Chapter 9
Real Estate Finance: The Laws and Contracts

Mortgage (or Deed of Trust DOT)

- Why use a mortgage?
- Two parts to a mortgage or DOT transaction
  - Security Interest
  - Promissory Note

The Note – Interest Rates

- Fixed rate
- Adjustable rate
  - Index rate
    - Common indices...
  - Margin
  - Limits to changes in interest rate or payment (caps)
  - Change Date
  - Teaser Rate
  - Example 1 See Class Website
  - Example 2

Payments

- Always in arrears (end of month)
- Virtually always monthly
- Various arrangements for fixed-rate loan:
  - Level payment
  - Partially amortized
  - Interest only; often called a “bullet” loan
  - Negative amortization?

The Most Common ARM Index Rate: One-Year CTM

Interest and Principal Payments on a Level Payment Loan
Loans with right of prepayment:
- All "conforming" and FHA/VA loans
- Home equity credit lines

Prepayment Penalty Example

Types of Prepayment Penalties
- Percentage of outstanding balance
- Yield maintenance
- Defeasance
  (also, can be lockout)

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

Recourse

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

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

Mortgage versus Deed of Trust
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)

Non-Foreclosure 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
- 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: $20,000

More Foreclosure (continued)

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

Power of Sale States

- States with Power of Sale
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

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
  - Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

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

Other Laws Regulating Home Mortgage Lending

- Home Ownership and Equity Protection Act (HOEPA)
  - 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

Dodd-Frank Act Creates Consumer Financial Protection Bureau

- Given oversight and enforcement power for:
  - All federal consumer financial protection laws
  - Anti-discrimination laws in consumer finance
  - To restrict unfair, deceptive or abusive practices
  - Receive consumer complaints
  - Promote financial education
  - Power to monitor emerging consumer financial risks
  - Centralizes a multitude of regulators within one for home mortgage lending

End of Chapter 9