

Chapter 8 Financing Real Estate

Chapter Outline

Student Learning Outcomes

After completing this chapter, the student should be able to:

1. Understand why the financing of real estate is of benefit to both home buyer and investor.
2. Explain how the money supply affects the cost of credit.
3. Define a promissory note, negotiable instrument and holder in due course.
4. Explain the various forms of security instrument used with real estate, and the foreclosure process used with each.
5. List and compare lenders in the primary mortgage market.
6. Explain federal financing disclosure requirements, including RESPA.
7. Describe the loan application process.

Suggested Items to Bring to Class for Discussion

1. Newspaper or Internet listings of current mortgage interest rates. Ask students to bring in a major newspaper's real estate section (usually from the Sunday edition).
2. Newspaper listings of trustee sales. In addition to indicating the parties and the amount by which the trustor is in default, the notice of trustee's sale will contain a legal description of the property.
3. Copies of the Special Information Booklet (available from lenders or on-line from HUD) to distribute to students.
4. If your class schedule permits, invite a local loan officer to make a presentation to your class and explain what is involved in obtaining a home mortgage loan, as well as current loan terms.

Lecture Outline

- I. Purposes of Financing Real Estate
 - A. The buyer receives the right to the present use of the property.
 - B. The buyer usually looks forward to the property's future appreciation; that is, its increase in value.
 - C. By paying down the amount owed, the buyer benefits from a forced saving program that increases the amount of equity the buyer has in the property.
 - D. Tax advantages may be available to both investor and homeowner.

- E. The leverage made possible by a relatively small down payment allows purchase of property of a much greater value.
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- II. The cost of credit is the interest charged for the use of borrowed money. Interest is measured in percentage points, with one point equal to one percent of the amount borrowed.
 - A. The money supply is determined by a variety of factors.
 - 1. The general health of the economy affects the availability of funds for borrowing.
 - a. Inflation results when there is more money available for spending than products and services available; increased demand and insufficient supply create a rise in prices.
 - b. Recession occurs when demand is lowered, causing lowering of prices; lower prices mean lower wages and less money available for purchases.
 - c. Government tries to control economic extremes by:
 - i. Increasing or decreasing spending or
 - ii. Increasing or decreasing the money supply by controlling the amount of money available for lending
 - 2. The Federal Reserve Bank System (the Fed), created by Congress in 1913, serves as the central bank of the United States and influences the money supply in several ways. History of the Fed is at www.federalreserve.gov.
 - a. The Fed raises or lowers reserve requirements (cash on hand) of member banks, thereby decreasing or increasing the amount available for lending.
 - b. The Fed establishes the discount rate (interest rate) member banks pay to borrow money from the Federal Reserve Bank System, affecting the prime rate that banks charge their most favorably rated commercial borrowers.
 - c. The Fed buys and sells government securities to affect the amount of funds available for savings and other investment, and thus for borrowing.
 - 3. There are 12 regional Federal Home Loan Banks. The Federal Home Loan Bank of San Francisco covers the Eleventh Federal Home Loan Bank District, which includes California, Nevada and Arizona.
 - 4. The Federal Deposit Insurance Corporation (FDIC) insures individual accounts in participating banks and savings and loan associations, up to a maximum of \$100,000.

B. The road to FIRREA

Abuses by lending institutions and lack of government oversight led to the failure of many thrift associations and passage by Congress of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

1. Office of Thrift Supervision (OTS) and Housing Finance Board were created to take over the savings and loan supervisory responsibilities that had belonged to the Federal Home Loan Bank Board.
2. FIRREA also established requirements for appraisals of property in federally related transactions, such as those involving loans made by a federally chartered or insured institution, loans insured or guaranteed by a federal agency and loans sold on the secondary mortgage market.

C. Usury is the charging of an exorbitant rate of interest.

1. State law
 - a. Proposition 2 exempts loans made or arranged by a real estate broker and secured by real property.
 - b. California constitutional law exempts:
 - i. Loans made by banks and savings and loan associations
 - ii. Loans of credit unions, personal finance companies and pawnbrokers, unless the loan falls in one of the statutory categories mentioned below
 - c. Maximum interest rate for consumer loans is ten percent per year.
 - d. Money, goods or other things intended for the purchase, construction or improvement of real property are subject to a maximum rate of ten percent or the prevailing Federal Reserve Bank discount rate plus five percent, whichever is higher.
 - e. Business loans are subject to a ceiling of the Fed discount rate plus five percent.
 - f. Refinancing of a loan is subject to the same maximum rate as the original loan.
2. Federal law preempts state law.
 - a. Depository Institutions Deregulation and Monetary Control Act of 1980 specifically exempts federally related residential first mortgage loans made after March 31, 1980, from state interest limitations.
 - b. The federal exemption includes loans used to finance manufactured housing (mobile homes) and acquisition of stock in a cooperative housing corporation.

- c. Federal law effectively limits California usury laws to private lenders.

III. Real Estate as Security--Real property can be used as security for a loan by the process of hypothecation, which allows the borrower to retain possession of the secured property.

A. A promissory note is simply a promise to pay a stated amount of money on the terms specified.

- 1. Payment terms define the type of note used.
 - a. A straight note requires payment in regular installments of interest only, with the principal due in a lump sum at the end of the loan term.
 - b. An amortized loan requires payment in regular installments that include both interest and principal.
 - c. A balloon payment is an installment that is at least twice the amount of the smallest installment.
 - d. With an adjustable-rate note, the interest rate charged may change over the life of the loan, based on the change in a specified index.
- 2. Joint and several liability means that all co-signors on a promissory can be held liable for full payment of the note.
- 3. A promissory note qualifies as a negotiable instrument if it is:
 - a. An unconditional promise
 - b. In writing
 - c. To pay a specified amount of money on demand or at a fixed or determinable future time
 - d. Payable on the order of a designated person or the bearer of the note and
 - e. Signed by its maker
- 4. Holder in due course (HDC) is one who takes negotiable instrument for value, in good faith and without notice of any defense to its enforcement.
 - a. Defenses to enforcement include:
 - i. Lack or failure of consideration
 - ii. Prior payment
 - iii. Cancellation
 - iv. Set-off or
 - v. Fraud in the inducement
 - b. A holder in due course may still not be able to enforce a negotiable instrument if:
 - i. The note maker lacked the legal capacity to make a valid agreement
 - ii. The note was forged
 - iii. The instrument is illegal or

- iv. There has been a material alteration in the terms of the note
 - c. The Federal Trade Commission has limited the rights of a holder in due course in consumer credit contracts for goods or services.
- B. The security instrument used in transactions secured by real property is commonly called a mortgage.
 - 1. A mortgage hypothecates property to secure the payment of a debt or obligation.
 - a. A lien on the property hypothecated is given by the mortgagor (property owner) to the mortgagee (lender).
 - b. The mortgagor continues to hold title.
 - c. The only remedy for default is judicial (court-ordered) foreclosure, unless the mortgage instrument provides a power of sale on default.
 - d. Mortgage with power of sale operates as a trust deed does when property is sold at a trustee's sale.
 - e. Judicial foreclosure procedure changed as of 7-1-83; instruments originating before that date follow the old rules.
 - f. Successful bidder at court-ordered sale receives certificate of sale, but does not receive possession until after statutory redemption period.
 - g. Deficiency judgment against mortgagor is possible if the proceeds of the sale are not enough to cover indebtedness plus court costs and sale fees, unless:
 - i. Mortgage was purchase money debt (mortgagee was seller of property) or
 - ii. Loan was to pay all or part of purchase price of owner-occupied residential dwelling of no more than four units
 - h. Antideficiency protection is provided to California homeowners by Code of Civil Procedure, Section 580b.
 - i. Before a foreclosure sale, mortgagor or subordinate lien holder may cure the default by paying all amounts owed (including court costs and fees), bringing about a reinstatement of the mortgage.
 - j. When mortgage has been satisfied, mortgagee must execute a certificate of discharge, which can be filed with the county recorder.
 - 2. The deed of trust is the form of security instrument preferred in California.
 - a. Title to property is transferred by trustor (usually, borrower), to hold on behalf of beneficiary (lender).
 - b. If trustor defaults on underlying debt, beneficiary so informs trustee by a declaration of default and trustee is

then to sell the property and use the proceeds to pay off the beneficiary. A notice of default is sent to the trustor, trustor's successors, junior lienholders, State Controller if there is a tax lien on the property, and anyone who has filed a request for notice with the recorder.

- c. The beneficiary has the option of requesting a trustee's sale or judicial foreclosure.
 - d. Reinstatement by the debtor is possible up to five business days prior to the date of sale, or the deed of trust may provide a longer period.
 - e. Creditor can credit bid amount of debt at trustee's sale.
 - f. There is no right of redemption following a trustee's sale. The purchaser can take possession immediately, or bring an unlawful detainer action to evict the present occupant.
 - g. The trustee's sale automatically bars any deficiency judgment if the sale proceeds fail to cover the unpaid balance of the debt plus interest, court costs and sale fees.
 - h. Following a satisfaction of the debt, the beneficiary must deliver the original note and deed to the trustee and request a deed of reconveyance to the trustor.
 - i. A deed in lieu of foreclosure transfers title to the beneficiary to avoid a forced sale.
3. Summary of differences between mortgage and trust deed include:
- a. Number of parties
 - b. Conveyance of title
 - c. Statute of Limitations; four years on underlying debt for judicial foreclosure, but no time limitation on power of sale as long as deed of trust is in effect
 - d. Available remedies on default
 - e. Period of reinstatement
 - f. Availability of redemption
 - g. Availability of deficiency judgment
 - h. Procedure following satisfaction of debt
- C. The Unruh Act requires explicit notice to the owner of a single-family, owner-occupied residence of owner's default on a trust deed or mortgage with power of sale.
- D. Home equity sales contracts must follow strict requirements of California Civil Code to prevent abuses in which homeowners unwittingly sell the equity in their homes for much less than their true value.
- E. Mortgage foreclosure consultants must follow specific notice and other requirements of the Civil Code.

- IV. Real Estate Lenders--The primary mortgage market consists of lenders who initiate loans with borrowers.
- A. Institutional lenders make most home and business loans.
1. Savings and loan associations are federally or state chartered, but all must be members of the Federal Home Loan Bank System.
 - a. Loan-to-value ratio is percent of property's market value represented by loan amount. Private mortgage insurance may be required if loan-to-value ratio is greater than 80%. Loans sold to Fannie Mae or Freddie Mac may be eligible for removal of PMI after loan has been paid down to 75-80% of current appraised value, depending on origination date.
 - b. Loans may be fully amortized, partially amortized, non-amortized (straight loans), or they may have negative amortization (required payment does not cover all interest due).
 2. Commercial banks can be federal or state; if federal, they must be members of the Federal Reserve System, while membership is optional for state banks.
 3. Insurance companies typically finance large commercial projects but also invest in the secondary mortgage market.
 4. Mutual savings bank distributes its earnings to depositors as dividends, rather than interest.
 5. Credit unions are organized under the National Credit Union Administration.
- B. Noninstitutional lenders consist of private individuals and nonfinancial institutions.
1. Mortgage companies make real estate loans, which they then sell to investors.
 2. Private individuals hold one-fourth of all mortgage debt.
 3. Nonfinancial institutions include pension funds, colleges and universities, trusts, estates, mortgage investment companies and other groups.
- C. Mortgage loan brokers are governed by the Real Property Loan Law, which is a part of the Real Estate Law.
1. The law sets maximum mortgage broker commissions for first trust deeds of less than \$30,000, and second trust deeds of less than \$20,000. Limits are also set on the maximum chargeable costs and expenses incurred by mortgage brokers.
 2. A broker who negotiates or makes a loan must complete and present a Mortgage Loan Disclosure Statement to the borrower before the transaction is completed.
 3. Advertising must include a statement that the broker is licensed by the Department of Real Estate.

- D. California Residential Mortgage Lending Act applies to those who make or service mortgage loans on one- to four-family dwellings.
 - 1. Commissioner of Corporations issues licenses.
 - 2. Real estate brokers are exempt from the law, as are federally or state licensed lending institutions, trust companies and insurance companies, estate representatives, trustee under a deed of trust and individuals lending their own money
 - 3. Also exempt is a California finance lender, as defined in the California Finance Lenders Law.

- V. Federal disclosure requirements include the following.
 - A. Truth-in-Lending Act was implemented by Regulation Z.
 - 1. A creditor for purposes of the act is defined.
 - 2. Exempt transactions are specified.
 - 3. Truth-in-lending disclosures must be made in a disclosure statement which must include:
 - a. Amount financed
 - b. Finance charge
 - c. Annual percentage rate (APR)
 - d. Total of payments
 - e. Total sales price (in credit sales)
 - f. Prepayment penalties, if any
 - g. Rebates, if any
 - h. Late-payment charges, if any
 - 4. Three-day right to rescind does not apply to residential purchase money first mortgage or trust deed loans; refinancing of such a loan when no new funds are advanced by lender; and refinancing of loan secured by property that is not occupied by the borrower.
 - 5. Advertising regulations must be followed.
 - B. Real Estate Settlement Procedures Act (RESPA) requires certain disclosures by lenders in federally related mortgage loans involving the sale or transfer of residences of one to four dwelling units. As of 12-2-92, RESPA also covers refinancing transactions, purchase of property for resale, purchase of property of 25 or more acres, purchase of a vacant lot, and an assumption or novation involving a transfer of title subject to an existing loan.
 - 1. Federally related mortgage loan is one made by a lender insured by FDIC or any other federal agency or one financed through any federal agency, such as FHA or VA, or sold to FNMA, GNMA or FHLMC.
 - 2. Special Information Booklet must be provided.
 - 3. Good faith estimate of transaction closing costs must be made.
 - 4. Uniform Settlement Statement must be prepared and presented to borrower and seller no later than day of closing.

5. No fee is allowed for preparation of RESPA or Truth-in-Lending documents.

VI. Other loan considerations

- A. A loan assumption may be allowed by the loan agreement, in which case new borrower takes the place of the old borrower.
- B. If property is purchased "subject to" an existing loan, the seller is still liable for the loan.
- C. An acceleration clause (also called a due-on-sale clause) may be used on default or sale of mortgaged property to declare entire amount of remaining indebtedness due immediately.
- D. The Uniform Residential Loan Application (Form 1003) prepared by FHLMC and FNMA, is used for most loans involving single-family residences.
 1. The Equal Credit Opportunity Act prohibits discrimination based on age, sex, race, color, marital status, religion or national origin.
 2. Funding usually is handled through escrow.