Unit 12: Real Estate Financing

LECTURE OUTLINE

I. Housing Affordability—Homeownership involves substantial commitment and responsibility

   A. Decision to rent or buy involves considering:

      1. How long resident will live in area
      2. Personal financial situation
      3. Housing affordability
      4. Interest rates
      5. Tax implications
      6. Impact of changes in home prices and tax laws

   B. Mortgage terms—interest rate may be favorable or unfavorable for buyers; government-sponsored programs may offer favorable terms

   C. Ownership expenses and ability to pay
      1. PITI (principal, interest, taxes, insurance)
      2. Credit score—FICO score
      3. DTI (debt-to-income ratio)

II. Promissory Note

   A. The borrower's personal promise to repay the debt

      1. Will contain the amount of the debt, the time and method of payment, and the rate of interest
      2. Is a negotiable instrument held by payee, who may transfer right to future payments by

         a. Signing the instrument over (assigning it) to third party
         b. Delivering the instrument to the third party

   B. Interest

      1. A charge for the use of money
      2. May be due at the end of each payment period—interest in arrears (the normal method of interest payment)
      3. May be due at the beginning of each payment period—interest in advance

4. Usury is charging interest at maximum rate allowed by law—federal law exempts federally related residential first mortgage loans from state usury laws.

C. Loan origination fee—expense that is paid to the lender to cover expenses in generating the loan; can vary, but typically around 1% of the loan amount

D. Discount points

1. Used to increase the yield (true rate of interest) required by an investor who would purchase a loan
2. Number of points determined by:

   a. Difference between the interest rate and required yield
   b. Length of time lender expects borrower to pay off loan

3. One discount point equals 1 percent of the loan amount.
4. Calculating discount points and investor yields

E. Prepayment penalty possible within first few years of loan term, if part of mortgage agreement

1. Borrower may pay off loan in full at any time before the end of the term of the loan or make additional payments of principal during the term.
2. Penalties may be assessed by the lender to compensate for unearned interest when a loan is paid in full prior to the scheduled end of the loan term.

   a. Prepayment penalties may be regulated by state law.
   b. Prepayment penalties are prohibited on mortgage loans insured or guaranteed by the federal government or sold to Fannie Mae or Freddie Mac.

III. Security Instrument—mortgage loans are secured loans that consist of the debt itself (promissory note) and the security for the debt (mortgage or deed of trust)

A. Hypothecation—pledging property as collateral without giving up its possession

B. A mortgage is a voluntary lien on real estate, given by the *mortgagor*, to secure the payment of a debt or the performance of an obligation to the *mortgagee*.

1. *Mortgagor = owner/borrower; mortgagee = lender*
2. Title theory—the borrower transfers legal title and retains equitable title. Legal title is returned to the borrower upon full payment of the debt.

3. Lien theory—the mortgagor retains both legal and equitable title. The mortgagee has only a lien on the property as security for the debt. If the mortgagor defaults, the lender must go through foreclosure proceedings to obtain legal title. (See Figure 12.1)

C. Deed of trust—similar, but not identical to, a mortgage (See Figure 12.2)
   1. Creates a three-party agreement that conveys "naked title" or "bare legal title" to a third party (the trustee) who has certain obligations to the lender (the beneficiary); the borrower is the trustor.
   2. Generally provides simpler and faster foreclosure than a mortgage and can be used to secure multiple promissory notes.

D. Duties of the borrower

   1. Payment of the debt in accordance with the terms of the note.
   2. Payment of real estate taxes.
   3. Maintenance of adequate insurance to protect the lender's interest in the property.
   4. Maintenance of the property to keep it in good repair.
   5. Lender authorization before making major alterations.

E. Provisions for default

   1. The lender may accelerate the maturity of the debt in case of default (*acceleration clause).*
   2. The lender can step in to pay the real estate taxes or insurance, or physically repair or maintain the property.

F. Assignment of the mortgage

   1. The note can be sold to a third party.
   2. The securing mortgage or deed of trust will be assigned with the note to its purchaser.
   3. When debt paid in full (satisfied), assignee is required to execute the satisfaction (release) of the security instrument.

G. Release of the mortgage lien or deed of trust

   1. Mortgage—the defeasance clause requires the execution of a satisfaction of mortgage (release of mortgage or mortgage discharge) when the note has been paid.
   2. Deed of trust requires the execution of a release deed or *deed of reconveyance.*

H. Tax and insurance reserves

1. Required for some mortgages by the lender; called reserve fund, impound, or escrow account.
2. Accounts set up for real estate taxes and insurance premium.
3. Federal regulations limit the amount that can be held as reserves.
4. Flood insurance reserves, if applicable

I. Buying "subject to" or assuming a seller's mortgage or deed of trust

1. "Subject to" the following:

    a. The purchaser is not personally liable for the debt.
    b. In the event of a foreclosure, the purchaser is not personally liable for a deficiency.

2. Assumption

    a. The purchaser is personally liable for the debt.
    b. In the event of a foreclosure, the purchaser may be held liable for any deficiency.
    c. Unless specifically released by the lender, the original borrower may also be liable for the debt or any deficiency.
    d. Loan may not be assumed in many cases without lender approval, requiring assumer to qualify.

3. Alienation clause

    a. Also called a resale clause, due-on-sale clause, or call clause; prevents future purchaser from being able to assume the loan.
    b. When the property is sold, the lender can declare the entire debt due immediately.
    c. The lender can change the interest rate to the market rate.

J. Recording mortgage or deed of trust

1. Recorded in the county where the property is located
2. Gives constructive notice of the debt
3. Establishes lien's priority

K. Priority of mortgage or deed of trust

1. Priority is established by the date and time of recordation.
2. Generally, the loan for the purchase is the first lien.
3. Subsequently recorded loans are second mortgages (junior liens).

4. Lien priorities can be changed with *subordination* agreements.

IV. Types of Loans

A. Straight loan (interest-only)

1. Periodic interest only payments
2. Payment of principal in full at end of term

B. Amortized loan—each payment pays interest accrued and partially pays off principal

C. Adjustable-rate mortgage (ARM)—rises or falls based on index to which is added margin; rate caps limit amount interest rate can be increased.

D. Growing-equity mortgage (GEM)—also called rapid-payoff mortgage, with fixed interest rate and increasing principal payments

E. Balloon payment loan—has final payment larger than others

F. Reverse mortgage—allows homeowner aged 62 or older to borrow money against equity in home

V. Foreclosure—the legal procedure in which the property pledged as collateral is sold to satisfy the debt; all junior liens are eliminated.

A. Methods of foreclosure—provisions vary from state to state

1. Judicial foreclosure—the property may be sold by court order.
2. Nonjudicial foreclosure used when a power-of-sale clause is contained in the security document.
3. Strict foreclosure—after proper notice is given and the defaulted debt remains unpaid, the court awards legal title to the lender.

B. Deed in lieu of foreclosure

1. Sometimes called a "friendly foreclosure"
2. The borrower forfeits any equity in the property and deeds it to the lender; lender must be willing to accept the deed.
3. Any junior liens remain and become the lender's liability.
4. Lender loses any rights pertaining to FHA, private mortgage insurance, or VA guarantees.

C. Redemption (see Figure 12.4)

1. Provides the opportunity for a defaulting borrower to redeem the property.
2. Equitable right of redemption—any time before the foreclosure sale, the defaulted borrower can bring the debt current and have it reinstated.
3. Statutory right of redemption—the specific period allowed for redemption after the foreclosure sale; state laws vary widely.

D. Deed to purchaser at sale

1. Given after any redemption period has expired.
2. Executed by a sheriff, officer of the court, or trustee.
3. Deed conveys whatever title the borrower had.

E. Deficiency judgment

1. Issued to cover any difference between the amount received at the foreclosure sale and the principal balance owed.
2. Becomes a judgment against the debtor.
3. Some states prohibit a deficiency judgment on a purchase money loan for the borrower's principal residence.

F. Short sale

1. Sales price is less than remaining debt.
2. Lender must approve.
3. Must be disclosed.

VI. Consumer protections—Dodd-Frank Act mortgage disclosure rules

A. Homeowners insurance

1. Basic form
2. Broad form
3. Comprehensive Loss Underwriting Exchange (CLUE)

B. Federal Flood Insurance Program

1. Required if property is in a special flood hazard area (SFHA)

2. Should be considered for property in all coastal states subject to hurricanes or any state through which major rivers run.

3. What's covered by flood insurance—FEMA defines a flood as a general and temporary condition of partial or complete inundation of two or more acres of normally dry land or two or more properties from:

   a. Overflow of inland or tidal waves;
   b. Unusual and rapid accumulation or runoff of surface waters;
   c. Mudflows or mudslides on the surface of normally dry land; or
   d. Collapse of land along the shore of a body of water under certain conditions.

4. Policies are of two types:

   a. RCV—replacement cost value
   b. ACV—actual cost value