Chapter 13: Residential and Commercial Property Financing

Understanding the Mortgage Concept
- secured vs. unsecured debt
- mortgage – pledge of property to secure a debt (See example in Figure 13.2, page 278)
- hypothecation – the practice of charging borrowers interest but leaving them in possession of mortgage property until the debt is repaid
- title theory – some states recognize that the mortgagee is the legal owner of mortgaged properties until the debt is repaid, making it easier for the mortgagee to sell the property and use the proceeds to satisfy the debt in the event of default by the mortgagor
- lien theory- some states recognize that the mortgagor is the legal owner of mortgaged property while the debt is being repaid and, in the event of default, the mortgagee must foreclose on the debt through a court action.

Promissory note – a written promise to repay a debt that usually accompanies a mortgage document. (Figure 13.1, pages 276-277)
- prepayment clause
- acceleration clause
- due-on-sale clause

Foreclosure – the process of seizing control of the collateral for a and loan and using the proceeds from its sale to satisfy a defaulted debt
- judicial foreclosure – used in states in which the mortgagor must initiated a court action to prove that the debt is in default and ask the court to order the sale of the property, usually at public auction.
- Nonjudicial foreclosure – some states’ mortgage process grants the power of sale to the lender should the borrower default.
- Strict foreclosure – some states’ mortgage process immediately transfers title to the pledged property to the lender upon default

Alternative Security Instruments
- Deed of trust – as an alternative to the mortgage document in some states, a lender may require the borrower to convey legal title to the pledge property to a third party (trustee). This title lies dormant as long as the debt is repaid as scheduled. In the event of default, the trustee can sell the property to pay the debt.
- Land contract – essentially an installment sale contract, land contracts create an obligation for the seller to transfer title to the property to the buyer at some future date based on an agreed-upon payment schedule. The buyer holds equitable title while the debt is being paid, but the seller holds legal title.

Other Issues:
- In the absence of a “due on sale” clause, a borrower is generally free to sell a mortgaged property “subject to” the existing mortgage. To prevent foreclosure, the new owner would
have to honor the existing mortgage. This strategy does not relieve the original borrower from liability for the debt.

- In some situations, a mortgagee may permit a mortgagor to sell a pledged property and “assume” responsibility for an existing mortgage. Most lenders require that the new owner meet minimum risk guidelines before agreeing to release the original borrower from liability.

- In the event of imminent foreclosure, a mortgagor and mortgagee may agree that the lender will accept a “deed in lieu of foreclosure” to avoid the expense of a lengthy foreclosure process.

Structure of the U.S. Housing Finance System

- The process of creating a new loan agreement between a borrower and lender is known as loan origination.

- Loan originations occur in the primary mortgage market.

- The secondary mortgage market consists of transactions involving existing loans being sold from originators to investors or from one investor to another.

Federal Housing Administration (FHA)

- Created in 1934 to help restore confidence to the nation’s housing finance system
- Helped develop lending standards that reduced lenders’ risk exposure
- Promoted the use of long-term, fully amortizing loans
- Established a mortgage insurance program to cover losses to lenders
  - Borrowers pay a fee to purchase an insurance policy that protects the lender from the risk of loss due to default by the borrower
  - In return, lenders are more willing to lend money at favorable rates with relatively small down payment requirements.

Private Mortgage Insurance

- Competes with government loan insurance and guarantee programs
- Borrowers pay a fee to purchase an insurance policy that limits the risk of loss faced by lenders in the event of default by the borrower
- In return, lenders are willing to lend money at favorable rates with relatively small down payment requirements
- Usually less expensive than FHA insurance, but requires a larger down payment amount than FHA insured loans

Federal National Mortgage Association (Fannie Mae)

- Created as a government agency in 1938 to buy FHA-insured mortgages originated by lenders and to sell securities backed by these mortgages to investors, thus providing a secondary market for mortgage loans.
- Converted to a private company in 1968.
- Continues today to purchase mortgage loans from originators and repackage these loans into mortgage backed securities that are sold to investors.

VA-guaranteed Loans
- As part of the “GI Bill of Rights,” veterans are able to obtain mortgage loans with little or no down payment and low interest rates.
- Private lenders are protected from risk of default by a guarantee from the Department of Veteran Affairs that assures repayment of the loan in the event the borrowing veteran defaults on the debt.
- Note that these loans are guaranteed (not insured), so no premium is charged to the borrower for the guarantee.

Government National Mortgage Association (Ginnie Mae)
- Created in 1968 as a federal agency, GNMA was anticipated to provide subsidized loans to borrowers.
- In 1970, GNMA introduced a program that guarantees the timely payment of principal and interest on FHA and VA mortgages. This guarantee made “mortgage backed securities” more attractive in the secondary market.

Federal Home Loan Mortgage Corporation (Freddie Mac)
- Created in 1970 to create and operate a secondary mortgage market for “conventional mortgages” (loans with privately mortgage insurance or with no insurance).
- Competes today with FNMA in the market for all types of mortgages and mortgage backed securities.

Mortgage Market Participants
- As of the second quarter of 2000, mortgage debt outstanding in the U.S. exceeded $6.6 trillion, with about 75% of this amount secured by one- to four-family structures.
- As shown in Table 13.1 on page 287, mortgage debt is held by
  o Commercial banks
  o Savings institutions
  o Life insurance companies
  o Federal agencies
  o Mortgage pools and trusts
  o Individuals and others

The Fannie Mae/Freddie Mac Uniform Residential Loan Application
- Most lenders use a standardized loan application form that complies with the requirements imposed on lenders by the secondary market powerhouses, Fannie Mae and Freddie Mac.
- The application is shown in Figure 13.3 on pages 290-292.
- The application collects information about the borrower’s income, other debts, other assets, employment history, etc. that is used by the lender to evaluate lending risk.

Federal Legislation Related to Loan Applications
- Equal Credit Opportunity Act – prohibits discrimination based on race, color, religion, national origin, sex, marital status, age, whether all or part of an applicant’s income is derived from public assistance programs, or whether the applicant has exercised any right under the Consumer Credit Protection Act.
Consumer Credit Protection Act – lenders must disclose the complete details of the loan to the applicant within three days of application, including the actual cost of the loan. Specifically, lenders must disclose the total finance charges associated with the loan and the annual percentage rate of interest. The APR is the effective annual interest rate the borrower will pay after all fees and charges are taken into consideration.

Real Estate Settlement Procedures Act
- Requires lenders to provide borrowers a copy of an information booklet titled “Settlement Costs and You: A HUD Guide for Home Buyers”
- Requires lenders to provide borrowers with a good faith estimate of the settlement costs associated with the loan within three business days
- Prohibits kickbacks or referral fees to parties who refer a borrower to a lender
- Gives the applicant the right to request a copy of any appraisal report used to evaluate the property being pledged as collateral
- Requires the use of the HUD-1 Uniform Settlement Statement at the loan closing.
- Requires the lender to disclose if the loan is expected to be sold in the secondary market
- Limits the amount of money the lender can require the borrower to deposit to cover property taxes, hazard insurance, or other periodic assessments.

Flood Disaster Protection Act
- Requires lenders to disclose to borrowers whether the property they are purchasing lies in a flood zone. If so, the lender must require that the borrower obtain flood insurance.

Fair Credit Report Act
- Requires that lenders obtain permission before investigating an applicant’s credit history and hand the applicant’s credit information with due care. If a loan request is denied based on information contained in a credit report, the lender must notify the applicant of this fact and provide contact information for the credit agency issuing the report.

Residential Mortgage Underwriting
- The process of evaluating the risk of an applicant and the property being pledged as collateral and deciding whether or not to approve the loan.
- Properties are evaluated by obtaining an independent appraisal of the market value of the property.
- Applicants are evaluated on the basis of their willingness to repay his or her debts using a residential mortgage credit report or a credit score.
- Lenders consider the amount and source of down payment funds the borrower intends to use in the transaction. Lower “loan-to-value” ratios imply lower risk.
- Lenders also evaluate risk by comparing the borrower’s income to the debt obligations.
  - Mortgage Debt Ratio: most lenders recognize that principal, interest, taxes and insurance (PITI) obligations should be no more than 28% of the borrower’s gross monthly income for a conventional mortgage or 29% for a FHA-insured mortgage.
o Total Debt Ratio: most lenders recognize that PITI and other monthly debt obligations should be no more than 36% of the borrower’s gross monthly income for a conventional mortgage or 41% for a FHA-insured mortgage.

o Successful applicants must qualify under both ratios simultaneously.

Sources of Capital in Commercial Property Markets
- Individual Investors
- Life Insurance Companies
- Pension Funds
- Real Estate Investment Trusts
- Commercial Banks
- Commercial mortgage backed securities (CMBS)

Commercial Underwriting Criteria
- Commercial loan underwriters are more concerned with the property’s ability to generate income to repay the debt than they are concerned with the borrower’s income.
- Lenders typically require that a property’s net operating income exceed the debt service requirement by 15 to 20 percent. By definition, the debt coverage ratio is calculated by dividing the net operating income by the debt service payments. A lender who requires a DCR of 1.2 is requiring that the property’s net operating income exceed the amount of the debt payments by 20%.
- Lenders also set maximum loan-to-value ratios for commercial loans. 70% LTV is common as a maximum LTV.