MAKE YOUR MORTGAGE MATTER

Control Home Financing to Increase Financial Stability and Wealth

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Published by HOH Logistics LLC | www.hohlogistics.com | Plano, Texas

Library of Congress Control Number: 2025901396

ISBN: 979-8-9924383-0-7 (eBook)
ISBN: 979-8-9924383-1-4 (Paperback)
ISBN: 979-8-9924383-2-1 (Hardback)

1. Business & Economics – Real Estate - Mortgages – United States
2. Business & Economics - Personal Finance – Budgeting-United States
3. Business & Economics - Industries - Financial Services – United States
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Printed in the United States of America

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PART 1: HOUSING AFFORDABILITY

"Most men appear never to have considered what a house is, and are actually though needlessly poor all their lives because they think that they must have such a one as their neighbors have."

-Henry David Thoreau
WALDEN

1. The Cost of Shelter

It's a trap! The American Dream is not "to own a home."

Life, liberty and the pursuit of happiness is the dream America offers to its citizens. Owning a home may indeed offer a pathway to a better life, economic liberty and financial happiness. This is true primarily because mortgages routinely offer a natural person the most leverage of their money. How to make the best use of that concept will be made in the third and final part of this book.

First, it must be understood that owning a house can be a trap. Anyone who has owned a house would likely agree with Thoreau who observed in 1854 that it is usually a tremendous financial burden. It can be a nightmare as much as a dream. Acknowledging and preparing for the expenses of homeownership is the immediate goal.

Secondly, it must be explained how to successfully navigate the mousetrap to get to the cheese. The primary intention of this mortgage book is to explain how to properly finance a house in ways best suited for financial success. Part 2 is a complicated section but of utmost importance, suggested to be read twice even by industry professionals. The details and subtle nuances between the endless mortgage configurations are what will determine if you are swallowing processed cheese or savoring a delicate brie.

A trap is usually set by distraction and disguise. Housing affordability has most recently been incorrectly referred to as it might relate to a person's ability to save for or have a down payment. The down payment is a function of how much leverage can be applied to purchase a home. With a standard 20% down payment, the leverage is 5:1, where $1 buys you $5 of house. With only a 5% down payment, the leverage is 20:1. The result is most often likely the opposite of making the house more affordable as it results in a larger mortgage and monthly payment.

This notion that the down payment is the key to housing affordability is incorrect as it pertains to a one-time event to purchase a house while ignoring the cost of keeping that house.

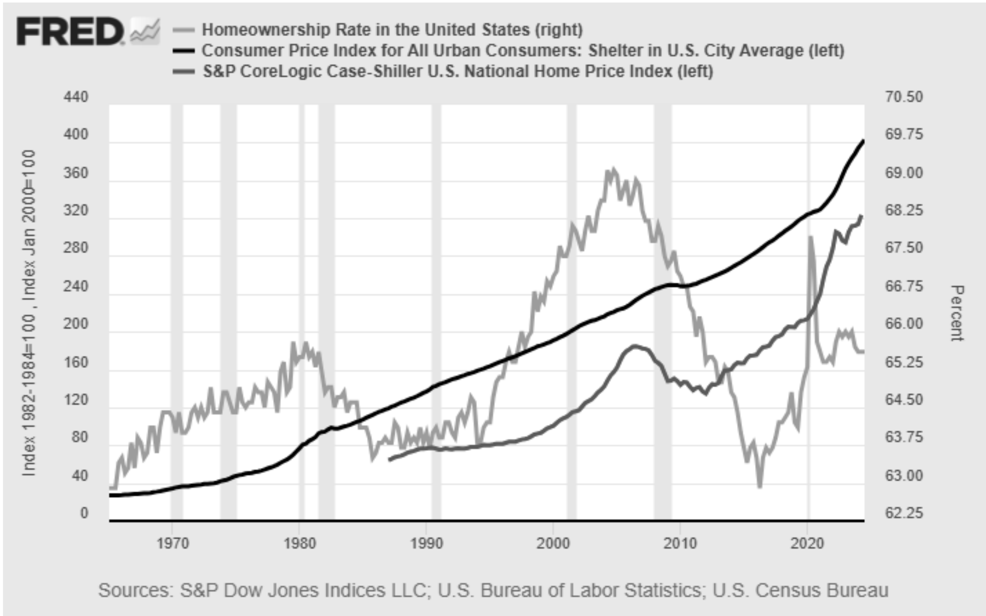
For instance, if a person were to be provided a house for free, the owner still must be able to afford the ongoing costs of ownership. It is similar to suggest that to rent an apartment a deposit, such as the standard first and last months' rent, is no longer required. But the renter still must be able to afford the rental payments each and every month.

Even when a house is owned free and clear of any mortgages or other liens, annual property tax payments are required to avoid the house being foreclosed upon by the municipality. And although homeowners insurance on a property that is owned outright is not required, it would be foolish to not pay that annual expense and risk the house burning down.

More traditionally and accurately, housing affordability is measured as a percentage of income that is applied toward the cost of shelter. In its simplest form, it is a rent payment.

One component of the U.S. Bureau of Labor Statistics Consumer Price Index is Shelter, as measured by two sub-components, the rent of a primary residence and owner's equivalent rent of residences. (Consumer Expenditures and Income: Overview, 2022) Since 1965, the cost of Shelter has risen by 1,500%. Since 1987, home prices have risen fivefold, as measured by the S&P CoreLogic Case-Shiller National Home Price Index. Yet the rate of home ownership in the United States has been in a range between 63% and 69% since 1965. Just fewer than 63% of households owned a house as recently as 2016. The percentage in 2024 was again about the same as 1980. (See Exhibit 1-1)

Exhibit 1-1



(U.S. Bureau of Labor Statistics, 2024) (S&P Dow Jones Indices LLC, 2024) (U.S. Census Bureau, 2024)

No different than providing student loans and grants to anyone that raises their hand has driven up the cost of a higher education, increasing the borrowing capability for a house has done more to increase home prices than to increase home ownership. Inflation has a lot to do with these increases, too. But, unfortunately, increasing the availability of mortgages has produced the unintended consequence of making home ownership arguably less affordable.

Research published by the Department of Housing and Urban Development clearly conveys the idea that increasing the percentage of income acceptable to be used toward shelter has a negative effect on consumers as would be expected. (U.S. Department of Housing and Urban Development Office of Policy Development and Research, 2017) Housing programs in the United States have long measured housing affordability in terms of percentage of income. In the 1940s, the maximum affordable rent for federally subsidized housing was set at 20 percent of income, which rose to 25 percent of income in

1969 and 30 percent of income in 1981. Over time, the 30 percent threshold also became the standard for owner-occupied housing, and it remains the indicator of affordability for housing in the United States. Keeping housing costs below 30 percent of income is intended to ensure that households have enough money to pay for other nondiscretionary costs; therefore, policymakers consider households who spend more than 30 percent of income on shelter to be housing cost burdened.

This same 2017 article by the HUD confirms that spending more than 30% of income on housing is detrimental to family finances. Yet less than a decade later, the same HUD continues to allow up to 50% of pre-tax income to be spent on a mortgage payment. If spending more than 30% on shelter is considered “housing cost burdened” then certainly 50% must be more burdened. Thoreau’s observation in 1854 of homeowners being “needlessly poor” is likely to apply today to borrowers that borrow the most allowed rather than the most they can afford.

Additionally, this maximum 50% of income only considers the mortgage principal and interest, property taxes, homeowners insurance and association dues. This disregards many other costs that first-time home buyers have likely not considered.

The mortgage payment will be discussed thoroughly in Part 2. But first it is important to establish the other costs associated with owning a house. Without consideration, buyers might immediately be encumbered with expenses that exceed their means. In other words, they may not be able to afford those costs of which many will be unavoidable, required, and perhaps unforeseen.

PART 2: MORTGAGE FAVORABILITY

> *"From a money making point of view the only criterion for playing is whether you're a favorite in the game or an underdog. If you're a significant favorite, then it's a good game, and you should stay in it; if you're an underdog, then it's a bad game which you should quit."*
>
> -David Sklansky
> THE THEORY OF POKER

13. The Definition of Mortgage

A mortgage is a loan to a borrower, the mortgagor, provided by a lender, the mortgagee. What specifically makes a mortgage different than other loans is that it involves real estate as collateral. A mortgage has two parts. First, the borrower gets a loan of money with an obligation to repay but also the right to repay any amount or all of the remaining balance of that loan at any time. The second part of the mortgage is the borrower's pledge of real estate, where the borrower grants the lender the right to seize and sell the property if the borrower fails to repay the loan as promised. (Fabozzi, The Handbook of Mortgage-Backed Securities, 2001, 1995)

There are really three contractual agreements that work in conjunction with each other. First, the mortgage, the agreement to offer real estate collateral in exchange for a loan. Second, the promissory note defining the specific loan amount, interest rate, and repayment terms. Third, the deed of trust, which allows the lender to place a title lien on the real estate property, prioritizing their right to recoup the balance of the loan amount and any expenses involved in doing so if the borrower defaults on the promissory note.

It is not at all the intention nor the desire of a lender to foreclose on the property, the process of seizing and selling as granted by the deed of trust. The lender is really a middle man who almost always sells the mortgage to an investor. The investor truly only ever wants the return of their money along with the promised interest rate of the loan.

The business of a foreclosure is the job of the loan servicer, to whom the mortgage payment is made by the borrower. The servicer is the bill collector and when the payments cease to be made, they are responsible for getting as much of the investor’s money back as possible. But they do not guarantee any amount.

In the event of a foreclosure, the servicing company first recoups the costs accumulated throughout the liquidation process. Servicing companies incur numerous large expenses as they are generally mandated through their contractual agreement with the promissory note holder to do many things to limit capital losses. These may include but are not limited to considerable outreach to the borrower in an attempt to cure any delinquent payments (when 30 days past due), seeking to mitigate losses when a default is triggered (generally when a payment is more than 90 days late) by offering the borrower a reasonable plan to avoid foreclosure with a loan modification or other remedy, legal costs to foreclose when necessary, paying the property taxes and homeowners insurance when due, property maintenance, and advancing unpaid but scheduled principal and interest payments to the note holder. Next, the senior lien holder (typically the first mortgage lender) gets back the remaining principal balance of their loan, then any junior lien holders in order of when they placed their liens, and the remainder of money left over, if any, goes to the borrower. This is true at the time of any sale whether it is forced or not.

As an example, let's say a home was purchased for $500,000 with a down payment of $100,000 and a mortgage of $400,000. After a few years the value goes up to $550,000 and the balance is paid down to $390,000. But then, unfortunately, the borrower loses their job and becomes delinquent on the promissory note payments. As a result, and despite all efforts to avoid the inevitable, a foreclosure ensues forcing out the borrower and the loan servicing company hastily sells the property for $525,000 less 6% to the realtors, $493,500. The servicing company billed $25,000 for its default avoidance measures and also had to pay $25,000 to lawyers for the legal process, along with what was due over that time frame which included the mortgage interest that accrued, call it $12,000, $5,000 to the county for property taxes, $2,000 to the homeowners insurance company, and $1,000 to the HOA. Secondly, the first-lien holder gets their $390,000. Next, if they existed, would be any junior lien holder. In this scenario, despite the default and foreclosure, the borrower would still be entitled to the balance of the liquidation proceeds, receiving a check for $33,500.

However, let's say the economy tanked and not only did the borrower lose their job but a lot of other people did, too. In this scenario, the house might only sell for $450,000 less the realtor's 6%, $423,000. The servicing company still gets fully reimbursed for their outlays of $70,000. The investor is left with only $353,000 of the $390,000 loan balance they are owed. Despite a 20% down payment and only a 10% drop in home price value, the lender loses money and the borrower receives zero.

The burden of capital loss, money lent but not returned, is the risk and responsibility of the investor. Therefore, it is the investor that determines the parameters of the mortgages that they will purchase from any lender. This is the main focus of Part 2.

There are two broad mortgage categories, commercial and residential, and many subcategories of each. Residential real estate is defined as any property with only 4 dwelling units or less. A loan for any other real estate will typically be defined as a commercial mortgage. In this regard, a "land loan" provided to purchase or refinance raw land with no improvement is a commercial loan. A construction loan would follow, which is a mortgage on raw land with consideration for the near future value of a planned improvement, a house. This type of loan is short term financing that almost always is dependent on a commitment by the borrower to refinance into a residential mortgage.

Somewhat similar is a renovation loan, often referred to as a "fix and flip." This is, however, a residential mortgage based on the near future value of a current house with specified restorations, improvements of an improvement, to be completed along a well-defined timeline. At the other end of the spectrum, one might consider a reverse mortgage where the borrower draws out the capital value of the house but without the obligation of repayment, rather, in exchange for diminishing equity. These are both good examples of the usefulness and variety of specialized residential mortgages.

Most residential mortgages fall into two categories, a purchase or refinance. Purchase money mortgages are provided based on the current value of a property according to the lesser of an agreed upon purchase price or the appraised value. These can be refinanced based on the current appraised value for the sake of obtaining a more favorable rate and/or payment, or to access equity, a "cash-out refinance," to be used for any purpose. The most common use is for debt consolidation as the interest rate and payment is often substantially lower than the interest rate of credit card debt. Both of these types of loans are offered as a first lien mortgage where the lender requires being in a senior position to any other financing on the property.

A subordinate lien mortgage would be a home improvement loan, pool loan, or a second-lien mortgage. These are usually in the form of a closed-end loan where there is a set amount borrowed in one lump sum, or a revolving loan called a home equity line of credit [HELOC]. Again, the use of this money can be for debt consolidation or most any other purpose.

The lien position, senior or 1^{st} versus junior or subordinate or 2^{nd}, recognizes who gets their money back in the event of a refinance or transfer of title such as a sale or foreclosure. Being first, second, third and so on is ranked by the chronological order based on when the lien was recorded against the title. Accordingly, any second-lien loans will have a slightly higher prevailing interest as the risk for a loss is greater than a first-lien mortgage which has a priority position in the distribution of funds from the liquidation of the property.

Federal IRS tax liens, state income tax liens, and municipal property tax liens are instances which will supersede the right of even the first lien holder to recoup their capital first. Tax liens jump the line.

Judgements from any court orders will usually receive their money after all lien holders have been satisfied. Certain other creditors with ties to the real estate, like past due property association fees, will have their claims paid prior to the title holder. This is all in effect to provide a clean title to the next property buyer.

PART 3: REAL ESTATE PRODUCTIVITY

"That the world after several millennia of steady individual saving, is so poor as it is in accumulated capital-assets, is to be explained, in my opinion, neither by the improvident propensities of mankind, nor even by the destruction of war, but by the high liquidity-premiums formerly attaching to the ownership of land and now attaching to money."

-John Maynard Keyes

THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY

29. Making the Payment

In addition to keeping copies of the three main documents, the mortgage, promissory note, and deed of trust, as well as keeping track of the survey for future use, perhaps the fourth most important document provided at closing is the First Payment Notice. This will be what appears to be three payment stubs or bills showing the amount, due date, and mailing address of where to send each of the first those payments.

The first payment of most all mortgages will be due on the first of the month on the second month following the month of the closing date. Normally, if a loan closes on January 2nd or January 31st, the first payment due date will be March 1. A loan closing on any day in February will typically have a first payment due date of April 1. Mortgage payments in the US are customarily due on the first day of each month, regardless of the day of the month that they close.

And when that payment is made, the interest due and payable is the interest that has accrued from the previous month. Interest accrues in arrears on mortgages. A payment that is made on March 1 will pay February's 30 days of accrued interest based on the outstanding principal balance on February 1. Likewise, the payment due on April 1 will pay 30 days of interest based on the loan balance on March 1.

This standard payment arrangement often leads to some confusion amongst borrowers regarding the interest due at closing when presented with the Closing Disclosure. Consider as an example a purchase loan that will fund on the first day of the month versus the last day of the month. The borrower will be required to pay at closing 30 days of interest for the full loan amount in advance on the first loan. Whereas, a loan funding on the last day of the month will be required to pay just one day of interest. Both loans will have a first payment due date of March 1. Because the lender has no other way to collect January's interest, it must be paid at closing.

Mortgages are commonly, if not always, calculated on a 30/360-day basis in the U.S. As opposed to Treasury and Corporate bonds where the interest is calculated on an actual 365-day basis and each day of ownership of the amount outstanding is accounted for, the mortgage industry is a bit more forgiving, one might say. Where on a mortgage of $500,000 at 6.00% interest, the first day of interest will be:

$500,000 x .06 =$30,000 ÷ 360 = $83.33

Closing on the first of the month as opposed to the last will amount in an additional $83.33 x (30 - 1) = $2,416.67 due at closing. This may make a significant impact on a borrower's ability to source the funds required at closing, the economics of the loan in terms of LTV and/or DTI, or even the financial impact of having that extra ~$2,400 in the bank that may be better used in the future.

Recognize that the decision of when to agree to close and/or fund the loan will likely need to be considered well in advance, like when agreeing on a purchase date in the contract negotiation stage of buying house. With regard to a refinance, it may be determined when the Clear to Close is provided. However, be aware that the CTC is usually only valid for a certain period of time. And delaying the closing may not provide any benefit as the interest due on the previous mortgage included in the payoff for that loan would offset the interest paid in advance on the new loan. Furthermore, delaying the closing on a refinance may result in updated paystubs and other documentation which could jeopardize the approval when holding out for a later date. But if it is a matter of days, it may be worthwhile to consider.

Years ago, borrowers were provided with a payment booklet that had an envelope size sheet or stub for each of the 180 or 360 payments due. Now only three are provided, per law, to make certain borrowers are informed about their first, second and third payment due dates. These will typically if not always show the payment to be made directly to the lender.

All loans in the U.S. are able to be sold. Whether a lender initially intends to retain the servicing as they may disclose or not, their circumstances may change and they always have a right to do so. Indeed, several servicers in the past have been prompted by regulators to sell their mortgage loan servicing portfolios as a result of not so consumer friendly mortgage accounting practices.

Mortgages are often sold and traded in the secondary markets for two different sets of value, the mortgage cash flows and the mortgage servicing rights. The primary value is the mortgage cash flow, the return of principal loan balance on an amortized basis and the majority of its associated monthly interest payment. The mortgage servicing rights are a smaller portion of the monthly interest payment, roughly 0.25% to 0.50% of the interest rate.

Mortgage may initially be sold as either servicing retained or servicing released. If the mortgage is sold with the servicing retained, then the payment will continue to be made to the initial lender. That lender collects the payment and assumes the responsibility of mitigating risk in the event of delinquencies and/or defaults. For that role, they keep that small quarter to half percent of the interest payment and forward the remaining interest and the principal payments to the investor on a timely basis. From time to time, these lenders may elect to sell any number of loans from their portfolio of Mortgage Servicing Rights [MSRs] to another servicing company. There is an active secondary market for these portfolios as their values change based on changing interest rate markets and the potential change in duration of those loans, essentially how long they believe those mortgages may be outstanding and not subject to lower rate refinance transactions, as well as the current credit profile of the underlying loan portfolio.

When the servicing of a mortgage changes hands, the current servicer is required to provide a notice of the sale by mail to the borrower. Likewise, the new servicer is required to make multiple attempts to inform the borrower of where the new payment is to be directed. Borrowers should take heed of these notices. They basically have a grace period of only three months in order to make the appropriate changes to send the payment to the new servicer. This is one reason why the first three payment stubs are provided at the closing. Oftentimes, lenders who are not also in the business of servicing loans will sell the servicing rights prior to even the first payment date of a new loan.

Standard promissory note agreements will convey that the loan will be considered late if the full payment has not been received by the 15^{th} of the month when due on the 1^{st}. Late payments are subject to a late fee, the amount of which may vary from loan to loan and is usually a percentage of the payment amount. Despite a loan being considered late on the 15^{th}, it is not considered delinquent until it is 30 days past due. This is when the lateness may be reported to the credit bureaus with the potential of having a considerable negative impact on a consumer credit score and even impact the ability to finance or refinance real estate in that consumer's future.

According to most promissory notes, when any single payment is 90 days past due the loan will be considered in default and subject to the initiation of foreclosure proceedings. Once a Notice of Default has been filed with the county where the deed of trust had been recorded, the consumer will generally not be able to finance any real estate properties with most lenders until the default has been satisfied in some manner with the servicer who filed the notice.

This has resulted in an unfortunate situation for some borrowers who have sufficient equity in another property. They work under the assumption that they could eventually obtain a cash-out refinance of another property in order to cure a late payment issue with the mortgage on the subject property. However, despite the significant equity position and perceived low risk of lending against that property, they misjudge lenders' willingness to lend to a consumer who is currently facing foreclosure on another property. The lesson of the story is to solve problems sooner rather than later. Most servicing companies really want to help borrowers avoid foreclosure.

Forbearance may be offered if the problem is seen as short term in nature. It should be arranged in advance with the servicing company. For instance, if a surgery would keep the borrower out of work for a temporary period of time, they would be wise to call the servicer prior to a late payment. A forbearance normally allows missed payments to be tacked onto the last payments as if those months of missed payments never existed. This would have little if any negative repercussions on a future ability to borrow.

A modification might be offered which is when certain terms of the promissory note are adjusted to make the new payments more affordable for the borrower's current income situation. This will likely have a negative impact on the borrower's ability to finance real estate in the future. The modification options would be limited to the loss mitigation strategy approved by the investor. The solution offered may not be as accommodative as necessary to provide a reasonable chance for the borrower to afford the new suggested payment.

If the clock is ticking and it is known that a mortgage will eventually become delinquent for reasons unavoidable, there are potential solutions that ought to be explored not ignored. Any options to avoid foreclosure are almost always entirely up to the servicing company. Communicating with them as early as possible when there may be difficulty in making timely payments should always be done without procrastination.

In addition to losing any home equity, time lost should be a major concern. Although lending standards change and also vary between different types of lenders, a foreclosure will generally limit the ability to finance real estate for several years, potentially as many 7 years. Maybe consider renting the house in order to make the payment. Consider selling the house prior to reaching 90 days of delinquencies or a Notice of Default has been recorded. Foreclosure proceedings will eventually result in an eviction by the county sheriff, constable or other office of law enforcement. Deed-in-lieu of foreclosure is no better in the eyes of creditors. This is voluntarily vacating the house rather being forcibly removed. But any adverse action with regard to mortgage real estate is best avoided if at all possible. Missing a payment intentionally is never advisable.

In the same respect, rather than waiting to make a mortgage payment until the 15th of the month, it is beneficial to satisfy the mortgage payment prior to the first of the month. Remember, the interest due the following month is based on the outstanding principal balance on the first of the month. Although the differences may seem as trivial as rounding up the mortgage payment amount to make just a small curtailment, shaving off just a small amount of interest due each month because of an advance payment can amount to a significant interest savings over the life of a loan.

In a similar manner, it is advisable to write in the memo line a note conveying that any additional payment amount be applied only to the principal balance. As stated earlier with regard to servicer not always acting in the best interest of borrowers, servicers have been found to have applied additional payment amounts to the borrower's escrow account rather than to the principal balance as a curtailment, as required by law. Writing a simple note in the memo line may be helpful if additional action is necessary when companies don't act as expected.

Successfully completing all the scheduled payments or paying off the mortgage in advance will result in the servicer providing the borrower a lien release letter. They are also to file the letter with the county. The letter declares that the conditions of the mortgage have been satisfied and the lien holder relinquishes their right to hold a deed of trust on the property. This letter also ought to be kept in duplicate in a safe and another secure place along with survey.