Chapter 9

Real Estate Finance:
The Laws and Contracts

Some Effects of Mortgage Debt

• More households can own their home
• Businesses can use their cash for core activities
• Investors can leverage and diversify investments
• Homeowners can obtain credit on better terms than consumer debt (home equity credit lines)
  – Tax favored
  – Longer term
  – Lower interest rate

Two Elements of a Mortgage Loan

• Note: Exact terms of the financial obligation
• Mortgage (deed of trust): Pledges the property as security for the note

The Note – Interest Rates

• Fixed rate
  – 365-day interest (daily rate is 1/365 of annual rate; contrasts with commercial mortgage loans at 360-day interest
  – Monthly charge is 1/12 of stated annual rate

The Note – Interest Rates (continued)

• Adjustable rate (continued)
  – Margin: Lender’s markup
    • 200 to 300 basis points (bp)
    • Average is extremely stable at 277 - 278 bp
  – Change Date: Date that interest rate changes each time
    • New index rate commonly is the last published rate 45 days, for example, before the change date
  – Teaser rate: Initial, temporarily reduced interest rate
The Note – Interest Rates (continued)

- Adjustable rate (continued)
  - Interest rate caps: Limit on changes in interest rate charged
    - Periodic
    - Lifetime
    - Important question: Does cap apply to the teaser rate?
  - Payment caps: Limit on payment changes rather than interest rate changes
    - Can result in negative amortization: Unpaid interest added to the balance

Payments

- Always in arrears (end of month)
- Virtually always monthly
- Various arrangements for fixed-rate loan:
  - Level payment
  - Partially amortized (term for amortization, term to maturity, balloon loan)
  - Interest only nonamortizing; sometimes called a “bullet” loan
  - Negative amortization

The Note: Right of Prepayment

- Traditional common law: No right of prepayment unless explicitly provided
- Modern statutory case: Right of prepayment unless explicitly prohibited
- Loans with right of prepayment:
  - All “conforming” and FHA/VA loans
  - Home equity credit lines

The Note: Right of Prepayment (continued)

- Loans with restricted right of prepayment:
  - Subprime home loans
  - “Jumbo” home loans
  - Most income property mortgage loans
- Prepayment penalties
  - Percentage of outstanding balance
  - Yield maintenance
  - Defeasance
The Note: Other Terms

- Nonrecourse loan: No personal liability
  - Exculpatory clause
  - Single-purpose, single asset, bankruptcy remote entity for borrower
- Demand clause: Right of lender to require prepayment
- Inclusion of mortgage clauses by reference

Mortgage (Deed of Trust)

- Mortgagor: Borrower
- Mortgagee: Lender
- Title vs. lien theory
  - Title theory: Mortgage a temporary transfer of title
  - Lien theory: Mortgage a lien
  - Historic difference was lender’s claim to rents and possession in case of default

Important Mortgage (DOT) Clauses

- Description of the property
- Insurance clause
- Escrow clause
- Acceleration clause
- Due-on-sale clause
- Hazardous substances clause
- Preservation and maintenance clause

When Things Go Wrong

- Default: Failure to meet requirements of the note or mortgage
  - Technical default: Any violation of terms
  - Substantive default: Three missed payments (90 days)

Nonforeclosure Responses to Default

- Counseling and consumer debt reorganization
- Temporary reduction of payments
- Assisted sale
- Short Sale
- Deed in lieu of foreclosure
  - Advantages: quick, quiet, cheap
  - Disadvantages: other liens remain; bankruptcy can nullify and wipe out mortgage
Foreclosure
• Legal process of terminating all claims of ownership and all liens inferior to foreclosing lien
  – Risk of failing to notify a claimant
  – Presence of superior liens
  – Costly and time consuming
  – Distressed sale
• Importance of lien priority
• Recourses of the defaulted mortgagor
  – Equity of redemption
  – Statutory right of redemption

More Foreclosure (continued)
• Deficiency judgment: Judgment against mortgagor for unrecovered balance
  – Example:
    • Net foreclosure auction price: $100,000
    • Remaining loan balance: $120,000
    • Deficiency judgment: $20,000

More Foreclosure (continued)
• Judicial foreclosure vs. power of sale
  – Judicial foreclosure: Court-administered public auction
  – Power of sale: Public auction conducted by trustee or mortgagee (preferred by lenders)

Power of Sale States

Bankruptcy
• Possible threat to lender’s ability to foreclose
• Three forms of bankruptcy
  – Chapter 7: Liquidation
  – Chapter 11: Court supervised “workout”
  – Chapter 13: Wage-earner’s proceeding
• No form of bankruptcy can set aside a mortgage lien
• Chapters 11 and 13 can result in delays
• Soldiers and Sailors Relief Act of 1940

Acquiring Property with Existing Debt
• “Subject to” borrower does not sign mortgage note
  – No personal liability for mortgage loan
  – Property still is subject to the mortgage
• Assumption: Buyer adds signature to note
  – Personal liability for loan
  – Property subject to mortgage
Debt without a Mortgage

Laws Regulating Home Mortgage Lending

- Equal Credit Opportunity Act
- Federal Truth-in-Lending Act (TILA)
- Real Estate Settlement Procedures Act (RESPA)
- Other laws
  - Home Ownership and Equity Protection Act
  - Home Mortgage Disclosure Act
  - Community Reinvestment Act

Equal Credit Opportunity Act

- Prohibits discrimination in lending by:
  - Race
  - Color
  - Religion
  - National Origin
  - Sex
  - Marital Status
  - Age
  - Source of income (public assistance or part time)

Federal Truth-in-Lending Act (TILA)

- Statement of Annual Percentage Rate (APR)
  - Cost of borrowing
  - Computed as yield to maturity
- Disclosures:
  - Demand clause
  - Assumability
  - Variable rate
  - Late charges
  - Prepayment charge
- Right of rescission for 3 days for non-purchase, non-business home mortgage loans

Real Estate Settlement Procedures Act (RESPA)

- Applies to almost all standard home mortgage loans
- Requires:
  - Standard format closing statement (HUD-1)
  - Presentation of HUD booklet explaining HUD-1
  - Good-faith estimate of closing costs within 3 days of applying
  - Closing statement (HUD-1) available for inspection 24 hours before closing
  - Prohibits kickbacks from closing service vendors

Other Laws Regulating Home Mortgage Lending

- Home Ownership and Equity Protection Act
  - Targeted at abuses in subprime lending
  - Subprime: Loan to a borrower not qualifying for standard “prime” financing
  - Level of APR triggers certain requirements
    - Disclosure of fees
    - Prepayment fee for only 3 years
    - No balloon payment for 5 years
    - No negative amortization
    - No pattern of lending to households with inadequate income
- Home Mortgage disclosure Act
- Community Reinvestment Act
End of Chapter 9