Chapter 4 Summary
Real Estate Financing Principles: Real Estate Finance 1

Texas Real Estate Principles 2

The money to finance loans comes from a number of sources. The primary mortgage market is made up of lenders who originate loans. They make the money available directly to borrowers. The primary mortgage market is made of many different types of lenders.

A savings and loan association (aka “savings banks” or “thrifts) is a financial institution whose primary function is to promote thrift and home ownership. These institutions often offer their depositors a higher rate of interest on their deposits than commercial banks offer.

A commercial bank is a financial institution that is designed to act as a depository for funds and as a lender for commercial activities – usually short-term loans. Since this money can be withdrawn at any time by a depositor, the bank rarely uses these funds for mortgage lending. Commercial banks primarily do short term loans, including construction loans, home improvement loans, and manufactured housing loans.

Credit unions are nonprofit financial institutions into which members place their money, usually through direct deposit. Credit unions pay no income tax, so they can pay higher interest rates on deposits than other savings institutions. They also offer a wide variety of loans at far lower interest rates than their competitors. Credit unions make mostly short-term loans. When they do make real estate loans, they tend to be second mortgages or home improvement loans.

Life insurance companies hold a major portion of the savings of the American public. These companies are a major source of credit for shopping centers, office buildings, hotels and motels, industrial buildings and large apartment complexes.

The Real Estate Investment Trust (REIT) was formed with the goal of influencing small investors to combine their resources with others to raise venture capital for real estate transactions. REITs concentrate on income-producing properties and generally diversify their holdings both with regard to property type and geographical location. REITs prefer to target their lending activities towards land development projects and permanent financing for condominiums, high rises, warehouses, office complexes, single-family subdivisions and other major projects.

The loan departments act as mortgage bankers and can represent life insurance companies, real estate investment or mortgage trusts and, in some cases, other banks. When performing these activities, the bank will get an origination fee plus a percentage for servicing the account.

A mortgage broker is usually retained by a borrower to help obtain financing for a specific commercial property. Finding a suitable lender and arranging the loan entitles the broker to a commission or fee, which is paid by the borrower. Mortgage brokers rarely invest any of their own capital in a loan, so they are taking no risk of loss.

The secondary mortgage market consists of holding warehouse agencies that purchase a number of mortgage loans and assemble them into one or more packages of loans for resale to investors.

A mortgage is a financing instrument that creates a lien against a property. The lender who gives the money is the mortgagor, and the borrower who gives the mortgage is the mortgagor.
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There are a number of provisions that should be included in a mortgage document. They include:

- Identification of participants
- Property description
- Attachment of note
- Property taxes
- Insurance
- Preservation and maintenance of property
- Defeasance clause
- Acceleration clause
- Signatures and acknowledgement
- Prepayment penalty
- Due-on-sale clause

A monthly mortgage payment is generally made up of four parts: principal, interest, taxes and insurance.

- **The Principle** is the capital amount borrowed, on which interest payments are calculated. In an amortizing loan, part of the principal is repaid periodically along with interest, so that the principal balance decreases over the life of the loan. At any point during the life of a mortgage loan, the remaining unpaid principal is called the loan **balance**, or remaining balance.

- **Interest** is a charge for the use of the lender’s money. Interest may be paid in advance at the beginning of the payment, or in arrears at the end of the payment period, according to the terms of the note. Mortgage interest is most commonly paid in arrears.

- Consumers pay **taxes** to the government to cover public services, such as schools, police, fire and ambulance services.

- **Insurance** could include homeowner’s insurance, flood insurance and/or mortgage insurance.

If the purchaser defaults, the lender has the right to bring legal action through the courts to satisfy the debt via **foreclosure** – the process that leads up to selling the property that was pledged to secure the debt.

**Judicial foreclosure** allows the sale of the mortgaged property under the supervision of the court, with the proceeds going first to satisfy the mortgage, then other lien holders, and finally the borrower if any proceeds are left.

**Non-judicial foreclosure** is the process whereby the lender gives the borrower a notice of default (NOD) and the intent to sell the property in a form prescribed by that state’s statute.

A defaulting borrower who faces foreclosure may avoid court actions and costs by voluntarily deeding the property to the mortgagee. This is accomplished with a **deed in lieu of foreclosure**, which transfers legal title to the lender. The transfer, however, does not terminate any existing liens on the property.

The borrower’s **right of redemption**, also called equity of redemption, is the right to reclaim a property that has been foreclosed by paying off amounts owed to creditors, including interest and costs.

If the sale does not yield sufficient funds to cover the amounts owed, the mortgagee may ask the court for a **deficiency judgment**. This enables the lender to attach and foreclose a judgment lien on other real or personal property the borrower owns.
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In order to increase their investment, lenders often charge other fees when the borrower gets the loan, including:
- Loan origination fee
- Points or Discount points

In addition to paying the mortgage, the borrower (mortgagor) has several responsibilities during the mortgage term, including:
- Keeping the property in good repair.
- Pay all the property taxes and any assessments in a timely manner.
- Protect the property from loss due to fire or other untimely disaster by purchasing or maintaining the appropriate insurance.

Buyers can find out how much of a loan they can qualify for in one of two ways:
- Prequalification -- an informal process that can be done by a real estate agent or lender by asking a series of questions about their financial status and then establishing a price range for the home buyer(s).
- Preapproval -- a formal process that can only be done by the lender which requires the buyers to fill out a loan application and give the lender all of the same documentation required when applying for a loan after finding a home. A letter is then issued by the lender which states the maximum amount that will be lent to the buyers.

Being preapproved will make buyers more attractive to sellers and will make closing go more smoothly.

Lenders qualify buyers using what are called qualifying standards or loan underwriting standards. When a lender is processing a loan, there are four critical procedures involved. The lender must:
- Determine the ability of the borrower to repay the loan.
- Estimate the value of the property that is collateral for the loan.
- Research and analyze the marketability of the title.
- Prepare the documents necessary to approve the loan and close the transaction.

The evaluation process used to determine the borrower's ability to repay a loan and estimating the value of the property being used as collateral is called underwriting. To qualify for a mortgage loan, a borrower must meet the lender's qualifications in terms of income, debt, cash, and net worth.

Several types of repayment plans exist, including:
- Straight (interest-only) -- monthly payments allocated to interest. At the end of the term, the borrower must be able to pay off the entire principle or get another loan.
- Amortized -- fixed-interest, long-term loans of 15 or 30 years. At the end of the loan term, the full amount of the principal and all of the interest is totally paid off and the balance is zero.
- Balloon payment -- loan that has one large final payment due when the loan matures.
- Adjustable-rate -- a good option for short-term borrowers, adjustable rate mortgages, are made up of: index, margin, calculated rate or note rate, initial rate, adjustment period, mortgage payment adjustment period, interest rate caps, payment cap, and negative amortization cap.

Advantages of conventional loans over government-backed loans:
- Conventional loans are processed more quickly.
- Conventional loans have fewer forms and can be more flexible.
- There is no legal limit on loan amounts.
- Borrowers can seek out other lenders in case of refusal.
Disadvantages of conventional loans include:
- Higher down payments.
- Loans carry prepayment penalties.

The **conventional mortgage** is the most common type of loan and is generally viewed as the most secure. Most conventional loans require the borrower to make a down payment of 20% or more, making the loan 80% or less of the property's sale price. Conventional loans are typically uninsured. The mortgage itself provides the only security for the loan.

Most conventional loans have traditionally been designed as **fixed-rate loans**. With this common type of mortgage program, the monthly payments for interest and principal never change. Property taxes and homeowners insurance may increase, but generally the monthly payments will be very stable.

**Fixed rate mortgages** are available for a number of different loan terms. Fixed-rate fully amortized loans have two distinct features:

1. The interest rate remains fixed for the life of the loan.
2. The payments remain level for the life of the loan and are structured to repay the loan at the end of the term.

A **private mortgage insurance program** (PMI) insures the top 30% of a loan, protecting the lender in case the borrower defaults on the loan. By doing so, the lender passes the cost to the borrower by charging a fee at closing plus an additional monthly fee while the insurance is in force. The PMI payments will terminate once the loan has been repaid to a certain level.

For buyers who may not be able to qualify for a standard fixed-rate mortgage, there are other options that can put a conventional loan within their reach. They are:

- A **graduated payment mortgage (GPM)** where the monthly payment for principal and interest gradually increases by a certain percentage each year for a certain number of years and then it levels off for the remaining term of the mortgage.

- A **pledged account mortgage (PAM)** is a type of graduated payment mortgage under which the owner/borrower contributes a sum of money into an account that is pledged to the lender. The account is drawn on during the first three to five years of the loan to supplement the periodic mortgage payments, thereby reducing the borrower's monthly payments in the initial years. Once the account is empty, the borrower makes the full mortgage payment.

- A **buydown** is a variation of the PAM. In a buydown, the lump sum payment that is made to the lender at closing usually comes from a builder as an incentive to the buyer or from a family member trying to help out. That payment serves to reduce the interest rate on the loan for the first few years. At the end of that time, the rate rises.

- An **open-end loan** is an expandable loan which gives a borrower a limit up to which he or she may borrow. Each incremental advance must be secured by the same mortgage and any advances may not exceed the original borrowing limit.

- A **blanket mortgage** loan covers more than one piece of property. Land developers commonly use blanket mortgages when they buy a plot of land and divide it into many separate lots.
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A wraparound mortgage allows a borrower who has an existing loan to get another loan from a second lender without paying off the first loan. The second lender issues a new larger loan to the borrower at a higher interest rate. The new loan is a combination of the first loan and the second loan. The borrower makes the new higher payments to the second lender and then the second lender pays the first lender out of those funds.

A bridge loan is a short-term loan that covers the period between the end of one loan and the beginning of another. Bridge loans are typically used to cover the time period between the end of a construction loan and the issue of a permanent loan on a property and when a person needs to borrow money on his or her unsold home to fund the acquisition of a new home.

A purchase money mortgage is most commonly a technique in which the buyer borrows from the seller in addition to the lender. The purchase money mortgage is created at the time of the purchase and delivered at the time the property is transferred as part of the sale transaction. This is sometimes done when a buyer cannot qualify for a bank loan for the full amount, so the seller “takes back” a portion of the purchase price as a second mortgage.

Lenders give construction mortgages to finance the construction of improvements to property, such as homes, apartments and office buildings. The lender commits to the full amount of the loan, but disburses payments over the life of the construction project.

Home Equity Loans occur when owners borrow against the equity they have built up in their home. Homeowners can use a home equity loan for purchasing high dollar items, consolidating other loans or debt, medical expenses, college tuition or making home improvements.

A package mortgage is one that includes all the personal property and appliances that are installed on the property. This type of loan has been used extensively in the sale of furnished condominiums.

A reverse annuity mortgage is quite different from the others. With a reverse annuity mortgage, the lender is making payments to the borrower. This system allows older property owners to receive regular monthly payments from the equity in their paid-off property without having to sell. The borrower pays a fixed rate of interest and then repays the loan either when the home sells or from the borrower’s estate upon his or her death.

A shared equity mortgage is a form of participation mortgage in which the lender shares in the appreciation of a mortgaged property if and when the property sells. The borrower agrees to the lender’s participation in the income, inducing the lender to make the loan. This is more common with commercial properties, but can also be done with residential mortgages.

The sale and leaseback arrangement is typically used by commercial enterprises to free up money that has been tied up in the real estate to use as working capital in the business. The owner of the real estate sells the property and then leases it back from the buyer. The buyer becomes the owner and the former owner becomes the tenant.