



# Chapter 9



## FINANCIAL INSTITUTIONS



# **I. OUR EVER- CHANGING ECONOMY (ECONOMIC CYCLES)**

# Elections and the Economy

---

- The economy is subject to shifting with every new election as taxing and spending policies change
- Similarly, the money market fluctuates with financing swinging between plentiful and scarce, often quarter to quarter
  - plentiful financing will often make selling property more likely; converse is also true

# Inflation and Deflation

---

- Inflation = too much money chasing too few goods; people making and spending \$\$\$ freely
- Deflation = when prices of goods, services and real estate actually decline
- Seller's market = prices rise due to too few properties being chased by too many buyers
- Buyer's market = prices decline when there are too many properties for sale and too few buyers wanting to buy them

# A. Federal Reserve Banking System (The "Fed")

---

- Our national central banking authority
- Controls interest rates by controlling the availability of money to banks, and indirectly to other financial institutions
  - the greatest single influencer of cost and supply of money
- Governed by the Federal Reserve Board:
  - nine-member committee
  - appointed by the president

# A. Federal Reserve Banking System (The "Fed")

---

- When the Fed wishes to affect monetary policy, it can:
  - buy (loosens) or sell (tightens) government T-Bonds and T- Securities
  - raise (tightens) or lower (loosen) reserve requirements of banks
  - raise (tighten) or lower (loosen) discount rate (the rate banks charge each other for money)
  - increase (tighten) or decrease (loosen) margin requirements (percentage loaned on stocks and bonds)

# B. Gross Domestic Product (GDP)

---

- The total value of all goods and services produced by an economy during a specific period of time
  - this is a key factor monitored by the Fed to indicate the direction of monetary policy

# C. Changing Interest Rates

---

- Credit crunches of recent years have forced salespeople to be creative in the world of real property finance – higher rates reduce the buyer ranks; lower rates swell the buyer ranks
- Salespeople must visualize all the ways a property can be financed before presenting it to a prospect
- Understanding the basic instruments and processes of real estate finance is essential
- **REFINANCING** – is the process of obtaining a new loan to pay off the old loan



# **II. SHOPPING FOR A LOAN**

# STEPS IN OBTAINING A LOAN



## 1. APPLICATION

DETAILED FINANCIAL INFORMATION ABOUT  
BORROWER

## 2. ANALYSIS/QUALIFYING

CREDIT SCREENING - BACKGROUND OF APPLICANT  
CAPACITY - BASED ON INCOME AND ASSETS  
COLLATERAL - VALUE OF PROPERTY  
DESIRE - DISCIPLINE TO MAKE PAYMENTS ON TIME  
RATIOS - LOANS TO GROSS EARNINGS

## 3. PROCESSING

LOAN DOCUMENTS, DISCLOSURE STATEMENTS

## 4. ESCROW

TRUST DEED AND PROMISSORY NOTE RECORDED

## 5. SERVICING

LENDER COLLECTS PAYMENTS, SENDS MONTHLY  
LOAN STATEMENTS

## \* APPRAISAL OF THE PROPERTY

THE PROPERTY MUST QUALIFY ALSO - "LOAN TO  
VALUE RATIO"

# Loan Qualification

---

- Individual lenders set their own evaluation standards
  - standards are generally reflected in the rates charged
  - debt ratios are today's most often-used criteria for evaluating a borrower's capacity to borrow
- Just as borrower is evaluated and must qualify, the property must also be evaluated to ensure that contract price reflects fair market value; appraisal is the method of determining this value

# Borrowing Money

---

- Borrowing the money to buy a home is generally the largest financial obligation a person will make in his or her lifetime
- Salesperson must advise caution and careful consideration before a promissory note is signed

# A. Loan To Value (L-T-V)

---

- The percentage of appraised value the lender will loan the borrower to purchase or refinance the property
- Lower LTV means higher down payment

# B. Estimate of Settlement Costs (RESPA)

---

- Before loan application is completed, lenders must provide a good faith estimate of the actual settlement costs to the borrower
  - advises borrower how much cash beyond down payment will be required to close escrow
- It must include:
  - rate of interest
  - points/fees to be charged
  - any additional loan fees and charges
  - escrow, title, and other allowable costs

## C. Credit Scoring (Access to Credit Profile)

---

- Gives lenders a fast, objective measurement of your ability to repay a loan or make timely credit payments
  - lenders must provide applicants with scores
  - any inaccurate info must be corrected by reporting agencies in a timely manner

# Credit Scoring Criteria

VA 59

## Credit Scoring



**CREDIT SCORING** gives lenders a fast, objective measurement of your ability to repay a loan or make timely credit payments. It is based solely on information in consumer credit reports.

Factors comprising a credit score include:

1. **Payment History** - What is your track record?
2. **Amounts Owed** - How much is too much?
3. **Length of Credit History** - How established is yours?
4. **New Credit** - Are you taking on more debt?
5. **Types of Credit Use** - Is it a “healthy mix”?

*The enactment of SB 1607 (Figueroa), CAR's landmark credit-scoring legislation, gives consumers access to their credit scores.*

- The most widely used credit bureau scores are developed by Fair, Isaac and Company; these are known as FICO Scores

# D. Loan Application

---

- Provides lender with:
  - information about property being financed
  - information about borrower (and co-borrower, if any)
  - sources of income and analysis
  - monthly housing expenses (present and proposed)
  - balance sheet (assets and liabilities)
  - other relevant information about borrower's financial status

# E. Equity

---

- Your net worth; it is the amount left after subtracting all that you owe (liabilities) from the value of what you own (your asset value)
- Lenders want to see your equity on paper – the Form 1003 (Uniform Residential Loan Application) provides this net worth/equity picture

# F. Liquidity

---

- The ease and rate with which one can convert assets into cash so that debt obligation(s) can be paid when due
  - cash is most liquid asset
  - real estate is illiquid

# G. Opportunity Cost (Cost of Non-Liquidity)

---

- The lost profit one could have made by an alternative investment action not taken
  - said another way, the cost of being illiquid



# **III. SOURCES OF REAL ESTATE FUNDS**

# Three areas of demand for borrowing money are:

---

- Construction funds to build
- Financing purchases
- Refinancing



# **IV. INSTITUTIONAL LENDERS**

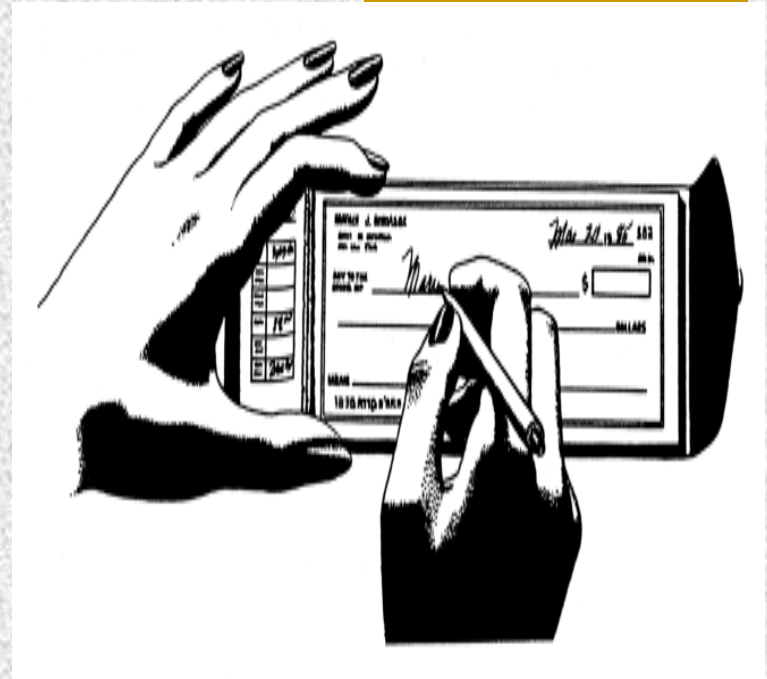
# Institutional Lenders

---

- Very large corporations which lend their depositors' funds to finance real estate transactions
  - financial intermediary between those with funds and those needing funds

# A. Federal Deposit Insurance Corporation (FDIC)

- A government corporation that, for a fee, insures each account of a depositor (savings banks and banks) up to \$250,000
- [www.fdic.gov](http://www.fdic.gov) (Federal Deposit Insurance Corp.)



# B. Federal Savings Banks

---

- Provide more real estate loan funds than any other financial institution
  - either federally or state licensed
  - primarily loan on owner-occupied SFRs/condos
  - can loan 80% of value of property to be purchased
  - can loan >80% (even 90 or 95%) if loans are protected by Private Mortgage Insurance (PMI)
  - usually charge points and fees

# C. Banks

---

- General purpose lenders
  - loans for anything from real estate to cars/boats
  - national banks must be members of the Federal Reserve System
  - state banks may be members of “the Fed” by choice
  - lending rates are not that much different from those of mutual savings banks; minimum of 2% spread between rate paid to depositors and charged to borrowers

# Banks will loan:

---

- First trust deed loans - for owners
- Construction loans (or interim loans) - for builders and developers
- Take-out loans (repayment of interim loans)
- Home improvement loans - for owners

# D. Life Insurance Companies

---

- Conservative lenders specializing in large loans to commercial projects
  - high-rise office buildings
  - shopping centers
  - hotels
- Also make conventional loans on residential properties
- In CA, restricted to lending 75% of property value unless insured by the FHA or VA

# Institutional Lender Priorities

## Priorities of Institutional Lenders

| <b>Federal Savings Banks<br/>(Residential Lenders)</b> | <b>Banks<br/>(General Purpose Lenders)</b> | <b>Life Insurance Companies<br/>(Big Money Lenders)</b>                       |
|--------------------------------------------------------|--------------------------------------------|-------------------------------------------------------------------------------|
| 1. Single-family homes and condos                      | 1. Business and auto loans                 | 1. Large shopping centers and office buildings                                |
| 2. Apartment buildings                                 | 2. Conventional home loans                 | 2. Hotels and industrial properties                                           |
| 3. Home improvement loans                              | 3. Government-backed FHA and VA home loans | 3. FHA and VA home loans through mortgage companies (Government-backed loans) |
| 4. Manufactured homes                                  | 4. Credit cards                            |                                                                               |
|                                                        | 5. Construction loans                      |                                                                               |



# **V. NONINSTITUTIONAL LENDERS**

# Non-Institutional Lenders

---

- Persons or organizations which make conventional loans on an a private or individual basis
  - conventional loans are those loans that are not insured or guaranteed by the United States government

# A. Private Individuals

---

- Usually second trust deeds taken back by the seller
  - most often, seller loans are used when money market is tight with common terms as follows:
    - relatively small loan amount <\$50,000
    - usually a relatively high interest rate (8%-15%)
    - short-term; usually 3-7 years with monthly payments
    - payments usually 1% of loan amount with balloon due at end of term if more than 6 years
    - acceleration clause if late payments or transfer

## B. Credit Unions

---

- Co-operative associations organized under the Federal Credit Union Act of 1934 to promote thrift among members having a common bond of association or occupation and provide them with a source of credit
- Playing an ever-increasing role in real estate finance but also offer savings plans, credit cards, vehicle loans
- Most are incorporated and accumulate funds by selling shares to members
- Loan rates are generally equal to or below current market rate
- [www.ncua.gov](http://www.ncua.gov) (National Credit Union Administration)

# C. Real Estate Investment Trusts (REIT)

---

- Companies that sell securities specializing in real estate ventures
  - if distribution of 95% of income to shareholders, does not pay federal income taxes on such distributions
- Equity Trust - invests in real estate itself or in several real estate projects
- Mortgage Trust - invests in mortgages and other loans or obligations on secured by real estate

# D. Pension Plans

---

- Are investment organizations that obtain funds from people before they retire and invest this money for their clients' retirement
  - more recently, larger real estate projects are seen as desirable or moreso compared to investments in stocks or in savings institutions or insurance companies

# E. Mortgage Bankers (Companies)

---

- Usually lend their own money or roll it over so they can originate, finance, and close first trust deeds or mortgages secured by real estate
- They then sell the loans to institutional investors and service the loans through a contractual relationship with the investors
  - “warehousing” loans entails a Mortgage Banker packaging loans prior to selling them to the secondary market

# E. Mortgage Loan Brokers

---

- Licensed by DRE and/or Dept. of Corporations as Residential Mortgage Lenders (RML) or CA Finance Lenders (CFL)
- A prime source of loans for homes and investment properties; largest originators of FHA and VA loans

# F. Private Mortgage Insurance (PMI)

---

- A guarantee to lenders that the upper portion (usually the amount of LTV above 80% LTV) of a conventional loan will be repaid if a borrower defaults and a deficiency occurs at the foreclosure sale
- PMI obtainable on 1-4 unit properties and covers up to the top 20% of the loan amount



# **VI. GOVERNMENT- BACKED LOANS**

# A. FHA Insured Loans

---

1. FHA Title I: Home Improvement Loans – the FHA can make home improvement loans to a maximum of \$25,000; the funds can be used only for home improvement purposes
2. FHA Title II: Home Purchase or Build Loans – Section 203b program: insures home loans (1-to-4 units) for anyone who is financially qualified; an FHA loan is based on the selling price when it is lower than the appraisal
  - max amount on homes sold at over \$125,000, LTV 96.50%
  - homes sold at between \$50,000 to \$125,000, LTV 96.50%
  - homes below \$50,000, LTV 96.50%

# A. FHA Insured Loans (cont'd)

---

- Differing median home prices in different geographic areas indicate different loan guaranty limits, county to county
- FHA does not loan money; just insures approved lender against foreclosure loss
  - collects a percentage of the loan for MIP (mortgage insurance premium)
  - if there is a default, FHA takes over property and reimburses lender

# A. FHA Insured Loans (cont'd)

---

- Advantages of FHA loans:
  - low down payment, generally lower rates
  - loans are assumable subject to FHA approval
  - no prepayment penalty allowed by FHA
  - minimum property requirements assure a 'quality' home
  - seller gets all cash – no need to carry 2<sup>nd</sup> loan
- Disadvantages:
  - processing time/red tape
  - properties may require repairs to meet minimum property requirements

# B. Dept. of Veterans Affairs (VA)

1. VA loan is not a loan, but rather a guarantee to an approved institutional lender



# a. Eligibility

---

- 90 days of active military service (181 days during certain peacetime periods).
  - persons still in the military
  - persons honorably discharged
  - american citizens who served in the armed forces of our allies during WWII
  - spouses of eligible personnel who died without using their benefits
  - persons receiving other than honorable discharges at the discretion of the VA

# Vets may be entitled to more than one loan

---

- Eligibility is restored after previous home on which VA loan was taken is sold and loan fully repaid
- Can also apply if eligible and if previous loan is not in default (does not need to be paid off) and they no longer own the property

## 2. Certificate of Reasonable Value

---

- CRV is an appraisal of the property to be purchased by the veteran
  - by independent appraiser appointed by DVA
  - CRV can be paid for by veteran, or by seller
- The amount of the down payment required for a VA loan is determined by the CRV

# 3. VA Loan Provisions:

---

- Up to 100 % LTV -- no down payment needed unless the purchase price exceeds the CRV appraisal or if for some reason, the lender requires one
- No limit to loans (generally California lenders will only loan up to \$417,000); fixed rate, graduated payment, growing equity mortgages, buy-down loans
- Usually a 30-year term
- No pre-payment penalties; seller pays discount points
- [www.va.org](http://www.va.org) (Department of Veterans Affairs)

# 3. VA Loan Provisions (cont'd)

---

## ■ Advantages of VA Loans:

- no down payment
- low interest rates due to VA loan guarantee
- no prepayment penalty allowed by VA

## ■ Disadvantages:

- buyer's creditworthiness is a requirement for assumption; only after 1 yr. if owner occupied, or two years if investor-owned
- buyer or seller can pay discount points
- lengthy processing time; red tape

# C. California Department of Veterans Affairs (Cal-Vet)

---

- Makes direct loans to veterans in the form of Land Contracts or Conditional Sales Contracts repaid in installments
- Cal-Vet retains legal title until loan is paid in full
- Only loans on owner-occupied properties
  - max loan amount \$521,250 for home; \$625,500 for a farm (up to max 95% of Cal-Vet appraisal)
  - Max for manufactured home (must include land) \$125,000 in a park; \$250,000 on a single-family lot
- Funds for loans come from sale of Veteran Bonds
  - availability of funds is limited; wartime vets have priority, especially disabled veterans

# Eligibility

---

- No residency requirement—all veterans eligible; honorably discharged after at least 90-days active service in the following military actions:
  - World War II — December 7, 1941 to December 31, 1946
  - Korean Conflict — June 27, 1950 to January 31, 1955
  - Vietnam Era — August 5, 1964 to May 7, 1975
  - Persian Gulf War — August 2, 1990 to date yet TBD

# Also eligible is a California veteran who:


---

- Participated in a campaign or expedition for which a medal was awarded by the government of the United States
- Was discharged with less than 90-days active duty because of service-connected disability incurred during his or her qualifying service period

## D. California Housing Finance Agency (CHFA)

---

- This is a state agency that sells bonds so that it can provide funds for low-income family housing on project or individual home basis



**VII. LENDING  
CORPORATIONS  
AND THE  
SECONDARY  
MORTGAGE MARKET**

# A. Private and Quasi-Governmental Corporations

---

- At one time, there were 3 federal corporations that used cash to buy and sell trust deeds between financial institutions
- These corporations are now either private or quasi-governmental and provide stability and flexibility for real estate financing; also replenish financing money to keep making home loans

## B. Secondary Mortgage (Trust Deed) Market

---

- Provides an opportunity for financial institutions to buy from, and sell first mortgages (trust deeds) to, other financial institutions for profit
- Enable lenders to keep adequate supply of funds for new loans



# 1. Federal National Mortgage Assoc. (FNMA) or "Fannie Mae"

---

- Private corporation dominating secondary mortgage market
- Sells securities on NYSE to raise funds
- Buys and sells conventional, FHA and VA loans

## 2. Government National Mortgage Assoc. (GNMA) or “Ginnie Mae”

---

- Government corporation
- Sells secondary mortgages to the public
- Provides the federal government with cash
- Sells federally insured shares in “pools” of trust deeds, on the stock exchange

### 3. Federal Home Loan Mortgage Corp. (FHLMC) or “Freddie Mac”

---

- Government corporation; issues preferred stock to the public
- Supervised by the Federal Home Loan Bank Board
- Buys home loan mortgages from savings banks to maintain their supply of money for loans to the public; packages loans they buy for sale to investors

# FNMA / FHLMC Loan Limits

---

## Loan programs

- **conforming**
  - **mainland limits (AK, HI 50% higher)**
    - **First Loan -- SFR: \$417,000; 2-family: \$533,850; 3-family: \$645,300; 4-family: \$801,950**
    - **Second Loan -- \$179,825 (sum of 1<sup>st</sup> and 2<sup>nd</sup> cannot exceed first loan limit)**
- **jumbos (any loan that exceeds these limits)**



# VIII. REAL ESTATE BROKER CAN MAKE LOANS

# Brokers can be lenders

---

- Brokers and salespeople can arrange financing for buyers or invest in loans for their own profit
- Mortgage Loan Broker Law requires loan broker to give a Mortgage Loan Disclosure Statement to all borrowers before they become obligated for the loan

# A. Mortgage Loan Disclosure Statement

---

- A form which clearly states all the details and all information and charges connected with a particular loan
- Mortgage loan brokers must provide this to the borrower before the note and instrument are signed and keep a copy on file for 3 years
- Mortgage Loan Brokers need no special license other than their real estate broker license

# B. Business and Professions Code

---

1. Article 7 (Loan Broker Laws) - on loans of \$30,000 and over for first trust deeds, and \$20,000 and over for junior deeds of trust, the broker may charge as much as the borrower will agree to pay
  - On first trust deeds less than \$30,000
    - less than 2 years up to 3 years – max commission 5%
    - > 3 years – max commission 10%
  - On junior trust deeds less than \$20,000
    - less than 2 years – max commission 5%
    - more than 2 years, less then 3 years – max commission 10%
    - 3 years and over – max commission 15%
  - Copy of appraisal must be given to Borrower

## a. **Threshold Reporting (Big Lending - \$2,000,000)**

---

- The requirement of reporting annual and quarterly loan activity (review of trust fund) to the Department of Real Estate if, within the past 12 months, the broker has negotiated any combination of 20 or more loans to a subdivision or a total of more than \$2,000,000 in loans.
- In addition, advertising must be submitted to the DRE for review

## 2. Article 5 - Broker Restrictions

---

- The licensee is prohibited from pooling funds
- A broker may not accept funds except for a specifically identified loan transaction
- Before accepting a lender's money, the broker must:
  - own the loan or have an unconditional written contract to purchase a specific note
  - have the authorization from a prospective borrower to negotiate a secured loan

# 3. Article 6 - Real Property Securities Dealer

---

- A DRE broker's license and endorsement are required: A \$100 fee plus a \$10,000 surety bond. DRE permit is required to sell specific security
- Commissioner's Permit - the approval of the proposed real property security and plan of distribution if deemed fair, just and equitable by Commissioner; a Commissioner's Permit requires a \$10,000 bond
- a. Real Property Securities Dealer (RPSD) - any person acting as principal or agent who engages in the business of selling real property securities (such as promissory notes or sales contracts)
  - can also accept funds for reinvestment in real property securities, but only after obtaining a RPSD endorsement on their broker's license, as well as obtain the \$10,000 surety bond

# Equity Sharing

---

- Shared Equity Financing – contractual arrangement whereby an investor shares any equity gain with a homeowner
- Investor usually puts up most if not all of down payment cash
  - receives no interest tax deduction
- Homeowner makes payments
  - receives tax write-offs

# HOMWORK

---

- Read Chapter 10
- Study for quiz
- Continue reading your supplemental text and be prepared to give oral book report

# Chapter 9 - Summary

---

- Inflation
  - Seller's market
  - Buyer's market
- Federal Reserve
  - GDP
- RESPA
- Institutional Lenders
  - FDIC
  - General purpose lenders
- Noninstitutional lenders
  - REITs
    - Equity trust
    - Mortgage trust
- Mortgage Bankers
  - Secondary mortgage market
  - PMI
- FHA
  - Title I & II
  - MIP

# Chapter 9 - Summary

---

- VA Loan
  - CRV
  - Cal - Vet
- Fannie Mae (FNMA)
- Ginnie Mae (GNMA)
- Freddie Mac ( FHLMC)
- Mortgage Loan Disclosure Statement
- Real Properties Securities Dealer
- Equity Sharing