Unit 13: Government Involvement in Real Estate Financing

***LECTURE OUTLINE***

I. Introduction to the Real Estate Financing Market

A. Federal Reserve System

1. Created to help maintain sound credit conditions.

2. Helps counteract inflationary and deflationary trends.

3. Attempts to create a favorable economic climate.

4. Divides country into 12 Federal Reserve districts.

5. Regulates the flow of money and interest rates.

a. Sets bank reserve requirements.

b. Controls bank discount rates, which influences the prime rate charged by banks.

B. The primary mortgage market—lenders that originate mortgage loans

1. Income generated for lender

a. Finance charges—loan origination fees and discount points

b. Recurring income—interest collected during term of the loan

2. Selling loans

a. Generates funds to make new loans

b. Servicing loans provides income to lender—collecting payments, accounting, bookkeeping, processing payments of taxes and insurance, and following up on delinquencies

3. Major lenders of home mortgage and commercial property loans:

a. Savings associations (thrifts) and commercial banks—fiduciary lenders subject to regulations set by government agencies

b. Insurance companies—investments such as long-term commercial real estate loans

c. Credit unions

i. Cooperative organizations that require membership to borrow

ii. Have become active in making long-term first and second mortgage loans

d. Pension funds

i. Becoming more active in making long-term first and second mortgage loans

ii. Funds channeled through mortgage bankers and mortgage brokers

e. Endowment funds

i. Rely on commercial banks and mortgage bankers to handle investments

ii. Source for financing low-risk commercial and industrial property

f. Investment group financing

i. Very popular for large real estate projects

ii. Funds come from sources such as partnerships and real estate investment trusts.

g. Mortgage banking companies

i. Originate real estate loans using funds borrowed from others as well as their own funds

ii. Often serve as intermediaries between investors and borrowers, but not as mortgage brokers

iii. Generally service a loan once it has been made

iv. Are usually organized as stock corporations

v. Are usually subject to fewer restrictions than commercial banks and savings association

h. Mortgage brokers

i. Act as intermediaries between borrowers and lenders

ii. Locate borrowers, process loan applications, and submit them to lenders

iii. Do not service the loan once it has been made

iv. Consult state's laws regarding licensure and registration of mortgage brokers

4. Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act)

1. Requires states to license mortgage loan originators
2. Requires all state agencies to participate in Nationwide Mortgage Licensing System and Registry (NMLS)
3. All mortgage loan originators (MLOs) must register annually and meet other requirements

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

1. The originating lender may service the loan for a fee.

2. Government-sponsored enterprises (GSEs)—purchase real estate loans and then assemble them into securities for sale to investors (see Figure 13.1)

a. Fannie Mae

i. Deals in all real estate loans, including FHA, VA, and conventional

ii. Buys block or pool of mortgages from a lender which are used as collateral for mortgage-backed securities which are sold on a global market

b. Freddie Mac

i. Provides a secondary market primarily for conventional loans

ii. Sells mortgage-backed securities like Fannie Mae

c. Farmer Mac

i. Federal Agricultural Mortgage Corporation

ii. Secondary market for agricultural mortgage and rural utilities loans, as well as agricultural and rural development loans guaranteed by U.S. Department of Agriculture (USDA)

d. Ginnie Mae

i. Exists as a division of HUD

ii. Administers special assistance programs for real estate loans

iii. Guarantees mortgage-backed securities issued by private offerors and backed by pools of FHA and VA loans

iv. Issues Ginnie Mae pass-through certificates, which provide a security interest in a pool of mortgages

II. Loan Programs

A. Loans are classified based on the loan-to-value ratio.

1. Value based on the sale price or appraisal, whichever is lower.

2. The lower the ratio of debt to value, the higher the down payment; a more secure loan minimizes lender’s risk.

3. Math Concept: Determining LTV

B. Conventional loans

1. Loan-to-value ratios are often lowest; borrower may make significant down payment.

2. Security for the loan is provided solely by the mortgage.

3. Payment of debt rests solely on the ability of the borrower to pay based on the borrower's

a. creditworthiness as indicated by credit reports,

b. amount of income, and

c. amount of existing outstanding debt.

4. Federal Housing Finance Agency (FHFA) publishes maximum loan limits for conventional loans that will be sold to Fannie Mae and Freddie Mac

C. Private mortgage insurance (PMI)—provides additional security for lender when down payment is less than 20% of purchase price

1. Borrower pays insurance premium with every payment.

2. PMI should be dropped automatically when borrower’s equity reaches 22% and borrower is current on mortgage payments, as required by Homeowner’s Protection Act of 1998 (HPA).

D. FHA-insured loans

1. FHA—part of the Department of Housing and Urban Development (HUD).

2. FHA insures real estate loans made by approved lending institutions.

3. Most common program covers fixed-rate loans for 10 to 30 years for one-to four-family residences.

a. Borrower or someone else pays up-front mortgage insurance premium (MIP) in cash or it may be financed.

b. The property must be appraised by an FHA-approved appraiser.

c. FHA sets maximum loan amounts.

d. Consult local lenders for current loan requirements.

4. Discount points may be charged by lender, to be subject of seller/buyer negotiation

5. As of December 15, 1989, assumption requires buyer qualification

6. HUD Home sales—Foreclosures of FHA-insured home by HUD

E. VA-guaranteed loans

1. The Department of Veterans Affairs (VA)

a. Authorizes the guarantee of home loans for eligible veterans and spouses

b. Sets the minimum service times of 90 days, 181 days, or two years, depending on the calendar dates of service

c. Reservists who do not otherwise qualify are also eligible if they have six or more years of continuous service.

d. 90 days of active service in the National Guard, with 30 days as specified, also qualifies an applicant

2. VA guarantees real estate loans made by approved lending institutions.

3. Financing provisions

a. Veteran applies for a certificate of eligibility

b. There is no limit on the amount of the loan as of 2020

c. VA guarantee applies 25% of the amount borrowed

d. The VA issues a certificate of reasonable value (CRV), which is the VA-approved appraisal

i. To indicate the property's maximum value for guarantee purposes

ii. If property appraises for less than the sales price, veteran can make a down payment in cash to make up the difference between the appraisal and sales price

4. Costs

a. Loan origination fee paid to lender

b. Funding fee charged by VA, with exemption for

i. veteran with service-connected disability or

ii. surviving spouse of veteran who died in service or from a service-connected disability

c. Discount points can be paid by the veteran or seller

d. Total closing costs for veteran (including VA funding fee) cannot exceed 4% of loan amount, but discount point are excluded from that calculation

5. Prepayment privileges—can prepay without any penalty

6. Assumption no longer possible with a VA-guaranteed loan without prior consent of the lender.

F. Agricultural Loan Programs

1. Farm Service Agency (FSA)a federal agency of the Department of Agriculture

a. Provides loans to help purchase or improve properties in rural areas, primarily farms and single-family residences.

b. Has guaranteed loan programs as well as a direct loan program.

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

a. Does not take deposits.

b. Raises funds through the sale of bonds and notes.

III. Other Financing Techniques

A. Package loan

1. One loan covers both real and personal property

2. Usually used in new home sales to include the financing for floor and window coverings, major appliances, and other similar items

B. Blanket loan

1. One loan secured by multiple parcels of property as collateral.

2. Usually used in the financing of subdivision developments.

3. A partial release clause enables borrower to get a release of one of the parcels while the lien remains in place on the other parcels.

C. Open-end loan

1. Secures a note for a current loan and for any future advances.

2. Allows a borrower to "open" the loan to increase the debt back to its original amount.

D. Construction loan—short-term or interim financing

1. Periodic payments to the general contractor or owner to pay for construction that has been completed since the last payment, often called "draws".

2. Lender inspects work before each payment.

3. Made to the general contractor at predetermined progress points.

4. Paid off and replaced by a permanent or "take out" loan when the work is completed.

E. Sale-and-leaseback

1. The seller sells the property and leases it back, receiving cash while retaining the use of the property; becomes the tenant.

2. The buyer receives the income from the rent and an ideal tenant; becomes the landlord.

F. Buydown

1. Some of the buyer's future interest paid in advance to the lender by the seller or some other individual.

2. Used frequently by home builders as an incentive to buyers.

G. Home equity loan

1. Usually junior to the loan obtained to purchase the property.

2. Can be a home equity line of credit (HELOC) or a fixed amount.

3. Interest paid on a home equity loan of up to $100,000 is tax deduction.

IV. Financing Legislation

A. Truth-in-Lending Act and Regulation Z—enforced by Consumer Financial Protection Bureau (CPB)

1. Requires lenders to disclose to borrowers the true cost of obtaining credit so that interest rates among lenders can be compared.

2. Always applies when a residence collateralizes the loan.

3. Does not apply to agricultural loans or business or commercial loans.

4. The consumer must be fully informed of all financing charges, including loan origination fees, finders' fees, service charges, discount points, and interest charges.

5. The lender must compute and disclose the annual percentage rate (APR)the true cost of the financing to be obtained.

6. For purposes of Regulation Z, a creditor is defined as one who

a. extends consumer credit more than 25 times a year or more than 5 times a year if the transaction involves a dwelling as security, and

b. subjects the credit to a finance charge or contracts for payments in more than four installments.

7. Three-day right of rescission

a. Applies to most Regulation Z consumer credit transactions.

b. Does not apply to owner-occupied residential purchase-money or first mortgage or deed of trust loans; does apply to refinances.

8. Advertising for real estate financing

a. Must give the annual percentage rate (APR).

b. APR must include the total finance charges.

c. If any specific loan terms (trigger terms) are mentioned, all terms must be included, such as the cash price; required down payment; number, amounts, and due dates of all payments; and the annual percentage rate.

9. Penalties for noncompliance

a. Liability to the consumer for twice the amount of the finance charge with a $400 minimum and a $4,000 maximum.

b. Court costs, attorneys' fees and actual damages.

c. Class action creditors liable for punitive damages of the lesser of $500,000 or 1% of creditor’s net worth.

d. For willful violations, up to a $5,000 fine or one year in prison or both.

B. Equal Credit Opportunity Act (ECOA)

1. Prohibits lenders and those who grant or arrange credit to consumers from discriminating on the basis of the following:

a. Race

b. Color

c. Religion

d. National origin

e. Sex

f. Marital status

g. Age (provided the applicant is of legal age)

h. Receipt of public assistance

2. Lenders and creditors must inform rejected credit applicants, in writing within 30 days, why credit was denied or terminated.

3. ECOA also requires that a borrower is entitled to a copy of the appraisal if the borrower paid for the appraisal.

C. Community Reinvestment Act of 1977 (CRA)

1. Financial institutions are expected to meet deposit and credit needs of their communities and participate in development and rehabilitation projects and loan programs.

2. Law requires statement by regulated financial institutions

a. Defining geographic boundaries of community

b. Identifying type of community reinvestment credit offered

c. Including comments from the public about lender’s performance in meeting community needs

D. Real Estate Settlement Procedures Act (RESPA)created to provide the parties to a residential real estate transaction involving new financing with disclosure of all settlement charges (see Unit 14)

E. Automated underwriting and scoring

1. Automated underwriting procedures shorten loan approval times

a. Lower cost of application.

b. Reduce lender’s time on approval process.

c. Strengthen buyer’s offer to purchase by including proof of loan approval.

2. According to Freddie Mac, the loan applicant’s credit score is a factor to consider, but the loan decision should be subject to human judgment.