to various creditors (accounting for approximately 30% of the score);

- The **length of time** the borrower has had a credit history (accounting for approximately 15% of the score);
- Any **new credit** which the borrower has received (accounting for approximately 10% of the score);
- The **types of credit** that the borrower has used (accounting for approximately 10% of the score).

The FICO score considers all of the categories/data used and does not base the score determination on any one piece of information, nor on any one factor without weighing all of the others. The percentages used are based on a consideration of evaluating the general population and may differ according to a particular person or group being evaluated. A particular factor might weigh more heavily for one individual borrower than for another borrower whose credit history is different. For example, if a borrower has not had a long credit history, the length of time or the payment history might not weigh as heavily in his evaluation as in the evaluation of a borrower with a long history of credit.

The Data Used

Payment History:

The borrower's payment history is used to show:

- The account payment information on the borrower's:
 - Credit cards;
 - Retail store credit accounts;
 - Loans being paid through installment plans;
 - Mortgages and the like.
- If there is any detrimental information about the borrower in the public record, such as:
 - A bankruptcy;
 - A judgment lien;
 - Lawsuits;
 - Mechanic's liens;
 - Wage attachments;
 - Filings with collection agencies for past due accounts, delinquencies and the like;
- If the borrower's history shows delinquencies; then the lender will pay attention to:
 - How long the account is past due;
 - The amount of money that is delinquent.
- How recent in the borrower's history have there been any:
 - Past due accounts;
 - Delinquencies;
 - Issues of adverse or derogatory public record which might be:
 - An account with a history of late payments that is turned over to a collection agency;
 - An account that was closed by the creditor and not by the borrower;
 - An issue that required the borrower to appear in court.
- How many past due accounts are on file;
- How many accounts have been paid within the agreed upon time.

Late payments will lower the borrower's credit score, but a borrower who has re-established a good history of paying on time or who is currently in the process of re-establishing a good history of paying on time, will raise his/her FICO score.

The Amount Of Money The Borrower Already Owes:

This is used to show:

- The outstanding amounts still owed on the existing accounts;
- How many accounts have outstanding balances;
- Whether there is currently no balance on the account or a zero (0) balance, showing that the borrower does not owe anything on that account;
- How much of the borrower's **available** credit is currently being used;
- What proportion of the balance of the installment amounts is still due in reference to the original amount of the money financed;
- How long it will be before an outstanding balance will be paid in full at the current installment payment frequency.

The Length Of Time The Borrower Has Had A Credit History

Sorted by specific account types, this shows:

- The amount of time that has passed since the account was opened or how old the account is;
- How long specific account types have been open;
- How long it has been since an account was used.

FICO evaluates the borrower's credit history in 3 ways:

- How old is the borrower's oldest account?
- How old is the borrower's newest account?
- What is the average age of all of the borrower's accounts?

Generally, In order to generate a FICO score, a borrower should have at least one credit account that has been open for a **minimum** of 6 months. There must be at least one "undisputed" account open for the last 6 months in order to generate the FICO score. An undisputed account would be one that had no negative issues and was reported to a credit-reporting agency such as Experian, Equifax and TransUnion. This requirement can be met by having only one account or by having several accounts. The significant factor is that there must be a minimum of one account that has been open at least 6 months to have the FICO score generated. This is subject to lender guidelines. Some lenders may require 2 "tradelines" or lines of credit open for at least 12 months. A tradeline could be a car loan, a credit card, a mortgage, etc.

For example:

If a borrower had opened his/her first credit card account only 2 months prior to applying for the mortgage loan, a FICO score would not generate because the account was too new. The borrower would not yet have "established credit" and there would be no way for the credit-reporting agencies to evaluate the borrower's credit report or credit worthiness until the account had been open for a minimum of 6 months.

A **closed** account will still appear on a credit report and be counted in the FICO score. Even an account that had been closed for 3 years would appear on the credit report. This **could** help in the scoring process by lengthening the amount of time of the borrower's credit history. (It could make a difference to the person reviewing the credit if the borrower chose to close the account or if the company holding the account closed it.) A closed account that was consistently paid on time will remain on the credit report for 10 years from the date that it was closed or from the last date at which the account was updated. Accounts that were not consistently paid on time or were delinquent in

payments will remain on the credit report for 7 years from the date that the first delinquency was recorded.

A borrower who has not used any form of credit in more than 10 years might not generate a FICO score when the credit report is pulled. This is not "bad" credit, it is "no" credit.

If a borrower is considering closing an existing account, he/she should consider the length of time that account has been open and how closing that account might affect his/her FICO score. Removing a long-standing credit account could reduce the FICO score's "snapshot" of the borrower's credit history at the time the credit report is pulled.

For example:

A borrower has had Credit Card A for 15 years and has had Credit Card B for 2 years with no other credit cards or currently outstanding loans. When FICO looks at this borrower's credit history, it will pull up a 15-year history of credit. If the borrower cancels Credit Card A of 15 years and only maintains Credit Card B of 5 years, when Credit Card A is removed from the credit report, for 7 to 10 years the credit history for the borrower will be significantly reduced. The borrower's credit history will have been reduced by 15 years, which may impact the credit score that the borrower receives. This is why borrowers are advised to leave the older credit cards open even if they choose not to use them.

Additionally, closing credit accounts can also impact the ratio between the borrower's credit limit and the borrower's available credit, which might lessen the FICO score. If the borrower has a lot of credit available, but owes very little, it can look good for the borrower. If a borrower chooses to close any accounts, he/she should close the account in good standing which has the highest interest rate and has been open for the shortest amount of time, thereby maintaining as long a credit history as possible.

A saying in the credit industry is that "The best credit is old credit".

New Credit The Borrower Has Received

This shows:

- How many, if any, new accounts have been recently opened;
- If new accounts have been recently opened, what types of accounts they are and the proportion of that type of account within the credit profile;
- Sorted by account type, how long recent accounts have been opened;
- How long has it been since the last inquiry into the borrower's credit history and profile;
- If there were any delinquency problems in the past, did the buyer re-establish a positive credit history.

The Types Of Credit The Borrower Has Used

This shows:

- The number of and the various types of accounts the borrower has used:
 - Credit cards;
 - Retail store credit cards;
 - Mortgage(s);
 - Installment loans, etc.

THE CREDIT SCORE

Credit Scores Are Generally Classified In Levels As Follows:

720 or higher
680-720
660-680
640-660
620-639

A credit score of 720 or above is considered very good and will usually mean that the lender will offer this borrower a lower possible interest rate than a rate offered to a borrower with a lower credit score. The lower the credit score, the less reliable the borrower is considered in terms of meeting his/her debt payment requirements. A borrower with a credit score of 660 to 620 will usually have difficulty securing financing and if he/she does secure financing, will most likely be required to pay a higher rate of interest to offset the risk that the lender is taking in issuing the loan.

As an example, here is a list of how a lender **might** offer different rates of interest for the same loan amount to a borrower depending on the borrower's FICO score:

FICO Score	APR
760-850	3.749%
700-759	3.989%
680-699	4.172%
660-679	4.391%
640-659	4.830%
620-639	5.390%

Remember, generally, a score above 720 is likely to receive a lesser rate of interest than a score between 660 and 720. However, a score below 660 is likely to have a higher rate of interest in order to compensate for the lender's feeling of greater risk with a lower credit score.

For example:

A borrower who has a credit score of 675 and is putting down 20% of the purchase price for a loan-to-value ratio of 80% is likely to receive a higher interest rate on his/her loan than a borrower who has a credit score of 740 and is putting down 30% of the purchase price for a loan-to-value ratio of 70%. In this scenario, even if both of these borrowers went into foreclosure, the bank would be safer and absorb less risk with the second borrower. Therefore, the bank is likely to give the second, less risky borrower, a lower rate of interest.

The interest rate that a lender might offer will also be based on the loan amount. A conforming loan (a loan under \$417,000) will be less costly because it will be easier for the lender to sell it into the secondary market.

In Addition To The Credit Score

The lender will consider other factors in determining the borrower's overall standing as a credit risk. These might include:

- The amount of the loan being applied for;

- The type of "documentation" being done for this loan:
 - Full;
 - Limited, currently only available with a private, portfolio lender:
 - Stated Income/Verified Asset;
 - Stated Income/Stated Asset.
- The borrower's debt-to-income ratio;
- The type of property being purchased;
- If the borrower will occupy the property (owner occupant or investor);
- The purpose of the loan (new purchase, refinance, investment);
- The loan-to-value ratio.

The Amount Of The Loan Being Applied For

The lender will consider if the loan is:

- A conforming loan and easily sold into the secondary mortgage market;
- A jumbo loan and not easily sold into the secondary mortgage market;
- Being held in the lender's own portfolio.

The Borrower's Debt-To-Income Ratio

The lender divides the borrower's **total monthly required** payouts by the borrower's **gross** monthly income in order to determine the percentage of a borrower's income that goes toward debt and then determines for how much of a mortgage loan the borrower qualifies. Although the allowable debt-to-income ratio can vary from lender to lender, it is usually within the range of 36% to 50% depending on the type of lender and the type of loan being sought. This is usually referred to as the "**back- end**" **ratio**.

The lender will look at and assess not only the total debt-to-income ratio, but also the **ratio of housing debt-to-income** that would be incurred in the property purchase. This is usually referred to as the "**front- end**" **ratio**.

For example a borrower has:

Monthly income:	\$10,000
Monthly housing expenses incurred with the purchase:	\$ 2,000
Total monthly liabilities or payable debts:	\$ 3,500

This borrower would have a front-end debt-to-income ratio of 20%

$$\mathbf{\$2000 \div \$10,000 = 20\%}$$

and a back-end debt-to-income ratio of 35%.

$$\mathbf{\$3500 \div \$10,000 = 35\%}$$

In assessing the borrower's overall debt, installment loans that have fewer than 10 payments remaining, such as a car loan, can be excluded from the debt. The only way to have a credit card debt excluded would be to pay the complete amount of the balance owed and to close the account.

The Type Of Property Being Purchased:

Default rates for investment properties, second homes, 2-4 unit properties, condominiums or for borrowers with low credit scores are higher than defaults on a standard, single-family, owner-

occupied property. Therefore, lenders will typically charge higher rates of interest, higher fees for issuing the loan, a higher down payment and administer other lending restrictions. This "risk-based pricing" is because the lender needs to charge more because of the increased risk the lender is taking.

THE LOAN OFFICER AND THE BORROWER COMPILE THE INITIAL INFORMATION: INCOME, ASSETS, LIABILITIES, RUN CREDIT REPORT

Full Documentation

In order to move forward in the loan process, the loan officer needs to verify the borrower's information. The list below is what must be assembled and verified for a **full documentation** loan in order for the application to be processed:

- Most recent 1-month's pay stub-Pay stubs cannot be more than 1-month old at the time the borrower submits the application.
If the borrower is paid: **Need to submit:**
Every week-----Last 4 pay stubs
Every 2 weeks-----Last 3 pay stubs
Monthly-----Last pay stub
- The most recent 2 years of the borrower's W-2s(and federal tax returns):
 - The W-2 is received by the borrower from his/her employer every year in order to enable the employee/borrower to compute and file a tax return;
 - A copy of the W-2 must be attached to the tax return when submitting it;
 - If the borrower submitted his/her tax return electronically, a copy of the borrower's W-2 should be in the possession of the borrower's tax preparer.
- The borrower's most recent 2 months of bank and investment statements:
 - Copies of **all** pages of the statements (front and back). Where a borrower does not receive paper statements, the borrower should print out his/her entire online statement;
 - Include all of the accounts held by the borrower-this includes checking, savings, investments, investment portfolios;
 - Accounts should show that the borrower has sufficient funds to cover the down payment as well as several months of mortgage payments;
 - If the borrower's accounts show any large deposits or withdrawals, the borrower must provide a detailed letter explaining why there were these large deposits or withdrawals.
- On every loan, the borrower must complete the IRS Form 4506-T which gives the bank permission to access the borrower's tax return.
- The purchase contract that is signed by the borrower and the seller.
- Earnest money deposit receipt.
- A copy of the borrower's driver's license or a legal identification card, front and back.
- A copy of the borrower's Social Security Card.
- The borrower's addresses for the last 2 years with contact information.

- Divorce decree, if applicable;
- Evidence of alimony or child support, if applicable.
- The 2 most recent years of the borrower's tax returns-All schedules;
- The loan application fee;
- If the borrower is purchasing a condominium, the lender requires Homeowner Association information including:
 - The association's common insurance information;
 - The declaration of condominium, rules and regulations, by-laws, addendums;
 - The condominium's budget;
 - The lender's condominium questionnaire which seeks to determine:
 - The number of units with delinquent assessment payments;
 - If any one person or entity owns more than 10% of the total number of units;
 - The percentage of renters to owners in residence;
 - If the association is in pending litigation;
 - If any special assessments have been approved within the last 2 years;
 - If there is a special assessment, will it be paid at closing.
- Money for appraisal and credit report.
- The borrower's insurance agent's contact information to show that the borrower has purchased insurance against personal liability.

If the borrower is self-employed and/or paid by commission, the lender needs:

- The 2 most recent years of federal tax returns, **signed by the borrower** including all pages and schedules. The lender does not need the state income tax returns.
- If the borrower owns a business, the lender needs the 2 most recent years of the borrower's personal tax returns as well as any business tax returns that the borrower filed on behalf of the company. (i.e. 1120, 1120S, 1065)
- If the borrower filed electronically, he/she may print a copy of the returns from the tax software that was used or request a copy from the borrower's tax preparer.
- The borrower's permission to run a credit report in order to verify the credit rating of the borrower.
- Depending on the borrower's business, the lender may require a Year-To-Date Profit and Loss Statement.

Stated Income Loans

Although Stated Income Loans are **not** readily available, any lender could do a Stated Income Loan and hold it in its own portfolio. Stated income loans may actually be illegal according to some state laws and federal laws. Many state and federal lending laws may impose "ability to repay" requirements on stated income loans.

While a **Full Documentation** loan requires the borrower to verify his/her income with tax returns, pay stubs and asset verification, a **Stated Income** loan allows the borrower to "state" his/her monthly income on the mortgage application **without** any verification of that stated income. That is to say that the borrower furnishes **no** tax returns or pay stubs to substantiate the stated income amount.

With any of the stated income loans, the lender verifies the borrower's employment through contact with the employer or, if the borrower is self-employed, by requiring a letter from a CPA verifying financial capability. The lender is usually conscious of the employment position that the borrower holds and judges the stated income accordingly.

For example:

Should the borrower be a high school math teacher stating that he earns \$30,000 per month, the bank is unlikely to trust this statement. But, should a physician state that she earns \$30,000 per month, the lender is more likely to accept that statement.

If the borrower's stated income does not coordinate well with the position that he/she holds, it is likely that the lender will decline or reject the loan application.

Further, the lender may require the stated-income borrower to submit an IRS Form 4506 authorizing the lender to request an IRS verification of the last 2 years of the borrower's tax returns. So the lender may exercise some method of caution.

The lender will usually charge a higher rate of interest for the borrower's privilege of stating income rather than doing a full documentation loan. This makes the increased amount of risk of default more palatable to the lender and may allow the loan to be sold in the secondary market more easily. Another way in which the lender might reduce the risk is to require a larger down payment and/or require a higher credit score for a stated-income borrower as opposed to a full-documentation borrower.

Lesson Two Review Quiz

- T F** 1. Loan Origination refers to the processing of a borrower's mortgage application.
- T F** 2. Origination Points are charged by the lender to pay the cost of originating or processing a new loan.
- T F** 3. Discount Points are interest that is pre-paid in order to lower or "buy down" the rate of interest being charged on the loan.
- T F** 4. The purpose of the Truth In Lending Act through Regulation Z is to inform borrowers of the true cost of borrowing in any transaction where a loan is secured by a residence.
- T F** 5. Pre-qualification and pre-approval are the same.
- T F** 6. The lender uses a credit report to determine if a potential borrower is credit-worthy and reliable.
- T F** 7. The lender looks at and assesses the total debt-to-income ratio and the ratio of housing debt-to-income that would be incurred in the property purchase.
- T F** 8. . A borrower with a credit score of 660 to 620 is considered a very good credit risk.

Answers

1. T
2. T
3. T
4. T
5. F
6. T
7. T
8. F

THE LOAN OFFICER AND CLIENT RESEARCH AND ASSESS LOAN PROGRAMS & PREPARE TOTAL COST ANALYSIS

Once the loan officer has determined that the borrower is credit worthy, the loan officer will consult with the borrower to determine what type of loan will be most suited to the borrower's needs in terms of many variables. It will be important to assess how long the borrower plans on owning the property, what the down payment will be, etc. A borrower who knows that he/she will not remain in that property for very long needs to assess which loan term might be most suitable for short term ownership.

For example:

Bob, the borrower, is purchasing a new home for in Arizona. He knows that his job is based on the completion of a particular project that will not extend for more than 3 years. Bob knows that his employer will be transferring him to another part of the country in 3 years, and with that circumstance in mind, both Bob and his loan officer do not think that it would be the best idea to get a 30-year fixed mortgage at a higher rate of interest instead of a 3-year ARM or even a 5-year ARM at a lower rate of interest. With that in mind, they would review the financial benefits of different types of loans.

Types Of Loans

Conventional Loans

A **Conventional Loan** is a mortgage that meets the funding terms and conditions of Fannie Mae and Freddie Mac. Currently, about 60% of all mortgages are conventional mortgages. These may be fixed-rate mortgages or adjustable-rate mortgages. Most of the conventional mortgages are packaged into pass-through mortgage-backed securities and then sold into the secondary mortgage market.

Conventional loans are considered by many to be the most secure loans since they usually have a lower loan-to-value ratio. (Loan-to-value ratio is the amount/proportion that the mortgage loan constitutes of the total value of the property being purchased.) The "usual" loan-to-value ratio for a conventional loan is 80% of the value of the property being financed and the borrower is contributing the other 20% of the purchase price in the down payment. However, there are variations on this ratio, and a lender might offer or allow a borrower with a high credit score to put down a smaller down payment.

Because **the government is not involved in a conventional mortgage**, lenders may set their own criteria for evaluating the borrower's credit worthiness and for evaluating the property being used as collateral for the mortgage loan. However, if the lender wishes to sell a mortgage loan into the secondary mortgage market of Freddie Mac or Fannie Mae, the loan must adhere to the guidelines established by those institutions or the lender will most likely retain the loan in its own portfolio.

Conforming Loans

Loans that meet the requirements established by Fannie Mae and Freddie Mac are "**conforming loans**" and may be sold to the secondary mortgage market. Loans that do **not** meet the

requirements of Fannie Mae and Freddie Mac are "**non-conforming loans**". A non-conforming loan may be held in the lender's portfolio.

For 2014, Freddie Mac is maintaining the base conforming loan limits at 2013 levels. Fannie Mae and Freddie Mac will purchase home mortgages with a maximum base conforming loan limit up to the following amounts:

For Properties Located In The Continental United States:

1-unit	\$417,000
2-unit	\$533,850
3-unit	\$645,300
4-unit	\$801,950

For Properties Located In Alaska, Hawaii, Guam & The US Virgin Islands:

1-unit	\$625,500
2-unit	\$800,775
3-unit	\$967,950
4-unit	\$1,202,925

For a borrower to qualify for a conventional loan the Fannie Mae and Freddie Mac guidelines suggest that the borrower's **total monthly expense for housing should not exceed 28% of the borrower's gross monthly income**. This includes the Principal, Interest, Taxes and Insurance, also known as PITI.

The **total monthly debt for the borrower should not exceed 36% of the borrower's gross monthly income**. Total monthly debt includes housing expenses and any regular monthly payments, such as:

- Car payments if more than 10 payments remain;
- Student loan payments;
- Alimony;
- Child support.

While the guidelines may **suggest** 28% for the borrower's total monthly housing expense and 36% of the borrower's total monthly debt, in reality what matters is what happens when a loan is run through the Automated Underwriting Systems (AUS) of Fannie Mae, Freddie Mac and FHA. If the AUS accepts the ratios or eligible findings, the loan will be accepted as good and can be done. Typically in such a circumstance, the back ratio amount or the total debt to income ratio, will usually not exceed 45%, but might go higher for an individual borrower. Conventional loans do allow for higher than 45% in certain cases. FHA may allow ratios higher than 60%. So, in effect, the 28%/36% are guidelines, not absolutes, and can be changed based on a borrower's individual circumstances and what the AUS of Fannie Mae, Freddie Mac and FHA will accept.

Automated underwriting software simplifies the process of evaluating the mortgage because loan officers can evaluate more borrower applicants in a shorter period of time than if the evaluation were done manually. Also, this software makes it easier for lenders to offer their services through the internet.

Private Mortgage Insurance-PMI

When a borrower receives a loan with a down payment lower than 20% of the purchase price, the lender will require the borrower to purchase **Private Mortgage Insurance (PMI)**, which protects or **"insures" the lender against the buyer defaulting on the loan**. Therefore, the lender will feel more secure in accepting the risk of a loan that has a loan-to-value ratio higher than 80%. **Private mortgage insurance can be financed within the loan and is paid as a monthly fee during the period in which the private mortgage insurance is in effect.**

PMI insures the lender for the top 20% (or whatever percentage is not provided to make up to 20%) of the loan, that part of the loan that the borrower was responsible for supplying in order to meet the 80% loan-to-value-ratio. Consequently, when the borrower's equity in the property reaches 20% and as long as the mortgage payments are current, the borrower may request in writing that the lender terminate the PMI.

For example:

If a borrower provided a 5% down payment on a property being purchased for \$200,000, that would bring the LTV to 95% and would require PMI. 15% of the loan needs to be insured in case the borrower defaults. If the borrower defaulted on the loan by discontinuing paying the mortgage payments, the private mortgage insurance company would pay the lender 15% of the loan, which is the portion that is being insured. That would mean that the private mortgage insurer would pay the lender \$30,000 to bring the LTV to 80% of the original purchase price if the borrower defaulted.

\$40,000 is required for the loan-to-value ratio to be 80%.

$$\begin{array}{r} \$200,000 \\ \times \quad 20\% \\ \hline \$40,000. \end{array}$$

The borrower provided 5% or \$10,000, the lender provided \$190,000.

$$\begin{array}{r} \$10,000 \\ + \$190,000 \\ \hline \$200,000 \end{array}$$

The PMI covered the remaining portion, 15%, of the purchase price that the lender ended up funding beyond the 80% LTV.

$$\begin{array}{r} \$200,000 \\ \times \quad 15\% \\ \hline \$30,000. \end{array}$$

$$\begin{array}{r} \$200,000 \\ -10,000\text{-The borrower's down payment} \\ \hline \$190,000 \\ -30,000\text{-The amount insured by the PMI} \\ \hline \$160,000\text{-The amount of principal not insured by PMI.} \end{array}$$

The **Homeowner's Protection Act of 1998** (also known as the PMI Cancellation Act) was signed into law on July 29, 1998 and became effective on July 29, 1999. It applies primarily to residential mortgage transactions taking place **on or after** July 29, 1999 for the purchase of or refinancing of a principal residence.

The Homeowner's Protection Act of 1998 also provides that when the borrower's equity reaches 22% of the original value of the property at the time the loan was issued, the lender is **required** to **automatically** cancel the borrower's PMI, whether the borrower has requested it or not. This law applies to loans that were issued after July 29, 1999 and there is no consideration given for any appreciation or depreciation in the market value of the property since the loan was issued.

The Homeowner's Protection Act of 1998:

- States that a borrower may initiate the cancelation of PMI by submitting a written request for cancelation to the mortgage servicer;
- **Requires** the servicer to cancel the PMI **per the borrower's request** when the cancelation date occurs, which is when the borrower's principal balance reaches 80% of the "original" value of the loan based upon the borrower's actual payments;
- Mandates that for cancelation of PMI, the borrower is required to be current on the mortgage payments;
- Requires that the borrower has not subjected the property to any subordinate liens;
- Does not consider the current outstanding balance of the loan relevant to the cancelation of PMI;
- States that if the borrower has not requested termination of PMI, the servicer is required to **automatically** terminate the PMI on the date that the LTV reaches 78% of the original value of the loan, based on the initial amortization schedule for a fixed rate loan or the current amortization schedule in effect for an ARM;
- States that if the borrower is not current on the date at which the LTV reaches 78% of the original loan, the servicer will terminate the PMI on the 1st day of the month following that date in which the borrower becomes current;
- States that at the time the loan is issued (usually at closing/settlement), the lender must apprise the borrower of:
 - The initial amortization schedule for the mortgage;
 - The borrower's right to request cancelation of PMI;
 - The date that the loan balance will reach an 80% LTV of the original value of the property as shown in the initial amortization schedule;
 - The borrower's right to request cancelation of PMI should the borrower's actual payments bring the LTV to 80% of the original loan prior to the scheduled date;
 - The date, based on the initial amortization schedule, at which the LTV will reach 78% of the original loan and PMI will automatically terminate.

The mortgage servicer must provide a telephone number for borrower's inquiries into canceling the private mortgage insurance. This number should be provided on the borrower's monthly mortgage statement.

If the loan were issued **before** July 29, 1999, the borrower's equity can be evaluated according to appreciation in the market and/or appreciation based upon renovations or improvements that the borrower has made to the property thereby increasing its value. The borrower would most likely present an appraisal to the lender in order to justify and prove the increase in value since the loan was issued.

For example:

Prior to July 29, 1999, a borrower purchased a home for \$200,000 with a 10% down payment and a 90% loan-to-value ratio. After having lived in the home for 3 years, the borrower invested in renovations including a new kitchen, 2 new bathrooms, the addition of a 1st floor family room, a new roof and hardwood floors. An independent appraisal of the property in today's market determined the current market value to be \$275,000, giving the borrower a higher loan-to-value ratio than when the loan was originally issued and thus increasing the borrower's equity in the home to more than 20%. The borrower would be able to request the termination of the private mortgage insurance.

PMI is generally ½% to 1% of the loan amount and varies according to:

- The amount of the loan being issued;
- The terms of the loan being issued;
- The size of the borrower's down payment.

For example:

A borrower is purchasing a home for \$100,000 and is providing a down payment of \$10,000 or 10% of the purchase price for a loan-to-value ratio of 90%. Therefore, the lender is providing a mortgage of \$90,000. $\$90,000 \times .5\%$ (½%) = \$450 per year. The lender will then divide \$450 by 12 months to arrive at the monthly premium to be paid in the mortgage payment. $\$450 \div 12 = \37.50 . So the borrower would pay an additional \$37.50 per month to the lender to provide PMI.

PMI is not based on the credit-worthiness of the borrower, but rather on the size of the mortgage being issued. A borrower with a credit rating of 700 taking out a loan of \$200,000 with a 10% down payment, would pay the same amount of PMI as a borrower with a credit rating of 800 taking out a loan of \$200,000 with a 10% down payment.

To RECAP:

- When the borrower's equity reaches 20% of the property's value, the borrower can request termination of the PMI as long as the mortgage payments are up-to-date.
- When the borrower's equity reaches 22% of the property's value, the lender is **required** to terminate the PMI as long as the mortgage payments are up-to-date.
- For a mortgage loan issued after July 29, 1999, the value of the property will be based on the value of the property at the time that the loan was issued, without consideration of the market's appreciation or depreciation affecting the property's current market value.

PMI is not always tax deductible. Currently, PMI is not tax deductible; that may change again.

Piggyback Loans

In order to avoid paying private mortgage insurance when the borrower has less than a 20% down payment, many lenders will offer a second mortgage, "piggybacking" it on to the first mortgage.

The form of a piggyback loan that is currently available is an "80/10/10 Loan". The lender would issue a first mortgage for 80% of the purchase price and a second mortgage issuer would assume a

subordinate lien for 10% of the purchase price. The borrower would provide 10% of his own funds as the down payment.

With the second mortgage of 10% filling in the missing amount required to meet an 80% LTV, the borrower would avoid PMI payments. This is currently the most common form of a piggyback loan. And currently, the most common subordinate loan in structuring an 80/10/10 would be for the second portion of financed 10% to be in the form of a Home Equity Line Of Credit (HELOC) rather than in a fixed rate loan.

This type of 80/10/10 loan is also helpful for the borrower who wants to limit his/her down payment, but has reached the lending limits for the loan amount for the first mortgage.

For example:

A borrower is purchasing a property for \$100,000. The lender is issuing a 30-year fixed rate 80% LTV first mortgage for \$80,000 at 5% rate of interest, a 10-year fixed second mortgage for \$10,000 at 7.5% rate of interest and the borrower is providing a 10% down payment or \$10,000 bringing the first mortgage's LTV to 80% and eliminating the borrower's need pay PMI.

\$80,000 1st Mortgage
\$10,000 2nd Mortgage
<u>\$10,000 Down Payment</u>
\$100,000 Purchase Price

Jumbo Loans-Non-Conforming Loans

The current Fannie Mae and Freddie Mac limit for a one-unit property is currently \$417,000. A loan that exceeds the conforming loan limits is a **Jumbo Loan** or a **Jumbo Mortgage** and usually carries a higher rate of interest. A jumbo loan would not typically be sold into the secondary mortgage market, but would be sold to outside investors. Therefore, a jumbo loan is not backed by Fannie Mae or by Freddie Mac. There are fewer investors to purchase a jumbo loan and jumbo loans are usually given at a higher rate of interest than a conforming loan.

Currently, since jumbo rates are higher and jumbo qualifying is more stringent than on a conforming loan, a lender might choose to structure a loan that exceeds the Fannie Mae and Freddie Mac limits as a conventional 1st mortgage of \$417,000 with a Home Equity Line Of Credit (HELOC) rather than in a fixed rate loan as the subordinate loan.

FHA-Insured Loans

The **Federal Housing Administration (FHA)**, does not issue loans, make loans or fund loans. It **insures** loans. It insures the lender against the borrower defaulting on the loan. Any loan that FHA insures must be made by an FHA-approved lender and properties purchased with FHA-insured mortgages must be appraised by an approved FHA appraiser.

The borrower must meet FHA credit qualifications and must not exceed the FHA maximum mortgage limit for that particular area of the country. Should the purchase price of the property being purchased with an FHA-insured mortgage exceed the FHA-appraised value, the buyer would be required to provide the difference in cash in order for the purchase to go to closing.

One benefit of an FHA insured loan is that the borrower who has a lower credit score and would have difficulty securing a conventional mortgage, might be able to qualify for an FHA insured loan. (Since credit score limitations are subject to changes, it is always advisable to consult with an FHA-qualified lender for the most recent credit score requirements.)

A borrower with a credit score **below 500** would **not** qualify for an FHA loan.

FHA insured loans allow more flexibility for a borrower in several ways:

- Lower down payment allowed-3.5% of the purchase price on a 1-4 family residence is the minimum down payment that a borrower must provide;
- Most of the closing costs and fees can be included in the loan-allows the borrower to avoid the need to have available cash for closing costs;
- The "up-front premium" or the **Mortgage Insurance Premium (MIP)** (FHA's version of PMI) can be financed into the mortgage.

VA-Guaranteed Loans AKA "The GI Bill"

The **Department of Veteran Affairs (VA)** does **not** issue loans, make loans or fund loans. The VA **guarantees** loans. Any loan that is guaranteed by the VA must be issued by a VA-approved lender. The VA can guarantee loans for the purchase or construction of homes for those veterans and their spouses who meet the eligibility requirements. VA loans are for a personal residence and not for investment properties.

A veteran who receives a VA-guaranteed loan may purchase the property at current market interest rates with a small down payment or with **no** down payment at all and will not be required to pay private mortgage insurance. (A VA-guaranteed loan can be 100% financing.) Closing fees or funding fees can be incorporated into the loan amount and financed into the loan. The limit of the VA-guaranteed loan is determined by the buyer's financial qualifications and by the lender's parameters. This guarantee is connected to the current conforming limits set by Fannie Mae and Freddie Mac. Generally, the VA-approved lender will loan an amount that is equivalent to 4 times the amount that the VA will guarantee. The veteran applies for a Certificate of Eligibility and the VA determines what percentage of the mortgage it will guarantee, thereby establishing the maximum guarantee it will give for that veteran's mortgage.

If the spouse of a veteran who died in the line of duty is not remarried, that spouse may still qualify for the VA-guaranteed loan. Surviving spouses who remarried after the death of the veteran, may regain their eligibility for a VA-guaranteed mortgage if the remarriage has ended because of divorce or death.

A person eligible for a VA-guaranteed loan is:

- A veteran who has served on active duty and has been honorably discharged after a minimum of 90 days of service if during wartime and/or a minimum of 180 days of continuous service if during peacetime;
- A veteran who enlisted in the military and began serving after September 7, 1980 and served for a minimum of 2 years;
- An officer who began serving after October 16, 1981 and served for a minimum of 2 years;
- A reservist who served for a minimum of 6 years;
- A member of the National Guard who served for a minimum of 6 years.

Assumable Mortgages

An assumable mortgage is one in which the purchaser "assumes", that is takes on, the seller's remaining mortgage and the terms of that mortgage, thereby releasing the previous owner of any remaining debt associated with the mortgage. The benefit of this would be that the buyer would not have to find his/her own mortgage. This might be particularly attractive during a time in which mortgage interest rates are very high. An older, existing mortgage might offer a significantly lower rate of interest. The buyer would need to provide a down payment or an additional mortgage that would cover the difference between the amount of the seller's assumable, existing mortgage and the purchase price of the property.

FHA will allow a qualified buyer to assume an existing FHA-insured mortgage. The rules for assuming an FHA-insured loan vary depending on the date that the original loan was issued. Generally, an FHA-insured loan that was originated before December, 1986 has no restriction on its assumption.

VA will allow a qualified buyer to assume an existing VA-guaranteed mortgage that was issued as of March 1, 1988. For a VA-guaranteed mortgage that was issued prior to March 1, 1988, the buyer may simply assume the mortgage without restriction, but is required to pay a processing fee for the assumption.

Currently, the only assumable mortgages are FHA and VA loans.

PROGRAMS AND "LOCKING" OPTIONS REVIEWED WITH CLIENT & EXPLAINED IN DETAIL

The loan officer will next be reviewing the various loan programs available and mortgage options with the client. There are various types of loans available and, with consultation as to the specific situation and needs of the borrower, the loan officer should counsel and guide the borrower as to which loan program is best for his/her particular needs.

Types Of Mortgages

Essentially, there are 2 main types of mortgages:

- Fixed rate;
- Adjustable rate.

A **Fixed Rate Mortgage (FRM)** is exactly as its name indicates. The rate of interest at the origination of the mortgage remains the same or "fixed" through the entire life of the mortgage. In a fixed-rate mortgage the rate of interest never changes. For a borrower who is risk-averse, the fixed-rate mortgage may be the most comfortable choice because the principal and interest payments are set for the life of the loan. There are no fluctuations in the rates or in the monthly payments of principal and interest. These loans are **usually** based on a 30-year amortization table.

(**Amortization** is the repayment of a loan in equal, or nearly equal, installment payments until the loan reaches the end of its term. The repayment schedule is calculated so that all principal and interest are fully paid with the last scheduled payment.)

Fixed rate mortgages are generally scheduled as:

- 40-year fixed;
- 30-year fixed;
- 20-year fixed;
- 15-year fixed;
- 10-year fixed.

The 30-year fixed and the 15-year fixed terms are the most commonly issued fixed rate mortgages.

An **Adjustable Rate Mortgage (ARM)** is a loan that has a variable interest rate. The interest rate that is set at the origination of the loan can change throughout the term of the loan. ARMs usually have a fixed rate of interest for a specific amount of time and then the rate can readjust or reset. An ARM is established with a pre-set margin (**margin** is the addition of the lender's cost of doing business) that is tied to an index such as:

- The **LIBOR** (London Inter Bank Offering Rates);
- **COFI** (Cost Of Funds Index);
- **CMT** (Constant Maturity Treasury).

Dependent on the economic conditions at the time of the adjustment, the rate can increase or decrease according to which way the index it is connected to moves. These loans are usually based on a 30-year amortization table.

The **London Inter Bank Offering Rates (LIBOR)** as an index reflects the short-term interest rates that British banks and the U.S. Federal Reserve use. LIBOR is an international rate for dollar-based deposits and is used as a common index for ARMs.

The **Cost Of Funds Index (COFI)** is based on the 11th District Cost of Funds as an index and reflects the rates that banks pay on savings accounts. It is the slowest-moving index for ARMs since the rate of resets adjusts up or down more slowly than with any other index. If rates are going up, the adjustment to the ARM interest rate is slower to rise. However, if rates are going down, the adjustment to the ARM interest rate is slower to drop.

The **Constant Maturity Treasury (CMT)** as an index tracks the daily changes in the rate of interest for the 1-year Treasury Bill. This index very quickly reflects the short-term interest rate changes. The contract between the lender and the borrower will delineate the terms of the ARM loan and how and when the loan will reset. The terms should include:

- The dates at which the loan's interest rate resets or adjusts;
- The index to which the ARM's rate is tied;
- The margin rate for the loan's interest (the index rate plus the lender's premium for doing business);
- The limits of how much the rate can increase in one year;
- The limits of how much the rate can increase over the life of the loan.

The ARM interest rate reset or adjustment occurs when the lender changes the interest rate from the last designated payment period to the next designated payment period. When the reset date arrives, the lender calculates the interest rate for the upcoming term according to the index rate to which the

ARM is tied and the additional margin rate. As a result, the payment for the loan is recalculated accordingly.

This recalculated payment uses:

- The new interest rate;
- The loan balance as it stands after the last received mortgage payment and;
- The remaining term of the loan.

All of these factors are used to recalculate the loan so that the loan will still be paid off with the last payment at the end of the loan's term.

While a standard ARM resets once per year, most ARMs are **Hybrid Adjustable-Rate Mortgages**, which means that they begin with an initial, fixed rate of interest for a certain period of time that then turns into an adjustable rate mortgage. A mortgage that is a 3/27 ARM, a 5/25 ARM, or the like will have a fixed rate of interest for the initial 3 or 5 years of the loan and then turn into an adjustable rate mortgage for the remainder of the loan.

For example:

The 3/27 ARM is amortized over 30 years, with the first 3 years of the loan at a fixed rate of interest. The following 27 years of the loan are adjustable as to the rate of interest that the borrower will be charged.

Adjustable rate mortgages are **generally** scheduled as:

- 7/1 ARM;
- 5/1 ARM;
- 3/1 ARM;
- 1-year ARM.

For example:

A 5/1 ARM has a fixed rate of interest for the first 5 years and then changes the rate of interest once a year after the initial fixed 5 years. The rate of interest on the loan continues to adjust or reset for the remainder of the loan's term or until the borrower sells the mortgaged property or refinances into a different mortgage.

Interest Rate Caps For An Adjustable-Rate Mortgage (ARM)

On a periodic basis, ARM interest rates reset or adjust according to the indexes that they are tied to. In order to protect the consumer from unlimited and wildly rising rates, limits are set that are called **caps** or **rate caps** in that they "cap" the amount of adjustment that can take place on an ARM in any given adjustment period.

The frequency and the amount of the rate increases will be specified in the loan documentation that the borrower signs at closing. The loan documents for an ARM disclose:

- The index to which the ARM is tied;
- The margin the lender is charging (the addition of the lender's cost of doing business);
- The designated rate caps,
- The designated adjustment periods of the loan.

For Example:

The terms and rate caps on a 5/1 LIBOR ARM might read:

**Loan term 30 years;
First adjustment period 5 years;
Subsequent adjustment periods 1 year;
Index 1-year LIBOR;
Margin 2.25%;
Initial rate cap 5%
Annual rate cap 2%;
Lifetime rate cap 5%.**

There are three basic types of caps or rate caps:

- The Initial Cap;
- The Periodic Cap or Annual Rate Cap;
- The Lifetime Cap or Aggregate Cap.

The **Initial Cap** is the amount limit that the rate can change the first time it is adjusted after the fixed period. Therefore, it is the "initial" cap.

For example:

In a 5/25 ARM, the initial rate change would come at the end of the first 5 years of the loan. The maximum amount that the interest rate can increase would be the initial cap. A 5/25 would have the interest rate fixed for the first 5 years. At the end of that 5-year period, the first reset or "initial" adjustment would take place. A 5/25 with an interest rate of 3.75% for the first 5 years of the loan that are "fixed" with an initial cap of 2%, could adjust to a rate of 5.75% at the initial reset if interest rates at the time of the adjustment supported it.

Not all ARMs have initial caps that are different from the period cap. An ARM with an initial cap is likely to have an initial cap that is higher than the subsequent periodic caps. If the ARM has no initial cap, the first adjustment to the rate after the fixed rate period would adhere to the periodic cap amount.

The **Periodic Cap** or **Annual Rate Cap** is the amount the rate can change during each subsequent rate change period after the initial adjustment.

For example:

If a 5/1 ARM with an initial rate cap of 2% and a periodic cap of 1% adjusted at the end of the first 5 years according to the initial rate change cap, the rate of interest would be scheduled to change every year thereafter. (Some loans may adjust more often than annually, i.e. every 6 months.) So a 5/1 ARM with an introductory rate of 3.75% set for the first 5 years of the loan that are "fixed" and an initial cap of 2% for the first reset/adjustment, could adjust to a rate of 5.75% at the initial reset. The next periodic adjustment could increase the rate of interest by 1% more and bring the rate of interest up to 6.75% if interest rates at the time of the adjustment supported it.

The **Lifetime Cap** or **Aggregate Cap** is the maximum amount the rate can change or increase from the introductory rate during the **entire** life of loan. Throughout the full 30 years, it cannot exceed the amount of the lifetime cap. Typically, caps might be structured as 6/2/6. This means the rate can change up to a full 6% once it initially becomes an adjustable-rate mortgage, then readjust an additional 2% each subsequent adjustment period, but never more than an additional 6% beyond the introductory rate throughout the life of the loan. The caps allow the interest rate to go both up and down. So if the market interest rates are going down, the adjustable-rate mortgage can go down!

For example:

A 3/1 ARM with an introductory rate of 3% has 5/2/5 rate caps. At the end of the third year (the end of the fixed rate period), the loan could reset up to a rate of interest that adds an additional 5% to the introductory rate, but cannot increase more than that 5%. This does not mean that it will reset that much, but only that it can. The amount that it will actually reset will be based on the prevailing economic conditions at the time and the index to which the loan is tied.

If the 3% interest rate were readjusted by 5% in the initial reset, the rate of interest would then go to 8%. (5/2/5)

- **3% introductory rate + 5% adjustment = 8% newly adjusted rate of interest.**
- **Because the maximum cap is 5%, the loan can never exceed 8% interest. (5/2/5)**

If in this 3/1 ARM the prevailing economic conditions and the index to which the loan were tied justified only a 2% increase for the initial reset, the introductory 3% interest rate would be readjusted to 5%. (5/2/5)

- **3% introductory rate + 2% adjustment = 5% newly adjusted rate of interest.**

For each additional reset period, increases and resets could not go more than 2% of whatever the readjusted rate of interest had been at the previous reset period (5/2/5). If the previous reset had brought the interest rate to a total of 5%, the next reset could be a maximum of 2% more as this is the periodic cap limit. (5/2/5)

- **3% introductory rate + 2% initial adjustment = 5% reset rate of interest.**
- **5% interest rate after initial reset + 2% reset adjustment for second reset = 7% second reset rate of interest.**

At the third adjustment, if the current interest rate on the loan is at 7%, even though the periodic cap allows for a 2% adjustment each time the loan adjusts, the loan cannot adjust up more than an additional 1% because the lifetime cap on the loan is 5% over the introductory rate (5/2/5) or a maximum interest rate of 8% for the entire life of the loan.

- **3% introductory rate + 2% initial adjustment = 5% reset rate of interest at initial reset.**
- **5% interest rate after initial reset + 2% reset adjustment for second reset = 7% second reset rate of interest.**
- **7% interest rate at the time of third reset period + 1% reset adjustment = 8%, the lifetime maximum cap for the loan.**

The rate of interest will never go to 0%, and will likely have a "floor rate", which is either the original starting interest rate, or something determined by the lender, such as 2% below the original start rate. The **floor rate** is the lowest rate to which the ARM mortgage can adjust downward. The highest rate of interest that an ARM mortgage can adjust up to (the lifetime cap) is referred to as the **ceiling rate**.

Below is a comparative chart showing the variations on Conventional Fixed-Rate loans and Conventional Adjustable Rate loans.

Loans	Rate	APR**	Points	Estimated Monthly Payments*		
				# of Payments	Amount	Rate
Conventional Fixed						
Conventional Fixed: 30 year	3.500%	3.664%	0.75	360	\$898.09	3.500%
Conventional Fixed: 20 year	3.250%	3.536%	1.25	240	\$1,134.39	3.250%
Conventional Fixed: 15 year	2.875%	3.149%	0.625	180	\$1,369.17	2.875%
Conventional ARM						
Conventional ARM: Adjusts in 3 years	3.625%	3.548%	1.375	36	\$912.10	3.625%
				324	\$873.76	3.250%
Conventional ARM: Adjusts in 5 years	2.750%	3.257%	1	60	\$816.48	2.750%
				300	\$862.51	3.250%
Conventional ARM: Adjusts in 7 years	2.875%	3.258%	1	84	\$829.78	2.875%
				276	\$862.07	3.250%

Balloon Mortgages

Balloon mortgages begin with the initial term of payments based on the amortization for a 30-year fixed-rate loan (payments calculated to pay off the loan with equal payments over 30 years or 360 payments total). The initial term is usually 5 years (5/25) or 7 years (7/23), but can be different terms. During the initial term of the loan, the borrower pays regular mortgage payments of the same, equal amounts just as in a fixed-rate mortgage. After the initial term of payments, instead of the loan resetting, as with an ARM, the remainder of the loan balance becomes due in full; hence the "balloon" payment due at the end of the fixed timeframe.

For a 5/25 Balloon Mortgage, the first 5 years of the loan will be the same monthly payments based on a 30-year amortization schedule set up so that these payments would pay the loan in full at the last payment or at payment 360. However, these scheduled payments actually only continue for the first 5 years of the loan, at the end of which the remaining amount, or principal, of the loan comes due in full so that 25 years worth of payments become due at once and in total.

At the end of the loan term, the borrower may choose to:

- Refinance the loan in to an ARM, a fixed-rate mortgage or even another balloon mortgage;
- Sell the property;
- Convert the balloon mortgage into a different loan as a lender might allow the borrower to reset the loan as an ARM at the end of the initial term. This would usually be reset to the current market rates of interest.

For example:

A loan of \$100,000 at 6% interest, whether it is a 5-year balloon, a 7-year balloon or a 30-year fixed-rate mortgage, will have a monthly payment of principal and interest of \$600. At the end of the 7-year period (84 payments) in the balloon mortgage, the balance left on the loan will need to be repaid in full. This would be the "balloon" payment. With the 30-year fixed rate mortgage, the borrower may simply continue to pay the same monthly payments for the entire life of the loan, all 360 payments.

As with a 7-year ARM, the 7-year Balloon Mortgage remains fixed for the first 7 years. The difference is that at the end of 7 years, the ARM rate of interest resets where the balance of the Balloon Mortgage becomes due in full.

A borrower might choose a Balloon Mortgage because:

- As with an ARM, he/she knows that he/she will not be in the home long enough for the mortgage to become due in full;
- The interest rate for the initial period of the loan is less than for an ARM of a comparably fixed length or for a 30-year fixed-rate mortgage.

Interest-Only Loans

Traditional mortgages require payment toward the principal **and** the accrued interest in each monthly payment. In this manner, the amount of the principal the borrower owes decreases over the term of the loan until the full amount of the principal is repaid at the end of the loan term with the last payment of the loan.

Interest-only loans are exactly that: the monthly payment goes toward paying **only** the interest and does not pay anything toward the principal of the loan. Although interest-only loans have benefits for some borrowers, the interest-only loan may also have an interest rate that is approximately 1/8 to 1/4 percentage point higher than a loan that pays toward principal.

Further, the terms of the loan may allow for a minimum payment each month which, in fact, is actually less than the amount of interest owed. If a borrower chooses this option, the amount of interest that is unpaid is added on to the principal amount and therefore increases the amount of principal owed on the loan. This addition to principal causes the borrower to owe more than the original amount of the loan and is known as "Negative Amortization".

Interest-Only Fixed-Rate Loans

There are fixed-rate mortgages that, as with any fixed-rate mortgage, have a scheduled monthly payment of the same amount each month. However, with an Interest-Only Fixed-Rate mortgage, the monthly payment covers **only** the interest being accrued on the mortgage principal and pays nothing toward the principal itself. Therefore, the borrower is only paying interest and is paying nothing

toward the principal of the loan. The period of time in which this "interest only" payment option exists is generally limited to the first 5 to 10 years of the loan. After that, the loan is reset to be a loan paying interest and principal with an amortization schedule to reflect the principal and interest payments. If the loan has been interest only for the first ten years, then the entire remaining principle with interest must be repaid in the next 20 years.

With an interest-only mortgage, the borrower may choose to pay toward the principal but is not obligated to pay principal as well as interest during the interest-only time period. Should the borrower choose not to pay toward the principal, the loan amount would remain unchanged from the original amount when the loan was issued.

For example:

On an interest-only mortgage of \$100,000 at 7.5% rate of interest, without paying toward principal, the borrower would pay only the interest of \$625.00 per month.

- $\$100,000 \times 7.5\% \text{ or } .075 = \$7500 \div 12 \text{ monthly payments} = \$625.00.$

The principal of \$100,000 has not been reduced and is still owed in full.

In a traditional loan where the borrower pays principal and interest each month, on a loan of \$100,000 at 7.5% rate of interest, the borrower has a monthly payment of \$902.77. The first portion of the payment goes to pay interest for that month and the remainder of the payment goes to pay down the principal of the loan. After the borrower makes the first payment on this mortgage, he/she will owe \$99,722.23 in principal.

- $\$100,000 \times 7.5\% \text{ or } .075 = \$7500 \div 12 \text{ monthly payments} = \$625.00 \text{ toward interest.}$
- $\$902.77 - \$625.00 = \$277.77 \text{ toward the principal.}$
- $\$100,000 - \$277.77 = \$99,722.23 \text{ principal remaining after the 1st payment.}$

For month two of the borrower's payments, the principal is \$99,722.23, the monthly payment is still \$902.77 and the rate of interest is still 7.5%.

- $\$99,722.23 \times 7.5\% \text{ (or } .075) = \$7479.167 \div 12 = \$623.26 \text{ toward interest.}$
- $\$902.77 - \$623.26 = \$279.51 \text{ toward the principal.}$
- $\$99,722.23 - \$279.51 = \$99,442.72 \text{ principal remaining after the 2nd payment.}$

At the end of the second mortgage payment, the borrower will owe \$99,442.72 toward the principal amount of the loan.

An interest-only mortgage may be good for some borrowers and not for others. It may suit a borrower:

- Who may have fluctuating cash flow, sometimes not having enough to pay toward principal, but who can make the interest payment on a regular basis. This might be suitable for someone who works on commission only and/or who receives larger, periodic bonuses. (It would be advisable for this borrower to pay toward principal when he/she has the extra money in order to pay down principal and increase his/her equity in the property);

- Who otherwise would be purchasing a "starter" home with the concept of moving into a more expensive home in the near future when his/her income increases. This would of course carry closing costs and moving costs to make 2 such purchases and moves. An interest-only mortgage might allow the borrower who is certain that his/her income will go up in a short amount of time to qualify for "more house" because of the interest-only loan and therefore only need to purchase once, avoiding 2 sets of closing costs and moves;
- Who is the owner of an investment rental property and who might have fluctuating cash-flow due to vacancies at different times, making the option of the lower interest-only payment a good choice when cash-flow is less and paying toward principal when there are no vacancies and cash-flow is good.

Interest-Only ARMs

There are interest-only Adjustable Rate Mortgages in which only the interest is paid and there is no payment toward principal during the initial fixed-rate period of the loan. After that period ends, the loan must be amortized for the number of years remaining on the loan so that the entire mortgage will be paid in full by the end of the loan term. Because the entire principal must then be paid in a shorter period of time, the monthly payments following the initial interest-only period will be significantly higher than the interest-only payments. This is often referred to as "Payment Shock" as the monthly payment can jump up to double or even triple what the borrower had been previously paying.

For example:

A 5/1 Interest-Only loan will have payments going only toward interest for the first 5 years of the loan. The interest rate is fixed for 5 years and the principal of the loan remains the same as when the loan was issued. Although the loan itself is amortized over 30 years, nothing is paid toward the principal within the initial 5 years. When the initial 5-year period ends and the borrower is required to begin paying back the interest and the principal of the loan, that principal will now need to be paid in full within 25 years (the remaining term of the loan) rather than within the traditional 30 years of the amortization schedule. The amount of principal that would have been paid during the first 5 years was not paid and so is added on the amount that must be paid within 25 years.

In a traditional loan, whether a 30-year fixed or an ARM of \$100,000 (or any amount) amortized over 30 years, in each monthly payment the borrower is paying toward interest and principal and from the first payment on is decreasing the amount of principal owed.

In an interest-only loan, whether a 30-year fixed or an ARM of \$100,000 (or any amount) amortized over 30 years, the first 5 years of monthly payments pays nothing toward the principal. Therefore, at the end of the first 5 years (or 10 if that is the loan) since the borrower has paid nothing toward the principal, the principal amount has not decreased and is still \$100,000. With 25 years (or 20 years) left for the loan to be repaid, the \$100,000 principal will now be amortized over 25 years of payments rather than 30, making the monthly payment toward principal larger than it would have been if the borrower had been paying toward principal for the entire life of the loan. A borrower, who during the first 5 years of

the mortgage has only had monthly payments of interest, would then be paying a significantly higher monthly payment that included the interest and a payment of principal, the principal being amortized over 25 years rather than 30 years.

Most borrowers plan to refinance the mortgage at the expiration of the interest-only period. However, they have essentially no equity in the property other than what their down payment was and in a declining market, refinancing might not be an available option if they owe more on the property than it is worth in current market conditions.

No Money Down Mortgages

During the booming years of the housing market, in the early 2000s, there were many lenders who offered 100% financing through a program of an 80/20 combination/combo loan. Currently, No Money Down mortgages are not being offered except for those mortgages that are guaranteed by the Veteran's Administration (VA).

Mortgage Rate vs. The Annual Percentage Rate (APR)

The mortgage rate is the rate of interest that the borrower will pay every month. The **Annual Percentage Rate (APR)** is the rate of interest that includes the costs of:

- Processing the loan;
- Underwriting the loan;
- Origination fees;
- Private mortgage insurance;
- Any other fees incurred to secure the mortgage.

Consequently, the **APR** is more representative of the **true cost** of the loan as it incorporates the costs connected with securing and closing the loan for the borrower. APR is based on the concept that the borrower will hold the loan for the full term and that the costs of securing the loan will be spread out over the life of the loan. However, if the borrower has a high-cost loan and holds the mortgage for a short period of time, the resulting APR may be higher than what was quoted or advertised because the costs of the loan are not amortized over the anticipated life of the loan, but have been condensed into a shorter payment period.

As shown in evaluating the payment of discount points to buy down a mortgage rate of interest, all costs associated with the loan need to be considered in order to see which loan is actually the better deal.

Because some costs are not included in the APR and some banks/lenders calculate the APR differently from each other, it is often difficult to make an exact comparison of the true costs incurred in securing a mortgage. And remember that the APR assumes that the borrower will keep the loan for the entire term or full amortization; it does not take into consideration that the borrower might sell the property or refinance the mortgage thereby not going the full amortization of the loan.

Sometimes the APR on an ARM will be lower than the interest rate because the lender calculates the full term amortization based on the concept that interest rates will be lower when the interest rate resets. This can be misleading, so it is good to know which way this is being calculated.

Third-party fees such as title insurance, appraisal, etc. are **not** usually included in the APR.

Below is a typical rate sheet expressing the mortgage rate and the APR for various loan types. Please assume that the mortgage amount is the same for all.

Type	Rate	APR
30 Year Fixed	3.500%	3.664%
20 Year Fixed	3.250%	3.536%
15 Year Fixed	2.875%	3.149%
3/1 ARM	3.625%	3.548%
5/1 ARM	2.750%	3.257%
7/1 ARM	2.875%	3.258%

Locking In The Interest Rate

A "lock-in" is the lender's guarantee or promise for an agreed upon period of time that the borrower will receive a certain agreed upon rate of interest. Often, the rate of interest will be locked-in at the time of application. Once a rate quote is given, the rates can change and fluctuate according to market changes. If the borrower's conditions, such as income, credit rating, loan-to-value ratio, etc. change, the borrower's quoted interest rate can change as well if the borrower has not locked in a rate.

A written rate lock, particularly on a "Letter Of Commitment", will guarantee the borrower that particular promised rate as long as he/she closes the transaction within the specified time frame. Rates are flexible and can change a few times throughout each day as market conditions fluctuate and adjust. Lenders will often "lock-in" the loan's rate of interest for a fixed amount of time from the borrower's application. Generally, the lock-in period is anywhere from 7 to 90 days, with some lenders allowing for a "lock" of 120 days. (If the rate is extremely low, the lender is likely to allow the shorter period as a lock-in time.) Often, the loan officer can adjust the lock-in rate if interest rates go down after a borrower's lock-in, but this is not necessarily a given. Generally, a lock of longer than 60 days will require an additional fee in order to secure the lock-in for the extended period of time.

There may or may not be a fee associated with a lock-in.

The borrower needs to be conscious of how far along in the home purchasing process he/she is and how long the rate lock lasts. It would not make sense to have a rate lock that will expire before the purchase goes to closing. A better choice for the borrower would be a lender who locks in a rate that is satisfactory to the borrower, but which can "float down" should rates drop below the locked in rate. A lender might offer this option for a fee.

If closing/settlement of the property purchase does not take place within the loan lock-in period, the rate lock-in expires and the borrower will either need to pay a "lock-in extension fee" to retain the longer extension period or choose to lock in a rate again.

Lesson Three Review Quiz

- T F** 1. A Conventional Loan is a mortgage that meets the funding terms and conditions of Fannie Mae and Freddie Mac.
- T F** 2. Conventional loans are considered by many to be the most secure loans since they usually have a lower loan-to-value ratio.
- T F** 3. In a conventional loan, lenders may not set their own criteria for evaluating the borrower's credit worthiness and the property being used as collateral for the mortgage loan because conventional loans are government loans.
- T F** 4. The "usual" loan-to-value ratio for a conventional loan is 80% of the value of the property being financed and the borrower is contributing the other 20% of the purchase price in the down payment.
- T F** 5. "Conforming loans" meet the requirements established by Fannie Mae and Freddie Mac and may be sold to the secondary mortgage market.
- T F** 6. Loan-to-value ratio is the amount/proportion that the mortgage loan constitutes of the total value of the property being purchased.
- T F** 7. A borrower will pay private mortgage insurance (PMI) on a loan with a downpayment lower than 30% of the purchase price.
- T F** 8. . A loan that exceeds the conforming loan limits is a Jumbo Loan or a Jumbo Mortgage and usually carries a higher rate of interest.
- T F** 9. The Federal Housing Administration (FHA), issues loans, make loans and fund loans.
- T F** 10. Essentially, there are 2 main types of mortgages: Fixed rate and Adjustable rate.
- T F** 11. In a fixed-rate mortgage the rate of interest never changes.
- T F** 12. An Adjustable Rate Mortgage (ARM) has an interest rate that is set at the origination of the loan can change throughout the term of the loan and is tied to an index.

Answers

1. T
2. T
3. F
4. T
5. T
6. T
7. F
8. T
9. F
10. T

11. T

12. T

FINALIZING THE TRANSACTION

FINALIZING THE LOAN APPLICATION

The three main people involved in the mortgage loan process are the **loan officer/loan originator**, the **processor** and the **underwriter**.

The Loan Officer

The loan officer or loan originator is generally the first contact that a borrower has with the loan process.

The loan officer:

- Meets with the client;
- Takes the application;
- Usually pulls the credit report;
- Obtains the necessary documentation that the applicant needs to supply, including:
 - The purchase contract for the property being mortgaged;
 - Any addendums or riders to the contract;
 - The borrower's:
 - Pay stubs;
 - W-2 forms;
 - Bank statements;
 - Tax returns.
 - A copy of the borrower's ID card (i.e. driver's license);
 - The amount of earnest money deposited by the borrower;
 - Verification of the borrower's payment of earnest money.

The Processor

When all of the documentation for the loan application is complete, the loan officer turns over the borrower's documentation and information to the processor. The processor works for the mortgage broker or banker and is an assistant to the loan officer. The processor has the responsibility of verifying, organizing and compiling the relevant information for each loan applicant and of approving the loan application before sending it to Underwriting. Once the loan officer has submitted the file to the processor, the processor takes over the loan file. It is then the processor who takes the loan from pre-approval to closing, working as a "middleman" between the borrower and the underwriter and working to meet the underwriter's conditions for approving the loan. The processor verifies the facts of the application.

The processor:

- Verifies the applicant's:
 - Employment;
 - Income;
 - Assets;
 - Liabilities.
- Reviews the application to verify that all of the information is complete;
- Verifies and compiles the borrower's application information and enters the application into the system;
- Reviews the application to verify that it meets the standards for the type of loan for which the borrower is applying;
- Reviews the application to verify that it meets the standards for the amount of mortgage for which the borrower is applying;
- Reviews the projected expenses for the property being purchased;

- Reviews with the borrower:
 - The type of mortgage for which the borrower is applying;
 - The information about the property being purchased;
 - The borrower's information.
- Orders and coordinates loan documents;
- Orders the appraisal;
- Reviews the survey for the property, if applicable (surveys are not customary for a condominium purchase);
- Orders the title search;
- Orders:
 - The tax transcripts for the property;
 - The condo questionnaire, if necessary.
- Checks updates on the borrower's credit report and asset verification;
- Compiles all of this into a completed file;
- Submits the completed file to the underwriter/underwriting;
- Composes and sends a letter of approval or denial to the applicant after the underwriter has approved the loan;
- Submits an approved mortgage loan file to the Mortgage Loan Closer for funding and settlement;
- Issues the "clear to close";
- Records the status of loans showing the number of new applicants and the number of loans that have been:
 - Approved;
 - Canceled;
 - Denied.

The Underwriter

The underwriter is an employee of the bank, the mortgage broker or the mortgage banker, who is working on originating the loan. It is the underwriter's job to certify that the borrower fits within the end lender's guidelines for the loan that he/she is applying. **The underwriter is the one who makes the final decision as to whether or not the loan is approved.**

The underwriter:

- Is an expert in lending guidelines;
- Reviews the borrower's information and documentation;
- Re-submits the loan file to the processor if there are unanswered questions or unfulfilled requirements;
- Approves or denies the loan;
- Sends the loan package to the closing department of the bank or lender for funding.

Once the underwriter obtains the file, he/she reviews it and verifies that it is complete. If the loan had been pre-approved via automated or desktop underwriting, the underwriter will review it to verify that the documentation in the file is the same as the information that went into the automated underwriting. If all is the same, the underwriter will sign off on the loan and forward it for funding.

A file that has not gone through pre-approval via automated underwriting is a "manual underwrite" file. With a manual underwrite, the underwriter must review all of the information and do a risk assessment before deciding to approve the loan.

In reviewing what the processor has sent, the underwriter evaluates the risk involved with issuing this loan and determines:

- The ability of the borrower to repay the loan by reviewing the borrower's assets and liabilities;
- The risk of default with this borrower by reviewing the borrower's credit history in order to evaluate the borrower's willingness to repay the loan;
- Whether the loan file meets the end lender's guidelines set out for the loan program for which the borrower is applying;
- The loan-to-value ratio and evaluates it by reviewing the appraisal and assessing if the property being purchased is sufficient collateral to cover repayment of the loan should there be a foreclosure.
- Issues the commitment letter if the loan is approved or asks the processor to issue the letter.

As the underwriter reviews the information in a file, if he/she has questions about the information or requires additional information, the underwriter will send the file back to the loan processor, delineating the conditions that have to be met in order for the underwriter to give approval to the loan. This will cause the loan to be "suspended". Typically, when a loan is suspended, it is because the underwriter finds something detrimental to approving the file. Without the borrower clearing up what the underwriter deems detrimental, the loan cannot be accepted.

The underwriter delineates the conditions that need to be met in order to "clear up" the detrimental circumstance and sends the file back to the processor. The processor would then advise the borrower what needs to be done and once the borrower has remedied the problem, the processor resubmits the file to underwriting in order to obtain an acceptance of the loan and receive a "clear to close" from the underwriter. The processor and/or the loan officer obtains the information that the underwriter requires, and if that information correctly addresses the underwriter's concerns, the underwriter will approve the loan.

The "**3 C's Of Underwriting**" are:

1. Credit reputation;
2. Capacity;
3. Collateral.

Credit reputation refers to the borrower's:

- Credit score;
- History of foreclosures, bankruptcies, liens and/or judgments;
- Mortgage and/or credit delinquencies;
- Collections;
- Repossessions;
- Credit accounts histories;
- New credit requests within the previous 12 months prior to the loan application.

Capacity refers to the borrower's:

- Debt-to-income ratio;
- Self-employment or salaried employment;
- Cash in reserve;

- Borrowing with others or alone;
- Loan type:
 - Fixed-rate, ARM, balloon, etc.;
 - Term (Length of mortgage);
 - Purpose (new purchase, refinance).

Collateral refers to:

- The borrower's total down payment or total equity in the property being purchased;
- The type of property being purchased (1 unit, 2-4 units, condominium, etc.);
- The borrower's use of the property being purchased (primary residence, 2nd home, investment, etc).

The underwriter evaluates what the processor sends to him/her and then makes the final decision as to whether or not the mortgage is approved or denied. It is up to the underwriter to say "Yes" or "No" to the mortgage.

Processors usually take a minimum of 24 hours after to the borrower has signed the loan package to process the loan documents. Underwriters usually take a minimum of 48 hours to underwrite the loan. The time frame involved from application, to processing, to underwriting to approval usually takes between 14 and 30 days.

The underwriter reviews the appraisal, the title insurance information and the condo questionnaire if that were applicable to the borrower's purchase.

If the loan is **approved**, the borrower may receive a list of conditions which have to be met before the loan can move to the funding department and the borrower will receive the loan. This would be a "**conditional**" approval.

If the loan is **suspended**, the borrower may need to supply additional information, certain paperwork or an explanation to the underwriter before the loan process can continue.

If the loan is **denied** or **declined**, the borrower will need to seek out a different lender, apply under a different program or give up trying to purchase property.

Equal Credit Opportunity Act (ECOA)

If a lender or credit-issuer rejects or denies credit to an applicant, they must inform the applicant as to the reason or reasons why credit was denied or terminated. The **Equal Credit Opportunity Act (ECOA)** is a federal law prohibiting the rejection of issuance of credit to consumers, because of discrimination based on:

- Race;
- Color;
- Religion;
- National origin;
- Sex;
- Marital status;
- Age;
- Dependence on public assistance.

Commitment Letter Sent

The mortgage commitment letter is the lender's written commitment to the borrower certifying that the loan is approved and that the lender is ready to go to closing, fund the mortgage and complete the property purchase transaction. This commitment is given **after** the lender has reviewed the property's appraisal and the appraisal has justified the amount the lender is lending on the mortgage. While the mortgage commitment letter is a certification that the loan is approved and ready to be funded, it is not a "guarantee" that the mortgage will be given.

Once the loan is approved, the underwriter sends the commitment letter to the loan officer or the processor. It is dated and has an expiration date. Typically, the processor will review the conditions that the underwriter has stipulated and will then issue the commitment letter.

The commitment letter may normally include:

- A congratulations to the borrower for having been approved;
- The terms and conditions of the loan;
- The amount of the loan;
- The interest rate of the loan;
- The time period for which the loan is being given, i.e. 30 years, 15 years, etc.;
- Itemization of any documentation that the borrower still needs to provide for final approval, including proof of hazard insurance;
- Notification that the terms of the loan may be subject to change should the borrower's financial capabilities or the value of the property have changed between application and closing/settlement;
- The date at which the commitment expires.

For example:

The commitment letter may state:

For an anticipated closing date: "The borrower and the lender will use reasonable efforts to fund the full loan amount on or about August 27, 2012 and that the loan must close no later than October 28, 2012."

For proof of hazard insurance: "The borrower is required to maintain All-Risk Perils Insurance, including flood, windstorm and earthquake insurance if the property is located in a flood plain, hurricane and/or earthquake zone."

For Monthly payments: "The borrower will make monthly payments of principal and interest commencing on the first day of the second full calendar month following the funding of the loan/loan closing and on the first day of each subsequent month until the loan reaches maturity. The loan will be calculated on payment of principal and interest based on a 30-year amortization schedule."

Monthly payments may also include a pro-ration of the property's taxes to be held in escrow until the taxes come due and they may also include the borrower's payment of the hazard insurance policy. This varies from lender to lender as to what agreement the lender makes with the borrower about how taxes and insurance can or will be paid. Some borrowers are responsible for paying the property taxes directly to the county in which they live instead of escrowing them

with the lender, as well as paying the property's hazard insurance directly to the insurer instead of to the lender.

A commitment letter may be a "firm" commitment or a "conditional" commitment.

The **firm** commitment letter usually states:

- The time frame in which the loan must be repaid (the term of the loan);
- The rate of interest at which the mortgage is being issued;
- The date by which the loan **must** be closed and funded or it is canceled.

A **conditional** commitment letter usually states:

- The lender will issue the loan as long as the borrower meets certain conditions;
- These considerations might include:
 - A review of the borrower's credit;
 - A re-verification of the borrower's employment.
 - The final closing costs to the borrower;
 - The final terms of the loan;
 - The length of time in which those terms are valid and available (the date by which closing must occur).

A conditional commitment letter could state that the credit report expires on a certain date, that the income documentation validity expires on a different date and that the appraisal expires on yet another date. Consequently, if there is a delay in the closing date, the borrower may need to provide updated documentation and may need to have a new credit report pulled so that the information will be deemed current and accurate.

Good Faith Estimate-Truth In Lending Act-Regulation Z

Within three (3) business days after the buyer completes the loan application, the lender must provide the borrower with a **Good Faith Estimate (GFE)** of the anticipated closing costs. The GFE shows the costs associated with the loan settlement such as:

- Origination fees;
- Mortgage insurance;
- Title insurance;
- Escrow reserves;
- Hazard insurance.

If there is a change in the GFE, there is then a new 3-day waiting period before the closing can take place. So, for example, if the closing were scheduled for July 15 and the GFE has changed and the buyer was notified on July 14, the closing could not take place before July 17.

The **Truth in Lending Act** requires that within those same 3 days, the lender will also deliver a Truth In Lending Disclosure statement to the borrower. The Truth-in-Lending Disclosure statement details:

- The borrower's estimated monthly payment for the mortgage;
- The total cost of all finance charges for the loan expressed as an Annual Percentage Rate (APR). (Remember that the APR shows the actual dollar amount of finance charges that the borrower will pay up front or for the life of the loan and is shown as an annual interest rate.)

Regulation Z was enacted pursuant to the **Truth in Lending Act** and mandates that any lending institution must disclose to borrowers the true or "real" cost of borrowing (APR), thereby giving the borrower the opportunity to compare and contrast the actual costs of borrowing the same amount of money with different lenders. **Regulation Z is applied when a residence is the security for a credit transaction.** It is **not** applied to commercial loans, business loans or agricultural loans.

Clear To Close Approval Issued

When all of the necessary conditions have successfully been met and the underwriter has completed reviewing the loan documents and has approved the loan, the underwriter determines that the loan is "clear to close" and sends the loan to funding. He/she then notifies the processor that the loan is clear to close and the processor then informs the loan officer that the loan has been approved and is clear to close.

The Funding Department then:

- Issues a check or prepares for electronically sending or "wiring" the mortgage to the closing ;
- Puts together the closing documents;
- Sends the package to the closing agent.

Review Of The Final Settlement Statement

Prior to the actual closing, the title company sends, faxes or emails the final figures to the lender, to the attorney (depending on the state), and, if a real estate broker is closing the transaction (depending on the state), to the real estate broker.

In Illinois: As Illinois is an attorney state, the final figures would not be sent to the real estate broker.

The lender:

- Draws up the documentation package;
- Has the closing department for the lender review the documents and the closing figures;
- Forwards the documentation package on to the closer.

The package may be overnighted, faxed or electronically delivered to the closer or to the closer's office. If the lender is sending the mortgage money in the form of a check rather than electronically sending it to the title company, the money will be included in this package so that the title company can disburse the funds at the end of the closing.

Depending on the state in which the transaction is taking place, the loan officer, the seller's attorney or the real estate broker will then schedule a closing and coordinate all of the parties involved in the transaction so that the closing can take place.

In Illinois: It is generally the seller's attorney who chooses the title company that will be responsible for closing the transaction.

The Closer

The closer functions as an uninterested third party in the transaction, working neither for the seller nor for the buyer. The real estate title closer's job is to finalize the purchase, sale and transference of ownership from the seller to the buyer. The closer's duties may include:

- Verifying the title and its ability to be successfully transferred;

- Verifying the accuracy of the documents submitted;
- Disbursing the monies to and from the seller and the buyer;
- Calculating the pro-rations for:
 - Mortgage balances and payoffs;
 - Real estate property taxes;
 - Insurance premiums;
 - Assessments if a condominium sale;
 - Special assessments if any is still ongoing.
- Preparing the closing statement which includes:
 - The financial settlement between the seller and the buyer;
 - The closing costs incurred by the seller and the buyer.
- Obtaining and notarizing the signatures of the principals in order to ensure that the agreements will be legally acceptable;
- Collecting the buyer's down payment;
- Determining that the documents have been correctly executed as to be legally acceptable and binding;
- Determining that the documents are ready to be recorded.

The Closing Or Settlement

The closing is the finale of the entire process and may take place at a title company, the real estate broker's office, an attorney's office, etc. The buyer, the seller and anyone necessary to them for the closing (i.e. the real estate brokers and depending on the state, attorneys as well as the loan originator) may attend the closing.

The borrower/buyer signs all of the papers necessary for the loan to be finalized. The monies paid out at the closing generally come from the mortgage money which the lender supplies to the buyer. Through the closer and the title company, the buyer in turn, gives the money to the seller, who may be paying off his/her existing mortgage. The deed, keys and ownership of the property go to the buyer.

If there are additional funds that need to be brought to closing, the borrower will be required to bring a certified check. Often, the buyer's certified check is for more than the buyer is required to actually pay out. In that case, the title company will issue the buyer a check for the money that remains from the buyer's certified check after paying out the any required payments.

The buyer is responsible for paying:

- The selling price of the property (This could be the mortgage money plus the buyer's down payment money);
- The commission for the buyer's agent based on a Buyer Brokerage Agreement, so the buyer may or may not be paying this fee;
- Attorney fees if applicable;
- Transfer charges if applicable in that state, county or municipality;
- Origination fees which may have been rolled into the mortgage or are to be paid at closing;
- Appraisal fees;
- Recording fees;
- Interest due on the mortgage at the time of closing, if applicable:

- Since interest on mortgages is paid in arrears, the interest that needs to be paid at closing is the interest that extends through the end of the month in which the closing takes place, which is why many buyers choose to close at the end of the month.
- Title insurance to insure the lender.

For example:

A buyer closes on the purchase on October 25 and must pay the interest through the remaining days of October. The first mortgage payment that the borrower will be required to pay will be due in December. The December mortgage payment is actually paying the mortgage interest for the month of November.

When the borrower has signed the final documents, the documents are returned to the bank or lender for review and then electronic funding or wiring of the money is done, with the lender sending the money to the title/escrow company. Actual funding of the loan, the arrival of the money at the closing, may take some time and there may be a delay of the funds arriving.

Until relatively recently, the money from the lender to fund the mortgage arrived at the place of closing in the form of a check included in the closing package. Nowadays, lenders typically send these large sums of money via wire transfers at a specific time of day scheduled to coincide with the closing of that purchase transaction and the funding of the mortgage at the end of the closing. Lenders tend to wire the funds to the title company or escrow holder just prior to the end of the closing.

In Illinois: If a buyer must supply more than \$50,000 at the closing, the funds must be wired to the closing.

Occasionally, the closing may take longer than expected and the lender's office has closed for the day, causing the funds not to have been wired to the closing. Or, the lender may wire the funds late enough that the closer's office or title company is closing for the day and the funds have not yet arrived. The closing may then be a "dry closing", meaning that no money has changed hands (the loan is not yet funded), but the paperwork is signed and completed and the transaction is closed. And sometimes, if the closing is very late in the day and runs past normal business hours, the lender may not wire the funds for the mortgage loan until the following day.

The borrower will be paying interest from the day of the actual funding.

REAL ESTATE SETTLEMENT PROCEDURES ACT-RESPA

The **Real Estate Settlement Procedures Act (RESPA)** is a federal act that applies to the issuance of a new first mortgage (as opposed to a second mortgage) that is issued in a residential real estate transaction. RESPA was enacted in order to protect buyers and sellers in the real estate transaction by mandating that they would be fully apprised of all costs, fees and charges involved in the settlement/closing of a residential real estate transaction.

RESPA **only** applies to first mortgage liens on residential mortgages that involve:

- 1-4 family residences;
- Condominiums (Condos)

- Cooperatives (Co-ops).

Whether the property is being purchased as a residence for the borrower's own occupancy or as an investment property, RESPA applies. Additionally, RESPA applies to a home equity loan if the property being used for the home equity loan is already being financed by a federally related mortgage which would be a mortgage:

- Issued by a bank;
- Issued by a savings and loan association;
- Insured by FHA;
- Guaranteed by the VA;
- Issued by a lender whose deposits are insured by FDIC or other federal agency;
- Intended for sale to Fannie Mae, Freddie Mac or Ginnie Mae;

RESPA is **not** applicable to any loan that is issued:

- For a business;
- For a farm;
- On property larger than 25 acres;
- For temporary financing on a new construction project;
- For a residential purchase financed via a purchase-money mortgage/articles of agreement/contract for deed being held by the seller of the property;
- Where the purchaser is assuming the seller's existing loan. However, RESPA applies in the assumption of an existing mortgage:
 - If the terms of the mortgage are modified;
 - If the lender charges more than \$50 for the assumption.

RESPA requires that lenders give the specifics of a mortgage transaction through the Uniform Settlement Statement-HUD 1.

UNIFORM SETTLEMENT STATEMENT-HUD-1

Through the requirements designated in the Real Estate Settlement Procedures Act (RESPA), lenders are mandated to use the **Uniform Settlement Statement** commonly known as **HUD-1** to delineate all of the fees and charges that a borrower and/or a seller will be required to pay in order to close a loan. This includes fees that the lender or a third party might charge. If the charges are paid by the lender prior to the closing, these are referred to as Paid Outside Of Closing (POC).

The HUD-1 form includes a page that allows the borrower to compare the original Good Faith Estimate (GFE) that he/she received prior to closing to the actual charges that are listed on the HUD-1 form at the closing. Should there be any discrepancies between the GFE issued prior to closing and the actual charges listed on the HUD-1 at the closing, the lender has 30 days from closing to correct the discrepancies by reimbursing the borrower.

The borrower, but not the seller, has the right to review the HUD-1 one (1) business day prior to the closing.

Lesson Four Review Quiz

- T F** 1. The three main people involved in the mortgage loan process are the loan officer/loan originator, the processor and the underwriter.
- T F** 2. The processor has the responsibility of verifying, organizing and compiling the relevant information for each loan applicant and of approving the loan application before sending it to Underwriting.
- T F** 3. It is the underwriter's job to certify that the borrower fits within the end lender's guidelines for the loan that he/she is applying.
- T F** 4. The loan officer is the one who makes the final decision as to whether or not the loan is approved.
- T F** 5. The "3 C's Of Underwriting" are: Credit reputation, Capacity, and Collateral.
- T F** 6. The commitment letter, given after the lender has reviewed the property's appraisal justifying the amount the lender is lending on the mortgage, is a "guarantee" that the mortgage will be given.
- T F** 7. A commitment letter may be a "firm" commitment or a "conditional" commitment.
- T F** 8. If there is a change in the Good Faith Estimate (GFE), there is then a new 3-day waiting period before the closing can take place.
- T F** 9. The closer functions as an uninterested third party in the transaction, working neither for the seller nor for the buyer.
- T F** 10. The Real Estate Settlement Procedures Act (RESPA) applies to all mortgages.
- T F** 11. The Uniform Settlement Statement (HUD-1) delineates all of the fees and charges that a borrower and/or a seller will be required to pay in order to close a loan.

Answers

1. T
2. T
3. T
4. F
5. T
6. F
7. T
8. T
9. T
10. F
11. T

IMPORTANT TERMS

Amortization: Describes the manner in which a loan is paid in full over a period of time using installment payments, detailing the amount of each payment that goes toward paying off interest and toward principal and allows the loan to be paid in full at maturity.

Annual Percentage Rate (APR): The actual rate of interest rate that a borrower pays for the mortgage by factoring into the cost the fees, point and any other items which must be paid to obtain the mortgage.

Appraisal: A report done by an appraiser that determines the value of the property on which the lender will be deciding to issue a mortgage. The appraisal aids the lender in deciding if the value of the property that secures the mortgage is enough to issue the mortgage.

Balloon Mortgage: A mortgage that begins with fixed, monthly installment payments for a specific number of years after which designated period, the remainder of the principal must be paid in full.

Buy-Down: Paying interest on a mortgage up-front by paying discount points in order to reduce the rate of interest being charged on the mortgage.

Caps: The limits set on the amount and frequency that interest can adjust on an adjustable rate mortgage.

Closing: The culmination of the purchase and loan process where the borrower signs the loan documents, receives title to the purchased property and pays the seller the purchase price.

Conforming Loan: A mortgage within a particular loan amount that meets Fannie Mae and Freddie Mac guidelines.

Conventional Mortgage: A mortgage that is not insured by FHA or guaranteed by VA and can be sold into the secondary mortgage market.

Credit Report: A report that looks at the credit history of a potential borrower and gives the lender an understanding of whether the borrower is able to accept the debt of the mortgage and is able and likely to repay the mortgage.

Debt-to-Income Ratio: The ratio between a borrower's gross monthly income and the borrower's monthly liabilities including debt service and housing costs.

Discount Points: Prepaid interest that a borrower pays in order to reduce the rate of interest on a mortgage. 1 discount point is equal to 1% of the loan amount.

Down Payment: Money that the borrower pays toward the purchase price of the property being purchased that is not a part of the mortgage loan being issued by the lender. The borrower's down payment and the lender-issued mortgage loan together comprise the total purchase price of the property.

Equal Credit Opportunity Act: A federal law prohibiting lenders from discriminating against consumers applying for credit based on race, religion, national origin, sex, age, marital status or dependence on public assistance.

Equity: The amount of interest or value that a borrower has in the property that is above the value of the mortgage value.

Federal Home Loan Mortgage Corporation: Freddie Mac-one of the largest purchasers of conventional mortgages on the secondary market.

Federal National Mortgage Corporation – Fannie Mae-one of the largest purchasers of conventional, FHA and VA mortgages in the secondary market.

FHA Loan: A mortgage loan insured by the Federal Housing Administration and requiring as low as 3.5% down payment.

Fixed-Rate Mortgage: A mortgage whose monthly payments and rate of interest will remain the same throughout the term of the loan.

Hazard Insurance: Insurance that the lender usually requires the borrower to purchase in order to insure the property being mortgaged against damage from fire, severe weather, etc

Jumbo Loan: A loan that is above the current amount limit acceptable to Freddie Mac and Fannie Mae and so cannot be sold to Freddie Mac or Fannie Mae.

Loan-to-Value: The percentage of the purchase price or value of the property being financed that the mortgage covers.

Mortgage: A voluntary lien placed on a property that is being offered as security for the repayment of a loan.

Mortgage Banker: A loan originator or a company who acts as an intermediary, is an individual, an institution or a company that originates mortgages and may use its own funds to close the mortgage in its own name or may choose to use the funds of an end investor.

Mortgage Broker: A loan originator or a company, who brings the borrower and the lender together to create a mortgage loan between them. Generally, a mortgage broker will represent or work with more than one lender

Mortgagee: The lender or bank issuing the mortgage.

Private Mortgage Insurance (PMI): Lender-required insurance on a mortgage in which the borrower does not have a minimum of 20% down payment.

Mortgagor: The borrower who is offering the property as collateral for the loan.

Negative Amortization: A condition that arises when the mortgage payments do not cover the amount of interest per payment, so instead of the monthly payments decreasing the principal amount of the loan, the interest that has not been paid is added on to the amount of principal and increases the amount the borrower owes.

Note: The written promise that the borrower will repay the mortgage with interest. It states the amount of the principal, the time and method by which the debt will be paid and the rate of interest that will be paid.

Origination Fee: The percentage of the loan amount that the lender or mortgage broker (whoever "originates" the loan) charges to originate and process the loan.

PITI: Stands for Principal, Interest, Taxes and Insurance that generally comprise the monthly mortgage payments

Points: The percentage of the loan amount that constitutes the origination fee.

Pre-Approval: Although not a commitment to a loan, the pre-approval gives the purchaser strength in making an offer on a property as the buyer can say that there is a mortgage company ready to give him/her a mortgage and all he/she needs to do is submit the application and the contract on the chosen property. The pre-approval is a written, conditional commitment from a mortgage lender or from a bank stating that the borrower is pre-approved by them for the financing sited in the approval.

Pre-Qualification: Generally, a first step in the mortgage process in which the borrower verbally provides the loan officer with information concerning his/her assets and liabilities, income and debt in order that the loan officer may ascertain how much the borrower can afford to purchase, as well as to ascertain the borrower's viability in receiving a loan.

Principal: The amount that is loaned not including interest, taxes or insurance.

VA Mortgage: A mortgage given to a qualified veteran and guaranteed by the Department Of Veterans Affairs.