MasterCPE
Professional Online Education

Real Estate Financing and Investment

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Course Description

This course covers both financing and investing in real estate. The first section deals with two major aspects of real estate financing: (1) financial instruments and (2) the means of financing. It examines the financial side of the lending process. The second section deals with investing in real estate. Topics include: the advantages and pitfalls of real estate investing, how to value an income-producing property, how to use leverage and increase return, and buying a home.

Field of Study	Specialized Knowledge and Applications
Level of Knowledge	Overview
Prerequisite	Basic Math
Advanced Preparation	None

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Chapter 1:

Real Estate Financing

Learning Objective

After completing this section, you should be able to:

1. Recognize elements of the loan process.
2. Identify transactions covered and disclosures required by the lending laws.
3. Identify agencies involved in the mortgage market.
4. Recognize the classification and uses of different mortgage types.

This chapter deals with two major aspects of real estate financing: (1) financial instruments and (2) the means of financing. It examines the financial side of the lending process. The typical steps in the loan process are explained and pertinent lending laws are described. Both primary and secondary sources of funds are identified. Common types of loans are classified, and some innovative financing techniques are examined.

The Loan Process

Financial intermediaries providing the funds for development and purchase of real estate have traditionally taken a conservative approach towards the amounts they lend and the requirements the borrower must meet before securing the loan. This is no doubt partly due to the fact that the largest providers of credit are highly regulated by both federal and state agencies. Consequently, the loan process followed normally involves a number of steps, explained in the discussion that follows.

Qualifying The Borrower

The loan process begins when a potential borrower approaches either the lender or a representative of the lender with the intention of securing a certain amount of money. Historically, loan-to-value ratios were much lower than they are today and subsequently in case of default the lender was in low risk position. However, as loan-to-value ratios have increased, it has become necessary for the lender to look beyond the property and thus qualify both the credit and the financial ability of the borrower to repay the loan. This involves the filling out of a loan application which asks for employment, credit history, assets, liabilities and other personal information. Once this information is obtained the lender then verifies it. When it is verified, the lender can make a credit evaluation that becomes an important input into the final loan decision.

Qualifying The Property

Lenders are not in business to foreclose on property; rather, they are in business to lend money, charge interest on that money and hopefully receive payment of both interest and principal. However, under certain condition, both within and beyond the control of the borrower, the lender may find it necessary to foreclose on the property used to secure the debt.

Factors such as location, age, condition, surrounding land uses and general economic conditions all have an effect on the value of a piece of real estate. For most mortgages the amount of money loaned will be based on either the contract sales price or the appraised value, whichever is less. Therefore, before making the loan decision the value of the property must be estimated by the lender or someone employed to do so.

Qualifying The Title

So as to determine the lien position of a mortgage given on a piece of property, the lender seeks to qualify the title by examining the public records and tracing the legal history of the property. The lender normally desires a first lien position which can be determined by an abstract of title. Also, since the lien is on a piece of property, the lender wants to be assured that the property being offered as collateral is the same piece being purchased; thus a property survey will also be conducted prior to closing the loan transaction.

Closing The Loan Transaction

Once the buyer and the property have been qualified and after the lender is confident that title to the subject property is free and clear, the final step in the loan process involves closing the loan transaction. Depending on where one resides in the United States, the title closing process is referred to as a *closing, settlement, or escrow*. In California title closing is conducted by an escrow agent who is a neutral third party mutually selected by the buyer and seller to carry out the closing.

Online Loan Application

Many lenders (such as www.lendingtree.com, www.eloan.com, www.gmacmortgage.com, and the like) have online loan processing system in place. Typical online loan application involve the following steps:

- **Apply:** Complete an online loan application. Before starting the online loan application you will need to create an account, to protect your privacy and security of your information.
- **Review:** A loan officer will review your application. The lender will notify you of their decision by phone and/or mail. Your loan agent will contact you within 24 hours to confirm information and discuss your loan application.
- **Sign:** The lender will assign a processor to your loan and set up a signing appointment.
- **Fund:** Once they approve your application, you sign the loan documents and you satisfy all closing conditions, they will disburse your loan proceeds, usually within 7-10 days.

Lending Laws

Certain lending laws are applicable to all lenders providing real estate financing. Since the purpose of such laws is to provide protection for the borrower, the limitations and requirements imposed through these laws must be strictly adhered to. Among the pertinent lending laws are the following.

Usury

A number of states have laws which limit the interest rate that can be charged to individuals borrowing money in that state. These laws affect all lenders in a state regardless of what federal or state agency issued their charter. It should be noted that, if there is a national economic emergency, the federal government may temporarily suspend state usury laws.

California's usury law limits the interest rate on nonexempt real estate loans to the discount rate charged by the Federal Reserve Bank of San Francisco plus 5%. The California Constitution states that the following kinds of loans are exempt from state usury laws: (1) loans made by banks, savings and loans, and credit unions; (2) loans made by personal finance companies and pawnbrokers; (3) loans made or arranged by real estate brokers.

As a practical matter, the state's usury laws now apply only to private lenders.

Truth-In-Lending Law (Regulation Z)

The National Consumer Credit Protection Act, referred to as the Truth-in-lending Act, became effective July 1,1969. Regulation Z, published by the Federal Reserve System to implement this law, requires lenders to make meaningful credit disclosures to individual borrowers for certain types of consumer loans. The regulation also applies to all advertising seeking to promote credit. This advertising is required to include specific credit information. Consumers are given information on credit costs both in total dollar amounts and in percentage terms. The intent of Congress was to assist consumers (residential, noninvestment customers) with their credit decisions by providing them with specific required disclosure and does not attempt to establish minimum or maximum interest rates or other charges.

To Whom Does Regulation Z Apply?

Regulation Z applies to a person (or business) who is classified as a "creditor". A creditor is one who regularly extends consumer credit that is either subject to a finance charge or is payable in more than four installments. The phrase "regularly extends" means that a person or firm has been engaged in five or more transactions in the past calendar year. Regulation Z also requires that the note signed by the consumer be payable on its face to the creditor. In other words, Regulation Z applies only to actual extenders, real estate broker or salesperson who helps arrange creative financing to sell a house, the broker salesperson would not have to comply with Regulation Z disclosure requirements.

What Transactions Are Covered?

All real estate lending transactions involving consumers are covered by Regulation Z. Except for real estate transactions, all credit extended in five or more installments and not in excess of $25,000 for personal, family, household or agricultural purposes is covered by the regulation. The regulation does not apply to credit extended to non-natural persons such as corporations or governments, to credit extended for business and commercial purposes or for credit transactions with an SEC-registered broker for trading in securities and commodities. The regulation applies to new loans, refinancing or consolidation of loans. However, an assumption of a loan by a new borrower is exempt.

Notice that Regulation Z applies to consumer real estate transactions. Would a loan to renovate an apartment building be covered by the regulation? Since an apartment building is normally a business to collect rents from tenants, this would not be deemed a consumer transaction. Thus, the loan would be exempt from Regulation Z reporting requirements.

What Information Must Be Disclosed?

The law requires a lender to make several types of credit information disclosures. Two important disclosures include the finance charge and the annual percentage rate (APR). The finance charge includes a disclosure of the following: interest, finder and origination fees, discount points, service charges, credit report fees and other charges paid by the consumer directly or indirectly which are imposed as an incident to the extension of credit. Certain fees which are not in fact additional finance charges are exempt. These charges may include various title examination fees, escrow requirements and appraisal fees. To determine the charges which are covered or exempt, Regulation Z should be examined by anyone extending credit to consumers. (Note: this includes brokers, professionals and craftsmen as well as financial intermediaries, unless exempt.) The APR is the yearly cost of credit stated to the nearest one-eighth of 1 percentage point in regular transactions and the nearest one-fourth of 1 percentage point in irregular transactions. A transaction is irregular if repayment is in uneven amounts or the loan is made in multiple advances. The APR is usually different from the contract or nominal rate of interest and includes the impact on the effective rate from discount points and other charges. The calculation of the APR is complex and involves the use of actuarial tables which are available from the Federal Reserve and member banks.

EXAMPLE

Tom borrows $1,000 from Holly which is repayable in one payment at the end of the year. The loan is to finance a real estate purchase. They agree to a contract rate of 6% plus four discount points. What is the APR?

Actual amount borrowed: $1,000 - $40 (discount points) = $960
Amount to be paid back: 1,000 +$60 (contract interest) = $1,060
Actual interest: $1,060 - $960 = $100
APR = $100/$960 = 10.42%

This calculation would differ depending on the term of the loan and the amortization period. If the interest is collected in the beginning, the APR could be twice the contract rate. If the loan involves variable payments, then the creditor must disclose how the payments may change, including the index that is being used, limitations on increases and an example illustrating how payments would change in a given increase. In addition to the finance charge and the APR, anyone extending credit must also disclose such information as the number, amount and time that the installments are due, description of the penalties and charges for prepayment and the description of the security which is used as collateral, as in refinancing or using a second mortgage to obtain equity. The consumer has three business days to rescind (cancel) the credit transaction. This right of rescission does not apply to credit which was used to purchase the home originally.

Effect Of Violations

Violation of Regulation Z provisions can lead to both civil and criminal penalties. Civil penalties include a penalty of up to $1,000 paid to the borrower, actual damages plus attorney's fees. Criminal penalties include a fine of up to $5,000, up to one year in jail, or both.

Equal Credit Opportunity Act

As originally passed, the Equal Credit Opportunity Act prohibits discrimination by lenders on the basis of sex or marital status in any aspect of a credit transaction. As of 1977, the act was extended to cover additional protected groups of borrowers. These include individuals who are discriminated against on basis of race, color, religion, national origin, age, receipt of income from a public assistance program and good faith exercise of rights under the Consumer Protection Act. Exceptions to the protection of the law are individuals who do not have contractual capacity (minors) and individuals who are not citizens and whose status might affect a creditor's rights and remedies in the case of a default.

The purpose of this law and Regulation B, which was issued by the Board of Governors of the Federal Reserve System, was to assure that lenders would not treat one group of applicants more favorably than other groups except for reasonable and justifiable business reasons. Strict rules have been established to require fair dealing in all aspects of a credit transaction.

A creditor failing to comply with the law is subject to civil liability for damages in individual or class actions. These damages can be actual or punitive. Punitive damages are intended to punish a wrongdoer. These are limited to $10,000 in individual actions or the lesser of $500,000 or one percent of a creditor's net worth in class actions. A class action occurs when a specific group of individuals has been harmed from a violation of the law. In general, lawsuits must be filed within two years of a violation.

The law is very broadly worded and covers all phases of a credit transaction. The following is a lender's lists of " do's" and "don'ts":

1. Do not ask about a person's birth control practices or intentions to bear children; however, a neutral question such as whether the applicant expects his or her income to be interrupted in the future is considered proper.

2. Do tell the applicant that income from alimony or child support need not be disclosed unless the applicant wishes this source of income considered.

3. Do tell the applicant that the federal government needs certain information for monitoring purposes, but that this information will not be used as a means of discrimination. Note that the applicant may decline to furnish this information.

4. Do not require a spouse to co-sign a credit instrument except where state laws, such as California's community property law, require a signature to create a proper lien on property serving as security for a loan.

5. Do not use age in evaluating an applicant's creditworthiness. One exception to this rule is if the applicant is considered "elderly" (age 62 or over), and the age is being considered to favor the applicant.

6. Do not require the applicant to reveal marital status. This extends to the use of courtesy titles (Ms., Mr., Mrs., Miss) unless requested by the applicant.

7. Do furnish credit information in the names of both spouses for the purpose of establishing a credit history in each name if both are participating in the loan.

8. Do notify the applicant within 30 days whether you are approving the loan or taking an adverse action.

9. Do give a specific reason for an adverse action. Specific reasons could include: no credit file, insufficient credit references, law suits, liens, excessive obligations, delinquent credit obligations, unable to verify employment or income, denial by Federal Housing Administration (FHA) or other government programs, inadequate collateral.

10. Do retain records for at least 25 months after notifying applicant of action taken.

Fair Credit Reporting Act

This act, which became effective April,1971, attempts to regulate the action of credit bureaus that give out erroneous information regarding consumers. First, Banks and credit companies must make a consumer's credit file available to the person in question. Further, the consumer upon examining the file, has the right to correct any error that may appear in the credit reports. Secondly, if a creditor denies a loan to an applicant, the applicant must be given the name and address of the credit bureau that supplied the credit information to the creditor. Upon request, the credit bureau must supply the consumer with the pertinent information contained in the applicant's credit file. Finally, the act limits the access of the consumer's credit records to people who: (1) evaluate an applicant for insurance, credit or employment; (2) secure the consumer's permission; or (3) secure court permission. An amendment the Act requires each of the three consumer reporting agencies to provide one with a free copy of one's credit report once every 12 months.

Community Reinvestment Act

In order to prevent the practice of redlining and disinvestments in central city areas, Congress passed the Community Reinvestment Act. 'Redlining' is a practice whereby lenders refuse to make loans in certain geographic areas of a city. It is as if someone had taken a red pencil and drawn a line around the boundary of neighborhood and said that no loans would be made in that neighborhood.

To comply with the act, lenders must prepare Community Reinvestment Statements. These statements contain up to four basic elements:

1. The lender delineates a 'community' in which its lending activities take place. The lender may use political boundaries, to designate an 'effective lending territory' in which a ' substantial portion' of its loans are made, or any other 'reasonably delineated local area.' Care must be taken that such designations do not unreasonably exclude territory occupied by persons of low or moderate incomes (see also requirements in Federal Fair Housing Laws)
2. The lender must make available a listing of the types of credit it offers in each community.

3. Appropriate notice and information regarding lending activity by territory must be given or made available for public inspection. The specific language of the notice is dictated by the government.
4. The lender has the option to disclose affirmative programs designed to meet the credit needs of the community.

National Flood Insurance

In 1968, Congress enacted the National Flood Insurance Program. The intent of this legislation is to provide insurance coverage for those people suffering both real and personal property losses as a result of floods. To encourage the buying of national flood insurance, any real property located in a flood plain area cannot be financed through a federally regulated lender unless flood insurance is purchased.

Chapter 1 Review Questions – Section 1

1. Which of the following is NOT part of the loan process for real estate financing?

   A. Qualifying the borrower
   B. Qualifying the property
   C. Qualifying the title
   D. Qualify the physical address

2. The title closing process has many names, but which of the following is NOT one of them?

   A. Closing
   B. Settlement
   C. Escrow
   D. Ownership verification

3. What is name for type of laws found in many states that limit the interest rate that private lenders can charge individual borrowers?

   A. Usury
   B. Truth-in-lending
   C. Regulation Z
   D. None of the above

4. What does the National Consumer Protection Act's (Truth-in-Lending Act) Regulation Z require?

   A. Disclosures by sales person
   B. Credit disclosures by lenders to individual borrowers
   C. Disclosures by broker/salesperson
   D. Disclosures of real estate transactions

5. Truth-in-lending is one form of price standardization that, since the adoption of the Consumer Credit Protection Act on July 1, 1969, has been provided by U.S. government regulations. What is the purpose of this legislation?

A. Regulate the amount of interest that may be charged
B. Allow immediate wage garnishment by creditors
C. Disclosure the finance charge and the annual percentage rate
D. Prohibit the use of usurious interest rates

6. ____________________ is NOT part of information that must be disclosed by lenders

A. Finance charges
B. APR
C. Rate of return
D. Finder and origination fees

7. What does the Equal Credit Opportunity Act prohibit?

A. Regulating the action of credit bureaus that give out erroneous information to consumers
B. Redlining and disinvestments in central city areas
C. Discrimination by lenders on the basis of sex or marital status
D. Providing insurance coverage for those people suffering both real and person property losses as a result of floods

8. What does the Equal Credit Opportunity Act require?

A. Lenders to ask about a person's intention to have children
B. Spouses to co-sign a credit instrument (except in common law states)
C. Credit history of both spouses
D. Use age in evaluating an applicant's credit worthiness

Sources of Funds

Since such a small percentage of the purchase price of real estate is normally provided from the savings of the purchaser, available sources of funds need to be known to anyone desiring to purchase real estate. For purposes of discussion, the more common financial sources have been divided into four groups: (1) primary sources, (2) financial middlemen, (3) other sources and (4) the secondary mortgage market.

Primary Sources

Savings and Loan Associations

While savings and loan associations (S&Ls) are not the largest financial intermediary in terms of total assets, they historically were the most important source of funds in terms of dollars made available for financing real estate. However, in recent years they have experienced declines as a result fo the financial crisis and increasing competition from commercial banks and other lending institutions. At one time, they were the largest supplier of single-family owner-occupied residential permanent financing, although S&Ls are not limited solely to this type of financing. Savings and loan associations also make home-improvement loans and loans to investors for apartments, industrial property and commercial real estate. Recently, primarily as a result of the restructuring of lending activities through deregulation, the average S&Ls assets invested in mortgages has continued to decrease.

An S&L is either federally or state charted. Approximately 60% of the S&Ls are federally chartered. If federal, the Office of Thrift Supervision (OTS) controls federally chartered savings and loan association. This regulatory body, itself a division of the Treasury Department, helps to ensure the safety and stability of member savings and loans. As part of the act that created this agency, savings and loan deposits came under the protection of the FDIC insurance and remain so today. All federally chartered S&Ls are mutually owned (owned by depositors) and the word 'federal' must appear in their title. State chartered S&Ls can be either mutually owned or stock associations. (In a stock association, individuals buy stock which provides the equity capital.). In some states, these lenders are known as building and loan associations or cooperative banks.

While lending policies vary from association to association, most S&Ls are involved in the same type of activities and with the same basic lending requirements. The following are common lending policies:

1. The bulk of their mortgages are in conventional loans for single-family residential real estate.
2. Most S&Ls provide both FHA and VA financing, although these loans typically comprise a small percentage of total assets.
3. The majority of loans are made locally. Funds are typically not available to faraway geographic areas. However, recently some of the larger associations have been engaged in lending funds to users in other states through service corporations and correspondent accounts.

4. Residential loans are usually for 25- or 30-year periods calling for periodic (monthly) full amortization. The current average maturity for conventional mortgages on new homes is approximately 28 years.
5. While conventional loans can be made for up to 95% of a property's value, the average loan-to-price ratio on new conventional mortgages on new homes is between 75 and 80%.
6. Any S&L handling VA mortgages is subject to interest rate ceilings set by the federal government, regardless of who issued the association's charter.
7. All S&Ls are expanding the type of services they offer in terms of more consumer loans, checking accounts and services, heretofore, limited to commercial banks.

Commercial Banks

From 1960 through 1980, there were between 12,000 and 13,000 independent banks in the United States. However, starting in the 1980's, new banking regulations, competition and consolidation have decrease that number to less than 7,000. In terms of total assets, the more than 14,500 commercial banks are the largest financial intermediaries directly involved in the financing of real estate. Commercial banks act as lenders for a multitude of loans. While they occasionally provide financing for permanent residential purchases, commercial banks' primary real estate activity involves short-term loans, particularly construction loans (typically six months to three years) and to a lesser extent home-improvement loans. Most large commercial banks have a real estate loan department; their involvement in real estate is through this department. Some of the largest commercial banks are also directly involved in real estate financing through their trust departments, mortgage-banking operations and real estate investment trusts.

All commercial banks are either federally (nationally) chartered or state chartered. National banks are chartered and supervised by the U.S. Comptroller of the Currency. The word 'national' appears in their title, and they are members of the Federal Reserve System (FRS). However, only one-third of all commercial banks are members of the FRS, even though the member banks control the majority of total bank assets. Nationally chartered banks are also required to maintain membership in the Federal Deposit Insurance Corporation (FDIC). Federally chartered banks can make real estate residential loans up to 90% of the appraised value with a maturity of not more than 30 years. However, any government insured or guaranteed loans are exempt from these limitations.

State chartered banks are regulated by various agencies in their particular state, and membership in both the FDIC and the FRS is optional. Banks not members of the FDIC are normally required to maintain membership in a state insurance corporation.

Life Insurance Companies

Insurance companies play an important role as providers of capital for real estate from an equity (owner) standpoint. Unlike the savings and loan association or the bank, which normally deals directly with the borrower, the800 insurance companies typically do their lending through local correspondents, either mortgage brokers or mortgage bankers. Insurance companies normally specialize in large-scale projects and mortgage packages. Historically, between 25 and 30% of their assets have been invested in mortgages.

Insurance companies receive their money through the payment of premiums by their policyholders and since both the inflow of premiums and the outflow of claim payments can be predicted with reasonable accuracy, insurance companies are able to invest in those assets yielding higher returns but less liquidity than is available to either banks or associations. For their real estate investments, this normally means long-term commercial and industrial financing. While insurance companies have historically invested in residential mortgages, this form of investment has continued to become a smaller and smaller percentage of their portfolio. Few insurance companies presently originate residential mortgages.

All insurance companies are state chartered since there is no federal agency which issues charters. The result is less regulation in most states than is true for either S&Ls or banks. Less regulation generally results in liberal lending patterns which leads to the funding of a wide variety of real estate projects. Over 90% of the insurance companies are stock companies; however, the majority of the industry's assets are held by mutual companies.

Mutual Savings Banks

Located primarily in northeastern states, the 500 mutual savings banks are an important supplier of real estate financing. As their name indicates, these banks are owned by their depositors. who receive interest on their deposits.

All mutual savings banks are state chartered and typically are less regulated than their closest financing relative, the savings and loan association. The percentage of their assets invested in real estate mortgages is less than the average S&L, although a higher percentage of their total mortgage portfolio is FHA and VA loans. Most mutual banks have a relatively larger percentage of their mortgage. Mutual banks also make personal loans which can result in capital being moved from surplus areas to deficit areas. Over two-thirds of the mutual banks maintain membership in the FDIC. The remaining ones are insured by state savings insurance agencies. These state agencies exercise authority over both the type of investments and the amount of their assets invested in particular types of real estate.

Financial Middlemen

Mortgage Brokers

Mortgage brokers are not direct or primary suppliers of capital. However, they do play an important and necessary role in the financing process. A mortgage broker is a person who serves to bring together the user of capital(borrower or mortgagee). For this service, a finder's fee equal to one percent or so of the amount borrowed is normally paid by the borrower. The financial success of the mortgage brokerage firm depends upon the ability to locate available funds and to match these funds with creditworthy borrowers.

Certain sources of funds, particularly insurance companies and the secondary sources discussed below, do not always deal directly with the person looking for capital; rather, they work through a mortgage broker. Thus, if you wish to borrow from certain lenders you would need to go through a mortgage broker. Normally, the mortgage broker is not involved in servicing the loan once it is made and the transaction is closed.

Mortgage Bankers

The mortgage banker is also a financial middleman; however, the services offered include more than simply bringing borrowers and investors together. Mortgage bankers normally make mortgage loans, package these loans and then sell these packages to both primary lenders and secondary investors. Financial help is often sought from a lender, typically a commercial bank. The bank becomes a warehouse for mortgage money, and the mortgage banker draws on these mortgage funds until payment is received from the investors. Usually the mortgage banker continues to service the loan (collect debt service, pay property taxes, handle delinquent accounts, etc.) even after the loan has been packaged and sold. For this management service a small percentage of the amount collected is retained before forwarding the balance to the investor. Obviously, the success of the mortgage banker depends upon the ability to generate new loans. In some geographic areas, mortgage bankers are the primary source for financing real estate. All mortgage bankers try to stay in constant touch with investors and are aware of changing market conditions and lender requirements. Quite often the loan origination fee or finder's fee charged the borrower is more than offset by a lower interest rate from a lender not directly accessible to the borrower. Mortgage bankers are involved in both commercial and residential financing and also carry out related activities such as writing hazard insurance policies, appraising and investment counseling. As with mortgage brokers, mortgage bankers are regulated by state law.

Other Sources

Besides the four primary sources of funds, a number of other sources are available and each plays an important role in financing real estate. Most of these sources rely on mortgage brokers and mortgage bankers to assemble loan packages for them since they normally do not provide funds directly to the ultimate user.

Pension Funds

Pension funds are one of the newer sources available for financing real estate. Whereas these funds historically were invested in stocks and bonds, the recent growth of pension funds has meant new outlets had to be found for their investments. This growth, plus the favorable yield available through real estate investments, has resulted in active participation in financing real estate projects. Besides making mortgage loans, pension funds also own real estate. The majority of all their real estate activity is done through mortgage bankers and mortgage brokers.

Finance Companies

Traditionally, finance companies have provided consumer loans for the purchase of both durable and nondurable goods. However, as commercial banks have become more and more involved in personal loans, finance companies have turned to other forms of investment including real estate mortgages. In residential real estate, finance companies are actively engaged in second mortgages. This type of mortgage is usually made at an interest rate four or more percentage points above the rate on first mortgages and is amortized over a much shorter time period. Some of the larger finance companies--such as those owned by the automobile manufacturers--finance land development, provide commercial gap financing, acquire land leaseback and enter into joint ventures with real estate developers.

Real Estate Investment Trusts (REITs)

Federal legislation passed in 1961 created Real Estate Investment Trusts (REITs). REITs pool the money of many investors for the purchase of real estate, much as mutual funds do with stocks and bonds. There are three types of REITs. An equity trust invests their assets in acquiring ownership in real estate. Their income is mainly derived from rental on the property. A mortgage trust invests in acquiring short-term or long-term mortgages. Their income is derived from the interest they obtain from their investment portfolio. A combination trust combines the features of both the equity trust and the mortgage trust. Their income comes from rentals, interest, and loan placement fees. For more on REITs, visit National Association of Real Estate Investment Trusts (www.nareit.com/mynareit.cfm).

Credit Unions

While the majority of loans made by credit unions are consumer loans some of the more than 22,000 credit unions provide mortgage money for both residential and nonresidential financing. In addition to permanent loans, credit unions also make home-improvement loans directly to depositors. Credit unions normally use mortgage brokers to locate real estate investments for their portfolios.

Individual Investors

There are a number of large investors located throughout the United States who constantly lend money on real estate. These investors include individuals with available funds, groups of investors seeking mortgage ownership and large investment companies desiring to hold a diversified portfolio. They deal both direct and through mortgage brokers. Additionally, many of these investors seek to take an equity position in real estate. It is thus possible to raise equity capital through syndication instead of relying solely on mortgage funds.

Foreign Funds

Over the past decade, a substantial sum of foreign capital has flowed into the United States and much of it has taken the form of real estate equity capital. The relatively high return offered through real estate ownership in this country coupled with a stable economic system means a financially attractive alternative for foreign investors.

Farmers Home Administration (FMHA)

The Farmers Home Administration is an agency of the U.S. Department of Agriculture. Currently, FMHA administers two loan programs for rural housing: (1) a direct loan program and (2) a guaranteed loan program. Properties securing such loans may not be located in urban areas and , like FHA and VA, FMHA requires that the property meet certain minimum requirements. Although there is no statutory loan limit for such loans, the property must appraise for the contract sales price. Information on both loan programs is available from any office of the Farmers Home Administration.

State Finance Programs

Numerous states have enacted home financing programs that provide direct loans at preferred interest rate to citizens of that state who, for various reasons, have been unable to obtain financing from private institutions. Applicants must be residents of the state for a specified period of time and under most programs may not own other real property. In recent years, cities and countries have also established mortgage funds in order to meet the needs of the housing market in their political jurisdictions.

The Secondary Mortgage Market

The availability of funds for financing real estate is affected by economic conditions, both local and national. The result is that at certain times or in certain geographic locations little or no capital is available for mortgages; consequently, few if any loans are made. From the viewpoint of the lender, another problem is that real estate loans can be highly illiquid; thus, the supplier of funds can have a difficult time converting loans into cash. For these reasons, the need exists for some means by which a lender can sell a loan prior to its maturity date.

The secondary mortgage market attempts to meet these needs. Capital can be made available during times of tight money and at capital-deficit locations. By selling mortgages in the secondary mortgage market, a lender can convert existing mortgages into cash which can in turn be used to fund new mortgages. Likewise, an investor in the secondary market can buy existing mortgages, pay the seller a small servicing fee and avoid the time and expense of originating and servicing the loans.

Federal National Mortgage Association (Fannie Mae)

The largest and best known buyer of existing mortgages is the Federal National Mortgage Association (FNMA), known to many as "Fannie Mae." (www.fanniemae.com/index.jhtml).

Fannie Mae is a government-sponsored enterprise (GSE) chartered by Congress with a mission to provide liquidity, stability and affordability to the U.S. housing and mortgage markets.

Fannie Mae operates in the U.S. secondary mortgage market. Rather than making home loans directly to consumers, we work with mortgage bankers, brokers and other primary mortgage market partners to help ensure they have funds to lend to home buyers at affordable rates. We fund our mortgage investments primarily by issuing debt securities in the domestic and international capital markets. Fannie Mae was established as a federal agency in 1938, and was chartered by Congress in 1968 as a private shareholder-owned company. On September 6, 2008, Director James Lockhart of the Federal Housing Finance Agency (FHFA) appointed FHFA as conservator of Fannie Mae. In September 2008, we also entered into an agreement with the U.S. Department of Treasury that was most recently amended in December 2009. Under the agreement, Treasury will provide us with capital as needed to correct any net worth deficiencies that we record in any quarter through 2012. The agreement is intended to ensure that we are able to continue providing liquidity and stability to the housing and mortgage markets.

The Housing and Economic Recovery Act of 2008 changed Fannie Mae's charter to expand the definition of a "conforming" loan. Effective with the November 2008 release of the conforming loan limits, two sets of limits are provided for first mortgages -- general conforming loan limits, and high-cost area conforming loan limits. The conforming loan limits apply to all conventional mortgages that are delivered to Fannie Mae. The high-cost areas are determined by the Federal Housing Finance Agency. The company may purchase loans up to $625,500 in designated high-cost areas.

Maximum Original Principal Balance				
Units	**Contiguous States, District of Columbia, and Puerto Rico**		**Alaska, Guam, Hawaii, and the U.S. Virgin Islands**	
	General	High-Cost*	General	High-Cost*
1	$417,000	$625,500	$625,500	$938,250
2	$533,850	$800,775	$800,775	$1,201,150
3	$645,300	$967,950	$967,950	$1,451,925
4	$801,950	$1,202,925	$1,202,925	$1,804,375

*The limit may be lower for a specific high-cost area; use the Loan Limit Look-Up Table above to see limits by location. (www.fanniemae.com/aboutfm/loanlimits.jhtml)

Government National Mortgage Association (Ginnie Mae)

When the Federal National Mortgage Association reorganized in 1968, the Government National Mortgage Association (GNMA) (www.ginniemae.gov/index.asp) was completely separated as a legal entity. Referred to as "Ginnie Mae," this participant in the secondary mortgage market is a wholly-owned government corporation under the office of the U.S. Department of Housing and Urban Development (HUD). While FNMA is involved with the selling and purchasing of existing mortgage, Ginnie Mae is responsible for the liquidation and special assistance functions previously carried out by FNMA. GNMA receives its funds from U.S. Treasury and mortgage operations. Ginnie Mae is also involved with the mortgage securities pool plan and tandem plan. GNMA also makes financing available to certain urban renewal projects, elderly housing and other high-risk mortgages.

Federal Home Loan Mortgage Corporation (Freddie Mac)

In 1970, under the Emergency Home Finance Act, the Federal Home Loan Mortgage Corporation (FHLMC) or "Freddie Mac" (www.freddiemac.com/) was created as a wholly owned subsidiary of the Federal Home Loan Bank System. Freddie Mac was established as a secondary mortgage market for savings and loan associations who are members of the FHLBS.

Federal Home Loan Mortgage Corp. is engaged in purchasing residential mortgages and mortgage-related securities in the secondary mortgage market and securitizing them into mortgage-related securities that can be sold to investors. The Company purchases single-family and multifamily mortgage-related securities for its mortgage-related investments portfolio. It also purchases multifamily residential mortgages in the secondary mortgage market and hold those loans either for investment or sale. Freddie Mac finances purchases of its mortgage-related securities and mortgage loans, and manages its interest-rate and other market risks, by issuing a range of debt instruments and entering into derivative contracts in the capital markets. The Company operates in three segments: Investments, Single-family Guarantee and Multifamily. *Note:* The government decided to take over Fannie Mae and Freddie Mac in September 2008. It was one financial event among many in the ongoing Subprime mortgage crisis.

Chapter 1 Review Questions – Section 2

9. Which of the following is NOT a financial source for real estate?

A. Primary sources
B. Financial middlemen
C. National flood insurance
D. Other sources and the secondary mortgage market

10. Which of the following is NOT a common practice that most savings and loan associations (S&L) follow in their lending policies?

A. Making the bulk of their mortgages for single-family residences
B. Providing both Veterans Administration (VA) and Federal Housing Administration (FHA) financing
C. Most state chartered S&Ls set their interest rates regardless of federal regulations
D. Making the majority of their loans locally

11. Which of the following is a financial middleman?

A. Savings & Loan Associations
B. Commercial Banks
C. Mortgage Brokers and Mortgage Bankers
D. Life Insurance Companies

12. What is a pool of money from many investors for the purchase of real estate, such as a mutual fund does with stocks and bonds?

A. Credit union
B. REIT
C. Pension fund
D. Financing company

13. There are three types of REITs. ________________________ that invests their assets in acquiring ownership in real estate.

A. An equity trust
B. A mortgage trust
C. A combination trust
D. A real trust

14. What is an agency of the U.S. Department of Agriculture that administers two loan programs for rural housing?

A. VA
B. FMHA
C. FHA
D. GNMA

15. The secondary mortgage market does NOT include which of the following agencies?

A. Federal Home Loan Mortgage Corporation
B. Federal National Mortgage Association (FNMA)
C. Government National Mortgage Association (GNMA)
D. Savings and Loan Associations

Classification of Mortgages

In no area of real estate terminology is there more diverse classification of terms than with real estate mortgages. The following classification is offered as an aid in explaining the more common typed of mortgages used in financing real estate.

Method Of Payment

Straight-Term Mortgages

Prior to the Great Depression of the 1930s, the straight-term or term mortgage was the common means of financing residential real estate. Under this method of payment, interest only is paid periodically (monthly, quarterly, annually) and the initial amount borrowed, the principal, is not paid until the last day of the loan period. Typically, term mortgages covered short periods of time--three to five years--and there was normally little intent by either the borrower to repay the principal or the lender to demand payment of the principal. The original amount borrowed was either extended for another term at an agreed upon interest rate or the borrower would negotiate with a new lender and pay off the old loan. However, as a result of financial conditions during the Depression and the National Housing Act of 1934, which among other things established the Federal Housing Administration, term mortgages became less popular. Borrowers during the Depression were unable to pay the principal when it became due. Because of the tightness in the money supply, lenders were unable to roll these loans over, and thus had to foreclose. Over a million families lost their homes during this time. The failure of the money market led to the creation of the Federal Housing Administration and increased usage of the amortized mortgage. Today, term mortgages are generally used only in the financing of land and construction.

Fully-Amortized Mortgages

Unlike the term mortgage where none of the principal is repaid during the life of the mortgage, a fully amortized mortgage requires periodic (typically monthly) payment of both interest and principal. The first part of the payment covers interest on the outstanding debt as of the payment date, and the remainder of the payment reduces the outstanding debt. At the maturity date, the balance has been reduced to zero. The initial payments will consist of more interest than principal reduction; however, the percentage of the periodic payment reducing the subsequent payment is made.

Fully-amortized mortgages are currently the normal means of securing permanent financing. The maturity date is usually much longer than with a term mortgage. For residential property, this type of mortgage usually covers 20 to 40 years and for commercial property the time period is 10 to 15 years.

Partially-Amortized Mortgages

Partially-amortized mortgage also require periodic repayment of principal. However, unlike the fully-amortized mortgage, the principal has been only partially reduced. The remaining balance is referred to as a balloon payment.

As a result of higher interest rates and inflation during the early part of this decade, this type of mortgage has become more common in residential financing. Today, some lenders make loans based on, for example, a 30-year amortization schedule but with a five-year term. Thus, at the end of five years, the outstanding balance is due.

Budget Mortgages

Besides paying interest and principal each period, a borrower can also be required to pay a certain percentage of annual property taxes and property insurance. For a residential mortgage this means one-twelfth of the property taxes and one-twelfth of the property insurance each month. The advantage to the borrower is that a budget mortgage allows the spreading out of these annual expenses into 12 equal payments. For the lender, who normally places these funds into an impound or reserve account, the advantage is the assurance that these expenses will be paid when due.

Time Period

Construction Loans

These are also referred to as interim financing. A construction mortgage provides the funds necessary for the building or construction of a real estate project. The project can be a residential subdivision, a shopping center, an industrial park or any other type of property requiring financing during the time required to complete construction. Normally, the full amount to be loaned is committed by the lender, but the actual disbursement of the loan is dependent upon the progress of the construction. Funds are sometimes distributed to the borrower in a series of draws, depending upon the work required by the lender. Another method used is for the developer to submit all bills to the lender, who in turn pays the bills. In either case, interest is paid on what has been distributed and not on the total amount to be borrowed.

Typically, the interest rate charged is tied to the lender's prime rate, which is the interest rate charged to the lender's AAA customers. In addition to interest, the borrower is normally charged a 1% or 2% origination fee. Since construction mortgages are considered high-risk loans, a lender often requires a standby or take-out commitment from a permanent lender. A standby or take-out commitment means that another lender will provide permanent financing when a certain event, generally the completion of the project, occurs. This assures the construction lender that permanent financing will be available to repay the construction loan if the project is completed and other conditions are met. Sometimes, permanent lenders require a certain percentage of a project to be rented before the financing is provided.

Permanent Loans

The permanent loan is used to repay the construction loan. Whereas a construction loan is typically short term, permanent financing normally covers 10 years or more. Permanent financing will either be fully- or partially-amortized through periodic mortgage payments.

Since the payment will be paid from the income generated from the project, the lender can make the amount borrowed contingent upon a certain amount of the available space being leased prior to closing the loan transaction. For instance, the developer of a shopping center might be able to borrow $2,000,000 if 80% of the available space is leased. This could result in a gap in the capital needed for financing.

Gap Financing

Gap financing often covers a shorter period of time than permanent financing and usually at a substantially higher interest rate. First of all, it is a junior mortgage, which means the lender does not have the same lien position as the permanent lender; second, there is more risk involved. Normally, different types of financing are used. For instance, a commercial bank might provide the construction financing and a real estate investment trust the gap financing. Quite often all of this is arranged through a mortgage broker. Gap financing may also be needed if the conditions set by the permanent lender have not been met and the construction financing has expired. In this case, the gap financing would be senior financing.

Priority Senior Instruments (First Mortgages)

To hold the first mortgage on real estate means that the lender's rights are superior to the rights of subsequent lenders. This means less risk to the lender, which normally results in a lower interest rate charged to the borrower than charged on second or junior mortgages. Certain lenders only make first mortgages due to regulatory requirements; others limit mortgages to these senior instruments due to company policy.

Conventional Mortgages

The majority of permanent residential financing provided in this country is through the fully-amortized conventional mortgage. The term "conventional" refers to a mortgage that is not FHA-insured or VA-guaranteed. Since there is not third party to insure or guarantee the mortgage, the lender assumes full risk of default by the borrower. A lender's decision to make a conventional loan is usually dependent upon: (1) the value of the property being used to secure the debt and (2) the credit and income position of the borrower. As more and more conventional loans have been made, the loan-to-value ratio (relationship between amount borrowed and the appraised value of the property) has continued to increase, even though most lenders still limit the amount they will lend to no more than 80% of value unless private mortgage insurance is carried. This down payment requirement is higher than with either FHA or VA loans. As the market price of residential real estate has continued to increase, more cash down payment has been required of the borrower, and thus many people have been eliminated from financing with a conventional mortgage. With both insured and guaranteed mortgages, people have been able to purchase real estate with a smaller cash down payment.

Federal Housing Administration Insured Mortgages (FHA)

In 1934, Congress passed the National Housing Act, thus establishing the Federal Housing Administration (FHA) which immediately resulted in more construction jobs for the unemployed. This in turn helped to stimulate the depressed economy. In order to provide the means by which these new homes could be purchased, FHA (www.fha-home-loans.com/) established an insurance program to safeguard the lender against the risk of nonpayment by people purchasing these homes. The result was that the majority of homes financed were FHA insured. Even though the percentage of homes insured under FHA coverage has continued to decrease, the standards and requirements under FHA programs have been credited with influencing lending policies and techniques in financing residential real estate.

Under an FHA-insured mortgage, both the property and the borrower must meet certain minimum standards. The borrower is charged an insurance fee of one-half percent on the unpaid balance and can, under certain conditions, receive up to 97% financing on the appraised value of the property. If a purchaser using FHA financing is paying more than the appraised value, the difference between the appraised value and the sales price must come from the purchaser's assets. Borrowers are not permitted to obtain second mortgages to use as down payments. Also, FHA sets limits as to the maximum loan origination fee charged by the lender. The subject property must be appraised prior to the loan being made; this fee is normally absorbed by the mortgagor. FHA insures these loans for up to 30 years. Thus, the low closing costs, the relatively low down payment and the long amortization period permitted under FHA have all aided in providing residential financing for millions of people who otherwise would not have been able to purchase a home. On a conventional mortgage, the interest rate is determined by the lender rather than by the Secretary of Housing and Urban Development. This rate is periodically raised or lowered to reflect changes in the cost of money, although historically, interest rates on FHA mortgages have been slightly below conventional mortgage interest rates. In addition, borrowers financing with FHA coverage may be charged discount points since points can be paid by either the buyer or the seller. In recent years, FHA has expanded its operation; currently, the agency administers a number of programs dealing with housing. The basic home mortgage program is normally referred to as 203(b), and the program which provides insured mortgages for low or moderate income families is referred to as 221 (d)(2).

Veterans Administration Loan Guaranty Program (VA)

Included in the Servicemen's Readjustment Act of 1944 were provisions covering the compensation to lenders for losses they might sustain in providing financing to approved veterans. The maximum guaranteed amount, which has periodically been increased, is set by the VA (www.va.gov/ and www.homeloans.va.gov/faqelig.htm) as is the maximum interest rate charged by lenders. There are no provisions on the upper limits of the loan-to -value ratio, which means that it is quite common for an approved veteran to receive 100% VA financing. It should be noted that some lenders set limits on how much they will finance using VA financing. VA guarantees loans up to 30 years.

To qualify for VA financing the veteran applies for a certificate of eligibility. The property as well as the borrower must qualify. If the property is approved a certificate of reasonable value is issued. As is true with FHA, junior financing is essentially prohibited under VA. (Junior financing is rare and its terms keep it rare.) Coverage also extends to the financing of mobile homes, condominiums and nonreal estate purchases such as farm equipment and business loans. A VA loan is assumable; however, unless released by the lender, the veteran who borrowed the funds initially remains liable to the lender. Lenders cannot insert prepayment penalties under either VA or FHA loans. A mortgage without a prepayment penalty is commonly referred to as an open mortgage while one that cannot be prepaid is a closed mortgage. VA limits the points charged to the buyer to one point. Any other points must be paid by the seller.

California Farm And Home Purchase Program (Cal-Vet)

The Cal-Vet (www.cdva.ca.gov/calvet/) began in 1921 as a program to assist California veterans in acquiring suitable farm or home property at low financing cost. It is a complete financing program within the Cal-Vet office. The funds for financing come from the authorized sale of state general obligation bonds approved by the voters, and most recently from the sale of revenue bonds authorized by the legislature. The department purchases the property from the seller, and then sells to the qualified veteran on a land contract. The veteran holds equitable title, while the department holds legal title.

To be eligible, veterans must use their benefits within 30 years of their date of release from active military duty. No time limit is placed on those who were wounded, disabled, or prisoners of war. Nearly any veteran wanting to buy a home in California is eligible. They currently have funds for all qualified wartime era veterans, regardless of when they served in the military. They also have funds available for peacetime veterans who meet the criteria for Revenue Bond funds (first-time homebuyers or purchasers in targeted areas who meet income and purchase price limitations). There are no residency restrictions. Veterans are eligible regardless of where they entered service. Only one loan may be active at any time; however, a second loan is possible if the veteran served during multiple war periods.

The loan includes single-family homes, condominiums, town houses, and mobile home on land owned by the borrower.

Insured Conventional Loans

An insured conventional loan is one which is insured by a private (nongovernmental) insurance company. The establishment of FHA-insured loans and VA-guaranteed loans resulted in higher loan-to-value ratios and longer amortization periods than lenders were willing to offer under conventional financing. As the costs of housing continued to increase year after year, some means of providing protection against loss of high loan-to-value conventional mortgages was needed. Thus, in 1957, the Mortgage Guaranty Insurance Corporation (MGIC) or "Magic" as it is normally referred to, established a private mortgage insurance program (PMI) for approved lenders. MGIC offered the lender quicker service and less red tape than FHA. Today private mortgage insurance companies insure more loans than both FHA and VA. Unlike FHA, which insures the whole loan, PMI insures only the top 20 or 25% of the loan, and the insurer normally relies on the lender to appraise the property. While the majority of PMI loans are for 90%

loan-to-value, coverage does extend to a maximum of 95%. On a 90% loan, the borrower is normally charged one-half of 1% at closing and one-fourth of 1% of the outstanding balance each year thereafter. With a 95% loan, the rate is normally 1% of the loan at closing plus 1/4% of the outstanding balance each year the insurance is carried. Since only the top portion of the loan is covered, once the loan-to-value drops below a certain percentage, the lender may terminate the coverage, and thus, the insurance premium is no longer charged to the customer. In case of default, the insurance company can either pay off the loan or let the lender foreclose and pay the loss up to the amount of the insurance coverage.

Junior Instruments (Second Mortgages)

A junior mortgage is one which has a lower priority or lien position than a first mortgage. A third or even a fourth mortgage is also classified as a junior mortgage. What established a mortgage as being a junior mortgage is that it was recorded after the first mortgage was recorded and thus its lien position is inferior to the first mortgage.

Purchase Money Mortgages (PMM)

The term purchase money mortgage has a dual meaning in real estate financing. All mortgage loans for real estate purchases are designated purchase money mortgages by lenders, and thus all the different types of mortgages explained could be classified as purchase money mortgages. The second meaning of the term explains what happens when the buyer does not have the necessary cash and the seller agrees to take back a part of the selling price in the form of a purchase money mortgage. Such a mortgage is ordinarily subordinated to take a second-lien position since the primary lender will require a first lien position before making the loan. For the purchaser, this means less cash and possibly an interest rate on the PMM less than if those same dollars were borrowed from a primary lender. The seller can possibly induce a sale not otherwise possible by agreeing to take back a purchase money mortgage. The seller is protected in that a PMM places a lien on the property the same as any other second mortgage.

Home-Improvement Loans

In recent years, one result of increased housing costs and higher market prices has been the relatively fast equity build-up for owners of real estate. To an owner, this equity can become a source of capital that can be drawn out of the home for home improvements, personal or business reasons. Numerous commercial banks and finance companies make short-term (three to five years) junior mortgages based on a percentage of the homeowner's equity. Since they are junior mortgages, such loans normally carry an interest rate three or four percentage points above that charged on senior instruments.

Wrap-Around Mortgages

As its name implies, a wrap-around mortgage (or deed of trust) is a junior mortgage that wraps around an existing first mortgage. It is also called all-inclusive trust deed (AITD). This method of obtaining additional capital is often used with commercial property where there is substantial equity in the property and where the existing first mortgage has an attractive low interest rate. By obtaining a wrap-around, the borrower receives dollars based on the difference between current market value of the property and the outstanding balance on the first mortgage. The borrower amortizes the wrap-around mortgage which now includes the balance of the first mortgage, and the wrap-around lender forwards the necessary periodic debt service to the holder of the first mortgage. Thus, the borrower reduces the equity and at the same time obtains an interest rate lower than would be possible through a normal second mortgage. The lender receives the leverage resulting from an interest rate on the wrap-around greater than the interest paid to the holder of the first mortgage.

EXAMPLE

The sale price is $300,000. There is a mortgage balance of $200,000 payable at 9% interest. The buyer will pay $30,000 cash down and agrees to pay the balance at 11%. By using the wrap-around mortgage, the seller can have the buyer agree to a mortgage of $270,000 at 11%; the buyer makes the applicable monthly payment to the seller. The seller, in turn, continues to make payments on the underlying first mortgage which was written at 9%. This means that the seller, in his or her role as a mortgagee, now earns 11% on $70,000 (the difference between the new mortgage of $270,000 and the existing mortgage of $200,000) and 2% on the existing $200,000 loan.

The seller grants a deed to the buyer in the regular way. Note that for this method to work, the original lender must be agreeable to the seller transferring title.

Types Of Property Pledged

Package Mortgages

Quite often the sale of real property includes certain items and equipment as part of the sales price. Rather than acquiring separate mortgages on each of these items, the buyer can, through the use of a package mortgage, finance both the real property and the personal property. In residential real estate, a builder might include a stove, refrigerator, dishwasher or air conditioning in the sales price. For commercial real estate, certain equipment or furniture is often included in the sales price. The advantage to the purchaser is that these items can be financed over a much longer period and at a much lower interest rate than if a separate financial instrument was used. For the builder or seller, these items often serve as inducements used in financing the sale.

Blanket Mortgages

A blanket mortgage is often used by a developer to cover more than one parcel of land under the same mortgage. For example, a developer buys a large tract of land and plans to subdivide the land into 100 lots and then build homes on the lots. Rather than going to the expense and time of obtaining 100 separate mortgages, one blanket mortgage covering all the lots is obtained. Since the developer will probably be developing a few lots at a time, the mortgage will include a partial release clause which means that as the debt is paid, individual lots will be released from the mortgage. Thus, the developer can pay off part of the mortgage, have a certain number of lots released, build on the lots and then sell them free and clear from the lien that still exists on the unreleased lots.

Mobile Home Loans

Certain lenders, although not all, make loans on mobile homes. Typically, the amount financed is far much less than the average residential loan, and the amortization period is much shorter, perhaps seven to 10 years, even though longer terms are available under both FHA and VA financing. The amortization period is usually shorter since, unlike a permanent home, a mobile home normally depreciates in value, and thus, the lender wants to be repaid over a shorter period of time. A fear of some lenders is that since mobile homes are not permanently affixed to the land, the security for the loan, the mobile home, can be moved by a dishonest borrower, thus, not all lenders make mobile home loans.

Land Contracts

Also referred to as an installment sales contract, a land contract involves the seller's accepting a down payment on a parcel of land and a series of periodic payments of principal and interest. However, unlike other types of financing, title to the property does not pass until the last payment has been received. Although called a land contract, this means of financing can also be used to purchase improved land. Rules relating to land contracts differ from state to state. For instance, some states require that title be passed when a certain percentage of the loan has been paid by the borrower.

Leasehold Mortgages

Sale-leaseback mortgages are used by owners of commercial property as a means of raising capital. The process involves the simultaneous selling and leasing back of the property usually through a net lease. The advantages to the seller include the freeing of capital previously tied up in the project and the inclusion of the rental payment as a legitimate operating expense for income tax purposes. For the investor, the rental payment represents a return on investment and any depreciation for tax purposes or increases in value due to market conditions accrue to the investor.

Land Leases (Ground Leases)

A ground lease is ordinarily a long-term lease for a parcel of unimproved land. The tenant pays what is known as a ground rental and pays all taxes and other charges associated with ownership. The landlord receives a net amount which may have an escalation clause to periodically adjust the ground rental so that the property reflects the changing values of the land.

Normally, a ground lease contains a subordination clause. A subordination clause is an agreement that the first lien holder will agree to take a junior position to another lien holder. Without a subordination clause, it may be more difficult to construct improvements on the land. A lender, without a subordination agreement by the leasor of the land, will only consider the value of the leasehold in making a loan, while with a subordination will consider the full value of the property.

In certain parts of the country, most notably Baltimore, Maryland, the land under residential real estate is leased through a long-term lease agreement whereby the owner of the land receives periodic rent for the use of the land. Such an agreement covers an extended period of time, possibly 99 years, renewal at the lessee's option and results in a lower purchase price of the home, since the land is not owned in fee simple. Thus , less money has to be borrowed. The owner of the ground rent has a superior lien position to that of the lender, and therefore the lender normally requires the borrower to include the ground rent as part of the monthly debt service. State status regulates land leases.

Flexible Financing Techniques

As conditions and needs change, new and more flexible financing techniques have been introduced by lenders. The switch from term mortgages to fully-amortized mortgages and the increase in the loan-to-value ratio are examples of such action. While no one is sure as to exactly what lies ahead, a number of different types of financing techniques are currently being used.

Graduated Payment Mortgages (GPM)

Under the fully-amortized mortgage, each month's payment is exactly the same. The obvious advantage is that when securing a mortgage the borrower is assured of a level or constant mortgage payment. However, for some purchasers the required monthly payment is so high that a lender will not make the loan simply because the borrower's income is insufficient. With a GPM, monthly mortgage payments start at an amount less than would be required under a level annuity payment and increase periodically over the life of the mortgage. Therefore, the borrower can finance a larger purchase than if the monthly payment were level throughout the life of the mortgage. FHA has a number of GPM programs currently available.

Flexible Loan Insurance Program (FLIP)

This is a graduated payment mortgage developed to overcome the negative amortization aspects of the GPM. The key to the FLIP mortgage is the use of the buyer's down payment. Instead of being used as a down payment, the cash is deposited in a pledged, interest-bearing savings account where it serves as both a cash collateral for the lender and as a source of supplemental payments for the borrower during the first few years of the loan. During the early years of the mortgage, each month the lender withdraws predetermined amounts from the savings account and adds them to the borrower's reduced payment to make a full normal mortgage payment. The supplemental payment decreases each month and vanishes at the end of a predetermined period (usually five years). By using this type of program, a borrower is likely to qualify for a larger loan than with a conventional fully- amortized mortgage.

Reverse Annuity Mortgages (RAM)

Reverse mortgages are a way for seniors to enjoy their retirement as well as cope with inflation and what comes with it. The reverse mortgage enables older homeowners to convert part of the equity in their homes into income without having to sell, give up title or make monthly payments. Homeowners must be 62 or older to be eligible. In a reverse mortgage, the lender pays the homeowner – the opposite of a traditional mortgage where the homeowner pays the lender. The homeowner has the option to receive monthly payments, a lump sum payout, a line of credit or any combination.

Adjustable Rate Mortgages (ARM)

It is also known as variable rate mortgages (VRM). Under ARM, the interest rate charged by the lender can vary according to some reference index not controlled by the lender, such as the Cost of Living Index, the San Francisco District 12 Cost of Funds, the 1-year United States T-Bill, and the London Interbank Offered Rate (LIBOR). For the lender, this means that as the cost of money increases, the interest being charged on the existing mortgage can be increased, thus maintaining the gap between the cost of money and return. Either the monthly payment, the maturity date or both can be changed to reflect the difference in interest rates. In addition, the mortgage usually stipulates a maximum annual charge and a maximum total increase in the interest the lender may charge. Under current regulations established by the FHLBB, the interest rate may not be raised more than 2.5% points above the initial rate. The rate can be changed each 6 month, with no more than 1/2 of 1% change each 6 months.

The 11th District Index, which is probably the most widely used benchmark for ARMs is computed by the Federal Home Loan Bank of San Francisco. It reflects the cost of deposits at savings and loans in California, Arizona and Nevada. Most ARMs written in California in recent years are tied to this index.

Renegotiated Rate Mortgages (RRM)

The renegotiated rate mortgages, also known as the rollover mortgages, helps the lender to avoid being locked in to an interest rate that is below the cost of money. Here, at intervals such as 3 to 5 years, the loan is renewed at the going rate; the borrower is guaranteed at least a 30-year term and can pay off the loan without penalty at any time. If rates go up, so would payments if the loan was renewed, but the borrower could shop around to get the best deal.

Shared Appreciation Mortgage (SAM)

A shared appreciation mortgage is a type of equity participation loan in that in exchange for charging a below-market interest rate, the lender receives a predetermined percentage of any increase in value of the property over a specified period of time. For the lender, the money received from the appreciation of the property increases the effective yield on the investment. The borrower ,by agreeing to share the interest rate, in turn reduces the monthly mortgage payment. A SAM is normally written so that at the end of the shared appreciation period, the property will be appraised and the amount due to the lender through appreciation is due at that time.

Deferred Interest Mortgages

This financing technique is aimed at those people who only plan to live in a house for a short period of time. Under this mortgage, a lower interest rate and thus a lower monthly mortgage payment is charged. Upon the selling of the house, the lender receives the deferred interest plus a fee for postponing the interest that would normally have been paid each month.

Participation Mortgages

This term, when used to classify types of mortgages, has numerous meanings. One common type of participation mortgage is when more than one mortgagee lends on a real estate project, such as with a large commercial project. A second type of participation mortgage involves more than one borrower being responsible for a mortgage, such as with a cooperative apartment. Finally, a participation mortgage also represents an agreement between a mortgagee and a mortgagor which provides for the lender having a certain percentage ownership in the project once the lender makes the loan.

Sale-Leaseback

A sale-leaseback is a situation in which an owner of property sells the property to an investor and then leases the property back, usually for a twenty-or 30-year term.

EXAMPLE

Jay sells a property to Laura for $500,000 and agrees to lease it at a net rental to give her a 10% return on her investment. Jay will receive $500,000 in cash and will keep the property, pay Laura a net amount of $50,000 each year. At the end of the term, the property will revert to Laura.

Mortgage Options

Buyers face a big challenge in choosing a mortgage, but you can help them get off to a good start. How do you know which mortgage option is best for a particular buyer? Even if economic experts could agree about what will happen to interest rates during the next year, you still shouldn't choose a type of mortgage for a buyer. What you should do is stay as informed as possible about mortgage options. Then you can give buyers information that will help them make informed decisions. This section discusses some of the mortgage instruments currently used, as well as some of the features of those mortgages.

Fixed-Rate Mortgage

The most popular and traditional mortgage is the fixed-rate, which involves making regular payments based on a fixed interest rate. Unless interest rates exceed "comfortable" levels (typically about 10 percent), buyers are likely to choose this type of mortgage. According to the Federal National Mortgage Association (Fannie Mae), first time buyers often choose fixed-rate mortgages because they want the security of stable and affordable payments. Also according to Fannie Mae, financially motivate buyers may choose fixed-rate mortgages because they want low monthly payments throughout the loan term. For instance, because homes in some areas may appreciate more slowly than those in other areas, some people prefer to make low monthly payments so that they can put the money they save into other investments that bring greater returns. Also, buyers can reap the greatest cumulative tax deductions available over the loan term.

Generally, lenders require 20 percent down payments on conventional fixed-rate mortgages, but with Federal Housing Administration (FHA) insurance, only 5 percent is required.

Also, private mortgage insurance (PMI) can help buyers purchase a home with only a 10 percent down payment. As the name implies, buyers purchase PMI through private companies but lenders typically acquire the insurance for the buyers. First-year premiums are usually between .35 and 1.65 percent of the total loan amount, and depending on policy requirements, buyers must pay the premiums either in advance or monthly.

A twist on the 30-year fixed-rate mortgage is the shorter-term fixed-rate mortgage, with either a 10- or 15-year loan term. These shorter terms require larger monthly payments than a 30-year term, but the benefits that often attract buyers include the lower interest rates, faster equity buildup, and a substantial interest savings over 30-year mortgages.

With biweekly fixed-rate mortgages, payments are about one-half those of monthly fixed-rate mortgages with the same amortization schedule, and they're drafted automatically from the borrower's bank account every other week. Borrowers make the equivalent of 13 monthly payments in just 12 months, and as a result, they save on interest and their equity builds faster. Biweeklies amortize every two weeks rather than monthly, and loan amortization terms of 10,15,20, and 30 years are available.

Adjustable-Rate Mortgages

Adjustable-rate mortgages (ARMS) are a little riskier than fixed-term mortgages. In exchange for lower initial interest rates, borrowers take the risk that if lending rates rise, their payments will also rise.

With ARMs, rates are adjusted during the term of the loan according to changes in market interest rates. Borrowers typically choose a six-month or one- or three-year ARM, and as the names imply, the rate remains stable for the first six months, year, or three years. (There are, of course, other kinds of ARMs, which are also classified according to the frequency of their payment adjustments.) A per adjustment cap and a lifetime cap on the level to which the interest rate may be adjusted can help reduce some of the risk, and these are available on some ARMs, as are 15- and 30-year loan terms, and options to convert to fixed-rate mortgages.

Why do some borrowers opt for ARMs? Those who expect to move within a few years will often choose an ARM because of the low initial interest rates and then resell the home before the rates are adjusted. Borrowers refinancing their current mortgages may also choose ARMs if the lower initial interest rates can make up for the transaction costs of refinancing.

Remember, though, lenders use different indexes on which to peg their ARMs. The index used will determine the payments during the loan term. For example, cost-of-funds indexes are tied to the interest rates on savings accounts. Many lenders, however, now use the one-year U.S. Treasury securities index or the 11th-district cost of funds index to adjust their ARMs.

Also, treatment of closing points can be different with ARMs. A few lenders allow buyers to spread the cost of closing points in equal monthly installments over the first two years of the loan. Buyers should check the deductibility of these payments with their tax adviser.

Negative Amortization

With most loans, the payments cover the principal and interest, and the borrower will have repaid the loan by the end of the loan term. But some borrowers are taking more risks by using negative amortization loans. In those cases, monthly payments fall short of what the borrowers must pay to cover both the principal and the interest of the loan, and at the end of the year, the borrowers actually owe more than they owed before they make 12 payments. Why would a borrower do this? Lower monthly payments are available with negative amortization loans, and most often, borrowers who take this risk are buying in markets with extremely high prices. Many gamble that their home will appreciate enough to cover the difference between their payments and the new loan amount.

Taking Known Risks

Some borrowers are willing to take risks if they know the risks in advance. With graduated payment mortgages (GPMs) or growing equity mortgages (GEMs), payments increase during the loan term. Borrowers can plan for the larger payments because they know exactly how much the payments will increase. The difference between GPMs and GEMs is the treatment of the amortization schedule. GEMs are calculated on 30-year fixed terms, even though payments increase during the loan term. As a result, a 30-year loan is often paid within 15 to 20 years. With GPMs, the increase payments are scheduled within the 30-year term, and the "overpayments" are applied directly to the loan principal. The FHA offers five different types of GPMs, and the Veterans Administration (VA) offers its own GPM and GEM plans.

Let The VA Take Risks

Except for its GPMs and GEMs, loans guaranteed by the VA require no down payment, and a builder or seller may pay closing costs for the buyer.

The VA also offers veterans a buyer-down purchase plan in which the seller pays the lender to lower the borrower's interest rate either temporarily or permanently. In permanent buy-downs, sellers will typically offer to make the interest rate 1 percent below the maximum rate set by the VA for the entire 15- or 30-year loan term. With temporary plans, the 3-2-1 option is common. The interest rate is reduced 3 percent during the first year, 2 percent during the second year, and 1 percent during the third year. Then payments increase to normal levels for 30-year terms. Finally, to increase the options when a borrower decides to resell, no VA loans have due-on-sale clauses. Thus, another buyer may assume the veteran's loan at the original interest rate, or the veteran may incorporate a second mortgage, a wraparound, a contract for deed, or a lease purchase without the original lender's approval.

Let The FHA Take Risks

Not only does the FHA insure loans for lenders but also its insurance makes it possible for buyers to purchase a home with a small down payment. Under the FHA's 203b plan, virtually any U.S. resident 18 years or older can purchase a home with a 15- or 30-year fixed-rate loan and a 3 percent down payment on the first $25,000 of value and closing cost and 5 percent on the remainder. Another FHA option is the shared equity mortgage (SEM), whereby a marginal buyer can pair up with a relative or investor to purchase a home. With an SEM, loans often go as high as 97 percent of the home's value. Each investor owns a percentage of the home, and monthly payments are based on those percentages.

Seller Financing

If buyers are considering a home with an assumable mortgage at a fair interest rate or if the sellers have already paid their mortgage, remember to consider seller financing. With seller financing the seller determines the sales price and then acts much like a lender. He determines the amount of down payment necessary and the other terms of sale.

Seller financing becomes more common when interest rates are high and buying a home is out of reach for many who could otherwise afford it. But regardless of interest rates, this option helps qualify people to buy who might not be able to qualify for a loan through a lending institution or who may have the income to afford monthly payments but not the cash for a down payment. With seller financing, borrowers whom lenders might consider marginally qualified not only may qualify to buy but also may save money because closing costs are often nonexistent or less expensive than with lender financing. Why would a seller take the risk? Often, seller financing produces returns that are substantially higher than those of most other investments. Also, seller financing is treated as an installment sale for tax purposes. Finally, if the buyer defaults, the seller can take the property back under the contract or, if absolutely necessary, he can foreclose on the property.

A seller can also offer a wraparound mortgage to a buyer who already owns a home. With this option, the seller makes a money advance to cover or "wrap" the balance due on the old mortgage and the amount on the new loan at an interest rate below market levels. The term of the wrap is the time left on the old mortgage. So with the seller's help, the buyer's monthly payment is substantially less than for a new first mortgage at the higher interest rate.

Helping Find The Right Option

Maybe some of the buyers you're working with want to purchase a home, but they want low monthly payments so that they can save for their children's college education. Or maybe some of your prospects haven’t saved enough money to afford a down payment on the home they're interested in, but they want to invest in a home rather than pay rent each month.

Today's buyers have many financing options, and the challenge for them is to find the option that best suits their special circumstances. Your knowledge about their options can help ensure that their first step is the right one.

Qualifying The Buyer

According to an old blues lyric, "romance without finance ain't got a chance." So it is today with home buying. Without finance, you can't close a sale. The point of the qualifying process is to quickly sort out buyers' needs from wants and relate their buying power to the available housing stock. It's a valuable service the real estate professional is uniquely qualified to provide.

You've probably seen people emotionally wrapped up in the idea of buying a home, but before they could find one and buy it, they had to work out financing details--that is, unless they were able to pay cash. How do you know whether prospective buyers can jump the financing hurdle?

The answer is by qualifying the buyer. The process usually starts with a qualifying interview soon after you've met the buyer. Build a rapport with the buyer during the interview that will allow you to discuss personal finances, obtain key numbers to determine whether the buyer meets current lender requirements, and gather information about the buyer's lifestyle and housing needs. Of course, as a salesperson, you're an expert in marketing homes, not real estate finance. You should make it clear to the buyer that you can provide information but the buyer should--and will-- eventually consult with an expert such as a lender. If you train buyers for the mortgage loan marathon, they'll come through in good shape.

Part of the job of getting transactions completed on behalf of sellers is knowing that the buyers you bring to the sale are qualified and only then showing them the houses you know they can afford. "Seller will carry back" is appearing more often in listings in California, multiple listing services (MLSs). Sellers want their properties sold fast, and financing is essential to almost every transaction.

Build Trust And Rapport

Since the mortgage menu is a full one, you have more to discuss with buyers at the qualifying session than ever before. If you can prepare your buyers to organize their finances and choose the best loan for their situation, they'll be well on their way to a loan approval. And you'll get a closed transaction.

Establishing rapport with buyers so that you can ask them details about their personal finances isn't always easy, but it's necessary. You'll run into some buyers who are reluctant to reveal their financial situation. You tell them what a lender will ask to get a loan approved. That way, buyers understand why it's important to provide key financial information.

Many of your buyers will be move-up buyers with equity and money to make the down payment. They'll probably fit into the range of lender requirements. But first-time buyers may not have a clear idea of what's affordable. Qualifying them initially will help ensure they'll see the houses they can afford (see Figure 1).

Ask For Key Numbers

You would want to know gross and net income for the buyer--or for both husband and wife if they're co-borrowers--and get a rundown of debt payments and assets, including cash, certificates of deposit, and stocks and bonds.

Cash assets will tell you what buyers can afford for a down payment, which is a good indicator of how much house they can afford. But just make sure they've tapped every source of income they want to use for housing. If that's still not enough, they may have access to funds from co-borrowers, such as parents or other relatives. Income and debt will dictate the level of monthly housing payment a buyer can handle. With this information, you can estimate how much mortgage the buyer can afford. You find out the maximum that buyers can afford on the basis of income, debt payments, and the payment-to-income ratio. Then you determine the maximum for the fixed-rate mortgage and also for a variety of adjustable-rate mortgages (ARMs).

You have to elicit key financial information quickly to get the home buying process moving.

Some Lenders Like Conformity

The reason you need the financial data is that lenders have strict requirements. Often, you'll be working with a standard "conforming" loan and using the widely accepted lender requirements. Conforming loans are largely determined by Fannie Mae underwriting guidelines the maximum loan amount throughout most of the 90's was $240,000. This amount is raised now to $417,000. Lenders set maximum loan amounts and limit housing expense to a certain percentage of total income and total debt. The income ratios are 28 percent for the housing ratio (payments, interest, taxes, and insurance (PITI) divided by gross monthly income) and 36 percent for the debt-to-income ratio (PITI and monthly debt divided by gross monthly income).

That's what's dictated by the secondary market—Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation). They're among the largest single buyers of loans, so lender adheres to their requirements.

Federal Home Loan Bank Board (FHLBB) gives you this maximum mortgage amount every year according to a formula established by law. The formula is based on the average purchase price of homes on which mortgage loans closed during October as determined by the FHLBB's monthly national survey of home prices. It's set to be effective January 1 every year.

A rising percentage of loans are sold to the secondary market, so lenders pay close attention to the changes in conforming loan limits.

Loan To Value: Another Key Number

Another key figure for lenders is the loan-to-value ratio. This has proved to be an accurate predictor of risk in lending. Lenders like high down payments (20 percent or more) so that the loan-to-value ratio is 80 percent or less. Those loans are safe. A 90-95 percent loan-to-value ratio is somewhat more risky but not impossible to get. In today's competitive lending market, lenders vie to offer extra service to borrowers. They compete on the basis of extended loan-to-value ratios.

To cover the lender's risk, high-risk buyers usually pay extra in the form of private mortgage insurance (PMI). If you know that borrowers will need a high loan-to-value mortgage, you can explain ahead of time that PMI costs relatively little and provides the benefits of a lower down payment, more leverage, and more money available to the borrower. Then buyers won't be shocked at the extra payments.

Loans Matching Lifestyle

During the qualifying interview, you must deal not only with key numbers but also with the buyers' housing needs and lifestyle. Find out what they want out of housing. The length of time that buyers want to stay in a house is as important as anything else in determining the mortgage they should choose. Short-term owners will benefit from an ARM's low rates in the early years. For some buyers, especially first-timers, it's a matter of searching for an affordable loan. First-time buyers and those who need a high loan-to-value mortgage require more work on your part. With them, your qualifying work is even more important. Some may simply be unqualified and need more time to save for a home. But don't rule out such buyers automatically.

Look for any special circumstances that affect financing. Is the buyer a veteran? Can he qualify for a Veterans Administration (VA) loan at below-market rates? Are there relatives who can help pay for the loan? Ask buyers about IRAs or pension plan funds that may boost their net worth and help them qualify; ask them about friends or relatives who may co-sign the loan with them.

Buyers' comfort level or risk aversion is also an important factor in the kind of financing they'll seek. ARMs and negative amortization loans carry more risk and uncertainty for the borrower, depending on the ups and downs of interest rates. Fixed-rate loans are considered more traditional and conservative.

After You Think They're Qualified

After you've obtained the key numbers, you can do some "what if" calculations based on the buyers' lifestyle and housing needs. It'll help you arrive at a price range that's appropriate for them and an estimate of the maximum down payment, monthly payment, and mortgage amount they can afford.

When buyers have found a house and are ready to sign a sales contract, a lender will do the formal qualifying. If you think you have a special case on your hands or are unsure about it, you can rely on the lender sources you've cultivated.

Know When To Call The Lender

Although financing knowledge is becoming increasingly important to salespeople, there are limits to their expertise. Know the limits of your involvement in finance. If something goes wrong with the buyers' you're no longer their friend who helped them buy their dream house but just the opposite. Every real estate professional knows a mortgage lender. Call the lender up and have that individual talk to buyers.

Be Open To New Techniques

You'll need to work closely with lenders to keep up with the new mortgage programs they offer. Start out with, for instance, an intensive three- to four-hour financial seminar offered by a lender and then keep up-to-date by occasional visits with lenders. It's a good idea to check out new lenders and their loan programs by doing a dry run through the loan applications and reading the literature. Read critically. What are the advantages? Are there any hidden costs?

There is value in establishing a close relationship with three or four reliable lenders rather than shopping around for the lowest rate. You shouldn't shop rates for a quarter of a percent difference. Instead, you are better off working with your group of lenders to place most loans though you may try new lenders for hard-to-place loans. In return for loyalty, you may get good service and sometimes even a break on the rates.

Keep On Top Of Trends

If you find out all you can about the top financial options in mortgage lending in your town, you'll provide a valuable service to buyers, assuring them of good market information. You'll also avoid the possibility that buyer's remorse will set in after a bad loan experience or a loan rejection.

As closely as real estate salespeople and lenders must work together today, all parties to the sale will benefit if the relationship and the transaction begin right.

Figure 1
Qualifying For Conventional Loans

Completing a work sheet like this one can give you and prospective buyers a better idea of how much house they can really afford. Once you've filled it out together, you'll also know what kind of financing hurdles may lie ahead.

Part 1--Determine Cash Available for the Down Payment

1.Sale of assets		$ _______________
2.Sale of previously owned home		$ _______________
3.Other available cash	+	$ _______________
4.Total available cash	=	$ _______________
5.Minus estimated closing costs	-	$ _______________
Cash available for the down payment	=	$ _______________

Part 2--Determine Gross Monthly Income

1.Annual salary of buyer(s)		$ _______________
2.Other annual income	+	$ _______________
3.Total annual income	=	$ _______________
	/	12
Gross monthly income	=	$ _______________

Part 3--Estimate the Affordable Monthly Payment (PITI)

A. Use the housing-expenses-to-income ratio

1.Gross monthly income (from Part 2)		$ _______________
2.Current housing-expenses-to-income ratiox		_______________
Affordable monthly PITI	=	$ _______________

B. Use the debt-to-income ratio

1.Gross monthly income (from Part 2)		$ _______________
2.Current debt-to-income ratio	x	_______________
3.Affordable monthly PITI with debts	=	$ _______________
4.Total debts exceeding ten months	-	$ _______________
Affordable monthly PITI	=	$ _______________

C. Compare the two monthly PITI amounts

1.Enter the smaller of the two amounts for affordable monthly PITI
(compare the results of parts 3A and 3B) = $ _______________

Part 4--Estimate the Affordable Monthly PI

1.Actual affordable monthly PITI (from Part 3C)		$ _______________
2.Estimated monthly taxes and insurance	-	$ _______________
Affordable monthly PI	=	$ _______________

Part 5--Estimate the Maximum Loan Amount

(Use an amortization table or calculator)

Maximum loan amount	=	$ _______________

Part 6--Estimate Maximum Purchase Price

1.Down payment (from Part 1)		$ _______________
2.Maximum loan amount (from Part 5)	+	$ _______________
Maximum purchase price	=	$ _______________

Note: Adapted from RITE Financing Real Estate

Lend A Hand With Paperwork

Be ready to interpret financial terms if they are a foreign language to buyers. A home is the biggest investment most people make, so buyers are anxious to finance it on the best terms possible. Today, more loan choices than ever face the would-be borrower. Once you've prequalified a buyer, the next step is usually answering the buyer's questions about mortgage loans. It's here that your knowledge of real estate finance can help you stand out from other salespeople. You must be thoroughly familiar with the mortgage market in your town. You must also know what loans are available and on what terms, and you must be ready to help buyers get through the application process.

Get To Know Lenders

To be proficient, you need to know which mortgages work best in a variety of market conditions. Keeping up with real estate finance can take some time and effort, but it's time well spent.

Lenders are ready to cooperate in the learning process. They, too, operate in a competitive marketplace, so they're ready to help you.

Although lenders all have their own products to sell, they're also good sources of general information about the field. To take advantage of this expertise, several salespeople advised, "Take a lender to lunch." Get to know the local lenders, and make it a habit to keep in touch with what's going on in the local and regional lending business. Even experienced salespeople need to learn continually because consumer demands shift and loan features change. After buyers have asked about loan types, they'll probably ask about rates. To illustrate the changes in interest rates, you can show buyers what has happened in the recent past. Remember, however, that lenders will be providing the buyer with specific rate and loan information as required by federal law. Since October 1988, lenders have been required to disclose to buyers applying for a loan how that particular program works. For example, if buyers choose one of the many adjustable-rate mortgage (ARM) products available, they'll get substantial information about interest rates.

Although you can't advise buyers on which loan to choose, you can direct them to sources of mortgage information.

Learn The Loan Market

To give buyers the big picture, you can explain that almost all loans fit into one of two categories: fixed-rate or adjustable-rate. Even experienced move-up buyers may know that fixed-rate loans have recently appeared in equity building varieties. Borrowers can choose intermediate terms, such as 10, 15, and 20 years, as well as the traditional 30-year mortgage.

Now well accepted, the ARM was a significant innovation. It let buyers take advantage of a low initial rate and payment and offered them the possibility of a downward adjustment in the future, depending on the performance of the index to which it was tied. Among the popular indexes, the 11th District average cost-of-funds index has been gaining in popularity because it has been less volatile and, therefore, a better buy for borrowers concerned with interest rate risk.

Learning the ARM loan means learning to compare not only initial rates but also indexes, margins, rate caps, and life-of-the-loan caps.

The convertible ARM is a relatively new mortgage product that combines features of adjustable- and fixed-rate loans. For those who want to hedge their bets, the convertible ARM is a fantastic product. It's adjustable, but it's conservative because it can convert to a fixed rate during a window period.

Note: There are different variations of ARMs you may opt for, such as 1-year (fixed) ARM, 3-year ARM, 5-yearARM, 7-year ARM, and 10-year ARM.

A Point About Points

As important as knowing interest rates is knowing the lender's policies about the other key elements of a loan. What's tough on buyers is if they have a 90-day lock-in for the rate and the points, say, two points. You have to tell them it's a gamble. They can save some money or lose some in a volatile market. It makes a difference whether they float with the points or lock them in. If you make buyers aware of points at the outset of their mortgage search, it helps them prepare. What you get for a dollar with points is a determining factor.

Points and closing costs can raise the true cost of a loan significantly. These fees assume a variety of names: fees for recording of mortgage, lender's inspection fee, lender's points, and prepaid interest. If you prepare buyers for such fees and familiarize them with their purpose, they can be better shoppers and find out for themselves the true cost of a loan--the actual annual percentage rate (APR).

The Loan Application

Once you've discussed loan types with the buyers and given them the data they need to find financing, you should follow up to keep the loan process moving.

Guiding the buyers through the loan application process is easy if you've prequalified them properly. Loan applications themselves are no big deal.

Providing the basic personal information takes little of the buyers' time; amassing the financial data and credit history is what takes time and maybe some help from you as well. A typical loan application asks for employer, earnings, bank accounts and investments, debts (such as installment debts, charge accounts, auto loans, and alimony), and credit history.

The application process is now easier. For instance, lenders are more willing to accept paycheck stubs from the borrower as evidence of income instead of a written letter from the employer, along with W2 forms for the past two years to verify income stability. They're also more willing to accept a photocopy of a savings account statement instead of a letter from the buyer's bank. With this kind of documentation and photocopies of mortgage payments for 12 months of canceled checks for 6 months of rent payments, some lenders will now issue an approval within two weeks. The approval is contingent on an acceptable appraisal establishing value and on an acceptable source of down payment and closing costs.

Quick-approval loans that promise 15-day processing from application to approval are more common when lenders are competing for business. The salesperson can help buyers link up with a good lender. At this point, the application is in the lender's hands. But even so, you should be ready to follow up with the buyer and the lender to help ensure that a qualified buyer perseveres through the loan application process.

Watch The Finance Scene

Your assistance during the long wait between choosing a home and getting a loan can help close the sale. Remember, you're the link between the lender and the buyer. Keep in touch with the lender and alert the buyer to any missing documents or problems. You can also reassure the buyer who's unnecessarily anxious about loan approval. Working closely with a good lender is the key to successful financing. That's not all there is to a mortgage loan, however. Credit reports and appraisals are also crucial to the process, and you'll need to work just as closely with allied professionals in those fields. But if you keep pace with the financial side of real estate, you'll be a step ahead of the game.

Follow Up The Loan Process

Both the lender and the buyer could use your support while the loan is being processed. But what responsibilities do you and the lender have toward each other and to the buyer? Communication with all parties and paying attention to details can speed up the transaction--and that commission check.

Contact With The Lender

It makes sense to maintain contact with the lender to see how things are coming along. It's helpful, though, to know just whom you should contact. Usually a loan processor and a loan officer handle the loan. There's a difference between the two, though in smaller loan departments that person might be one and the same. The loan officer prequalifies the buyer, selects the loan most appropriate for the buyer, and is your main contact person.

The processor takes all the needed documentation (employment verification, account numbers of bank accounts, credit report, tax forms, and so on) and packages the loan so that it meets the requirements of the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac). The processor obtains the lender's stacking order and also orders the appraisal and title report.

The loan then goes to the loan officer, who'll keep you abreast of new developments regarding the transaction and let you know whether there's anything you can do to assist in the process. The loan is subsequently sent to the underwriter or a loan committee or both for review and final approval.

It's a process of check and double-check.

How often should you check in with the loan officer? That probably depends on your relationship. Communication is crucial between the real estate professional and the lender. Communication lines should be open during the follow-up.

Inform The Buyer

What about contact with the buyers? Salespeople should let buyers know what they can do to expedite the loan process: "If verifications get hung up somewhere, a buyer might have better luck calling and working his way through the system."

What else can a real estate professional do to help the process along? Check for earnest money funds, inform buyers about homeowner's insurance, and order a profile of the property. A salesperson can help out with the appraisal as well by obtaining comparables for the appraiser. The availability of appraisals of like-kind property makes the appraiser's job easier. However, some appraisers want the help of a real estate professional but others don't, so it's a good idea to check with the appraiser involved.

Loan Rejection or Acceptance

If a loan is rejected, there is some recourse for a real estate professional. You can try to help identify the problem (poor credit and employment problems, for instance) and be realistic and supportive. When a buyer's loan is rejected, you might want to tell the buyer, "This particular loan company rejected the loan. But there's latitude within the Fannie Mae and Freddie Mac rules and regulations. Even though one company disapproved the loan, it doesn't mean another won't approve you. It's a race to the finish line, and just because we stumbled, it doesn't mean we should give up. When a loan is accepted, you should let buyers know about closing costs before closing.

Communication is of utmost importance during the follow-up process. Your role as communicator and facilitator is more important than ever. You'll increase your professionalism and your reputation with lenders and buyers alike by being thorough and accurate.

Types Of Mortgage Loans

Loan Type	*Benefits*	*Drawbacks*
1.Fixed-rate, fixed payment a. Conventional 30-year mortgage	Fixed Monthly Payments for 30 years provide certainty of principal interest payments.	Higher Initial rates than adjustables.
b. Conventional 15 or 20 year mortgage.	Lower rate than 30-year fixed; faster equity buildup and quicker payoff of loan.	Higher monthly payments.
c. FHA.VA fixed rate mortgages (30-year and 15-year)	Low down payment requirements and fully assumable with no prepayment penalties.	May require substantial points; may have application red tape and delays.
d. “Balloon” loans (3-10 year terms)	May carry discount rates and other favorable terms, particularly when the home seller provides the loan.	At the end of the 3-10 year term, the entire remaining balance is due in a lump-sum or “balloon” payment, forcing the borrower to find new financing.
2.Adjustable rate a. Adjustable rate mortgage (ARM) – payment changes on 1-year,3-year, and 5-year schedules.	Lower initial rates than fixed rates than fixed-rate loans, particularly on the one-year adjustable. Generally assumable by new buyers. Offers possibility of future rate and payment decreases. Loans with rate “caps” may protect borrowers against increases in rates. Some may be convertible to fixed-rate plans.	Shifts far greater interest rate risk onto borrows than fixed-rate loans. Without “caps,” may also sharply push up monthly payments in future years.
b. Graduated-payment mortgage (GPM) – payment increases by pre-arranged increments during first 5 to 7 years, then levels off.	Allows buyers with marginal incomes to qualify. Higher incomes over next 5-7 years expected to cover gradual payment increases. May be combined with adjustable-rate mortgage to further lower initial rate and payment.	May have higher annual percentage rate (APR) than standard fixed-rate or adjustable-rate loans. May involve negative amortization-increasing debt owed by lender.
Growing-equity mortgage (GEM)-contributes rising portions of monthly payments to payoff of principle debt. Typically pays off in 15-18 years rather than 30.	Lower up-front payments, quicker loan payoff than conventional fixed-rate or adjustable-rate loans.	May have higher effective rates and higher down payments than other loans in the marketplace. Tax deductions for interest payments decrease over time.

Latest Mortgage Options

With real-estate prices shooting persistently upward, first-time buyers are finding it tougher to get in the game. Who ever heard of a $500,000 starter home? Lenders have responded by devising some novel loan structures, mostly designed to cut payments in the early years. While many of these products make pricey homes available to people who otherwise couldn't afford them, they can be burdened with risk. Here are some of the latest mortgage options.

40-Year Mortgage. These products are similar to 30-year fixed-rate mortgages, except that borrowers stretch the payments out for an extra 10 years. Lenders, however, charge a slightly higher interest rate, up to half a percentage point. This type of loan is good for first-time buyers who don't plan on staying in the house for more than a few years, and are looking for lower monthly payments.

Benefits: A 40-year mortgage offers lower monthly payments than a 30-year loan. On a $300,000 mortgage at, say, 6% for a 30-year and 6.25% for a 40-year—a home buyer could save nearly $35 each month,

Drawbacks: By extending the length of the mortgage, the borrower increases the amount of interest paid over the life of the loan. On that $300,000 mortgage, it would mean an additional $170,030.42.

Negative Amortization Mortgage. This interest-only product allows buyers to pay less than the full amount of interest necessary to cover the costs of the mortgage. The difference between the full amount and the amount paid each month is added to the balance of the loan. This loan is best for borrowers with large cash reserves who want the flexibility of lower payments during certain parts of the year but plan to pay off loans in large chunks during other parts.

Benefits: An even smaller monthly payment than an interest-only mortgage in the first few years.

Drawbacks: Should housing prices stagnate or fall, buyers would find themselves in "negative equity," meaning they would owe money to the lender if they sold their homes.

Flex-ARM Mortgage. Each month the lender sends the borrower a payment coupon that calculates four payment options: negative amortization, interest only, 30-year fixed and 20-year fixed. The homeowner decides how much to pay. (Some mortgages offer only an interest-only and a 30-year-fixed option.) This structure is recommended for people who like options and have large cash reserves for when payments increase in the later portion of the loan.

Benefits: The bank does all the thinking. Each month it recalculates the balance and tells the borrower how much he or she would owe under different scenarios.

Drawbacks: Borrowers could end up owing more on the mortgage than they can fetch for their homes.

Piggyback Mortgage. This is really two mortgages, also known as a combo loan. The first covers 80% of the property's value. The second, with a slightly higher rate, covers the remaining balance. Young professionals with high salaries but little savings would benefit most from this loan type.

Benefits: In most cases, homeowners save money since the second loan allows them to avoid paying costly private-mortgage insurance when buying a home with less than a 20% down payment.

Drawbacks: Rates on the second mortgage are higher. And rates can vary greatly depending on credit scores. Also, since the borrower has little equity in the home, should its value fall when it is time to sell, the borrower would need to pay the difference in cash.

103s and l07s. These loans have no down payment and allow people to borrow 3% to 7% more than the house is worth. They are best for people with large cash reserves who prefer to invest in, say, the stock market rather than tying up assets in real estate.

Benefits: Minimal up-front costs.

Drawbacks: Rates tend to be high. And borrowers run the risk of negative equity if the house loses value.

No-Doc or Low-Doc Loan This loan let you borrow without proving the usual income requirements. Most lenders expect you to have a credit score of at least 620.

Benefits: The borrower does not earn enough money to qualify for a normal loan but anticipates no trouble making the mortgage payments.

Drawbacks: The rate may be one-half to three points higher than an equivalent full-doc loan.

Online: Helpful Web Sites

Here are some helpful Web sites that will assist homeowners interested in refinancing their mortgages and other matters:

Mortgage Information

www.RealEstateABC.com

Lists the 100 most visited real estate Web sites. It also provides general information in its real estate and mortgage reading rooms—plus payment calculators.

www.eloan.com

A large online-only mortgage bank. It hopes that homebuyers will choose to apply for and close a loan online.

www.lendingtree.com

Submit your information and within 24 hours you will receive bids from four lenders interested in making your loan.

www.bankrate.com

Rates for mortgages, credit cards, car loans and home equity loans, articles and tips on refinancing, online loan shopping.

www.consumerworld.org

Links to more mortgage, credit and financial Web sites than you'll know what to do with.

www.getsmart.com

Search mortgage companies, credit card rates.

www.homepath.com

Financial calculators, refinancing, first-time buyers.

www.hsh.com

Clearinghouse for loan rates by region, rates for borrowers with poor credit, tracking ARM indexes, calculators.

www.loanpage.com

Rates, reference materials, calculators and a mortgage blog.

www.mbaa.org

Frequently asked questions, definition of terms and info about escrows.

www.relibrary.com

Answers questions concerning buying a home.

Home Valuation

Zillow.com

It provides a free estimate of a home. All a person has to do is enter an address and out pops a value, as well as recent sales of surrounding homes.

Chapter 1 Review Questions – Section 3

16. What are first mortgages that have superior rights of subsequent lenders with low risk and low interest rates known as?

A. Senior Instruments
B. Straight-Term Mortgages
C. Fully amortized mortgages
D. Budget mortgages

17. What is a method of payment that requires interest, principal and a certain percentage on annual property taxes and property insurance?

A. Budget mortgage
B. Straight-term mortgage
C. Fully-Amortized mortgage
D. Partially Amortized mortgage

18. What is a conventional loan that is insured by a private (non-governmental) insurance company known as?

A. FHA
B. VA
C. MAGIC (MGIC)
D. CAL-VET

19. Which of the following is an example of a junior instrument (second mortgage)?

A. Conventional mortgage
B. Wrap-around-mortgage
C. Federal Housing Administration Insured Mortgage (FHA)
D. Veterans Administration Loan Guaranty.

20. What is a flexible financing technique for older people who have little or no debt on their property?

A. Graduated Payment Mortgage (GPM)

B. Flexible Loan Insurance Program (FLIP)
C. Reverse Annuity Mortgage (RAM)
D. Variable Rate Mortgage (VRM)

21. What is the most popular and traditional mortgage that involves making regular payments on a fixed interest rate?

A. Negative Amortization
B. Adjustable-Rate Mortgages (ARM)
C. Fixed-Rate Mortgages
D. Graduate Payment Mortgages (GPM)

22. In qualifying a buyer and determining the cash available for the down payment of a prospective buyer, you do NOT need to which of the following activities?

A. Estimate the available cash from the sale of assets
B. Determine the amount from a previous owned home
C. Calculate other cash available less estimated closing costs
D. Use the housing-expenses-to-income ratio

23. Points and closing costs can raise the true cost of a loan significantly. What can these fees include?

A. Building trust and rapport
B. Mortgage recording fees and lender inspection fees
C. Matching the housing needs and life style of the borrower
D. Establishing the gross and net income of the buyer/buyers (husband & wife)

Chapter 2:

Fundamentals Of Investing

Learning Objective

After completing this section, you should be able to:

1. Recognize how to get started as an investor.
2. Identify the factors to be considered in investment decisions.
3. Recognize the relationship between inflation and interest and how it affects different investment options.

Getting Started As An Investor

Before you invest any funds, you should evaluate your present financial condition. Consider your income, expenses, taxes, future prospects for higher earnings, and all other details that affect your monetary situation. Decide how much you want to invest. Realistically, it can be done only with money left over after paying expenses, having proper insurance, and making pension contributions.

Then very carefully formulate your investment goal or goals. Will you invest in order to earn a profit? As a hedge against economic fluctuations such as inflation. To build up a retirement income? Your next step should be to examine the investment choices presented in this column and then decide which kinds of investments are best for you.

You should attempt to formulate an investment strategy based on your goals and financial characteristics. Investment planning should be aimed at arriving at a good mix of risk and reward. You should take into account the types of investments available including their return potential and riskiness. Also, you should be aware of the general risks of investing including those related to stock market price variability, inflation, and money market conditions.

Set your long-term goals first, thinking in terms of the middle and distant future. Then establish short-term financial objectives that are consistent with the long-term aims. After six months or a year, if you haven't been able to meet your short-term goals, you may have to reevaluate the long-term objectives. If, however, you have done much better than you expected to do, you may want to formulate more ambitious goals. Keep in mind that investing is an integral part of your overall financial planning.

Sources Of Money For Investing

If possible, try to invest 15% of after-tax income. Also, make sure before starting to invest in securities such as stock, your total assets should be two times your liabilities. Below are the possible sources of money available for investing.

- Discretionary income. After-tax income is disposable income, money available to you for spending or saving. You must commit much of your disposable income to fixed or semi-fixed expenditures such as housing cost, food, and transportation. Discretionary income is what is left after these expenses.
- Home equity. You may have a substantial amount of money sitting in your home. You can cash out some of it via either a home equity loan or equity line.
- Life insurance. If you have a cash value (e.g., whole-life or variable life) life insurance, you can borrow up to a certain amount.
- Profit sharing and pension. If you own some form of annuity, again you may borrow up to a certain amount at a low interest.
- Gift from your parent or rich uncle.
- OPM (other people's money).

Factors To Be Considered In Investment Decisions

Consideration should be given to safety, return and risk, stability of income, and marketability and liquidity.

Security of principal. It is the degree of risk involved in a particular investment. You will not want to lose part or all of the initial investment.

Return and risk. The primary purpose of investing is to earn a return on your money in the form of: interest, dividends, rental income, and capital appreciation. However, increasing total returns would entail greater investment risks. Thus, yield and degree of risk are directly related. Greater risk also means sacrificing security of principal. Remember: You have to choose the priority that fits your financial circumstances and objectives.

Stability of income. When a steady income is a most important consideration, bond interest or stock dividends should be emphasized. This might be the situation if you need to supplement your earned income on a regular basis with income from your outside investment.

Marketability and liquidity. It is the ability to find a ready market to dispose of the investment at the right price.

Tax Factors. Investors in high tax brackets will have different investment objectives than those in lower brackets. If you are in a high tax bracket, you may prefer municipal bonds (interest is not taxable), real estate (with its depreciation and interest write-off), or investments that provide tax credits or tax

In addition, there are many other factors to be considered, including:

- Current and future income needs
- Hedging against inflation
- Ability to withstand financial losses
- Ease of management
- Amount of investment
- Diversification
- Taxes and estate status
- Long-term versus short-term potential
- Denominations of investments required (For example, some real estate investment trusts (REITs) require a $5,000 minimum investment)
- Need for collateral for loans
- Protection from credit claims

Questions To Askd

In developing your investment strategy, it will be advisable to ask the following questions:

- What proportions of funds do you want safe and liquid
- Are you willing to invest for higher return but greater risk
- How long of a maturity period are you willing to take on your investment?
- What should be the mix of your investments for diversification (e.g., stocks, gold, real estate)?
- Do you need to invest in tax-free securities?

Types Of Investments

Investments can be classified into two forms: fixed-income and variable-income. Simply stated, fixed-income investments promise you a stated amount of income periodically. These include corporate bonds and preferred stocks, U.S. government securities (Treasury bills), municipal bonds, and other savings instruments (savings account, certificate of deposit). On the other hand, variable-dollar investments are those where neither the principal nor the income is contractually set in advance in terms of dollars. That is, both the value and income of variable-income investments can change in dollar amount, either up or down, with changes in internal or external economic conditions. These include common stocks, mutual funds, real estate, and variable annuities. A Treasury bill is a short-term U.S. government obligation that is sold at a discount from its face value. A Treasury bill is highly liquid and nearly risk-free, and it is often held as a substitute for cash.

Investments can be viewed as financial or real assets. Financial assets comprise all intangible investments--things you cannot touch or wear or walk on. They represent your equity ownership of a company, or they provide evidence that someone owes you a debt, or they show your right to buy or sell your ownership interest at a later date. Financial assets include:

1. Equity claims - direct
    a. Common stock
    b. Options and warrants
2. Equity claims - indirect
    a. Mutual funds
3. Creditor claims
    a. Savings accounts and certificates of deposit (CDs)
    b. Treasury bills
    c. Money market funds
    d. Commercial paper
    e. Corporate and government bonds
4. Preferred stock
5. Commodities and financial futures
6. Annuities

Real assets are those investments you can put your hands on. Real assets include:

- Real estate
- Precious metals
- Collectibles and gems

An investment may be short-term or long-term. Short-term investments are held for one year or less, while long-term investments mature after more than one year. An example of a short-term investment is a one-year CDs; a typical long-term investment is a ten-year bond. Some long-term investments have no maturity date. Examples of along-term investment are equity securities such as common stock and preferred stock. But you can purchase a long-term investment and treat it as a short-term investment by selling it within a year. *Note:* In selecting the types of investments you would want, be cautious in taking salespeople (e.g., brokers, mutual fund representatives) advice because their prime motivation is to earn a commission. Consult instead financial planners, CPAs, or investment advisors.

Common Stocks, Preferred Stocks, And Bonds

Common stock is a security that represents an ownership interest in a corporation. This ownership interest is evidenced by a transferable stock certificate. Each share is a fractional ownership interest in a corporation. You acquire an equity interest in the corporation by buying its stock. As a stockholder, you can vote for the board of directors of the corporation. The equity investment has no maturity date. Preferred stockholders have preference over common stockholders with respect to dividend and liquidation rights, but payment of preferred dividends, unlike bond interest is not mandatory. In exchange for these preferences, the preferred stockholders give up the right to vote.

A bond is a certificate evidencing a loan by you to a business or to government. You will receive interest and principle repayment for your investment. Bonds may be categorized as follows:

1. Mortgage bonds. Mortgage bonds are backed by collateralized property which may be
2. Debentures. They are backed by the issuing corporation's good faith and credit. The issuing company must be financially sound. High credit ratings are essential. Government bonds are examples.
3. Subordinated debentures, honored after debentures in the case of liquidation or reorganization (though still before stocks). Junior debentures are sometimes issued by finance companies.
4. Income bonds. The bonds pay interest only if there is profit.

Risk, Return And Investment Policy

How much financial risk should you be willing to take on an investment? Risk is the chance you take of losing money on an investment; it is the uncertainty regarding the investment's final payoff, in other words. The more an investment can vary in value during the maturity period, the greater the risk you take when you buy and hold on to it.

All investments involve some degree of risk. In general, you will have to find a balance between risk and return; the higher the risk, the greater must be the return. Aggressive investment policies attempt to maximize return and take above-average risk. Defensive investment policies are designed to reduce risk but also provide less return. If you invest aggressively, you tend to buy and sell more frequently. In a defensive strategy, there is a "buy and hold" philosophy. Aggressive investment may include buying securities on margin (credit) so as to increase profit potential. Defensive investment does not rely on credit (or leverage). Diversification is a defensive policy.

Aggressive investing involves concentration by investing in a few securities at one time in anticipation of a high return. Often, the more money you invest in one source, the higher the rate of return. For example, a bank will usually pay you a higher interest rate on a $100,000 investment compared to a $10,000 investment.

Most investors favor safe investments over risky ones. If you are one of them who wants a safe investment with predictable but low return, invest in U.S. government securities, bank account, or money market mutual fund. If you are retired, you may favor safe investments providing fixed yearly returns.

Appreciation in the price of a security is not as important as stable, guaranteed income. Risky investments are undesirable due to uncertainty. Thus, a retiree may be satisfied with a long-term government bond.

Marketability And Liquidity

Marketability should be distinguished from liquidity. Marketability means you can find a ready market if you want to sell the investment. Liquidity means the investment is not only marketable but also has a highly stable price.

Liquidity may be important if you have limited investments or are saving for a specific personal or business item (e.g., down payment on a house). However, liquid investments typically earn less of a return than illiquid ones. You desire to minimize delays and transaction costs to convert the investment into immediate cash. Liquid investment include savings accounts, money market funds, and certificates of deposit. If you may need funds in an emergency, liquid fund should exist!

The following table depicts marketability and liquidity factors for an investment.

Investment Marketability And Liquidity

	Marketability	*Liquidity*
Savings accounts	Not applicable	Good
Corporate bonds	Good	Average
Short-term U.S. government securities	Good	Good
Long-term U.S. government securities	Good	Average
Common stock	Good	Poor
Real estate	Average	Poor

How Interest Rates Affect Your Investment?

Bonds are sensitive to changes in interest rates. When interest rates go up, bond prices go down. If you paid $1,000 (par) for a bond that paid 6%, or $60 interest per year, and then interest rates went up so that newly issued bonds were paying 8%, or $80 interest, no one would want to buy your bond for $1,000. Why would anyone take 6% if that person could get 8%? The price of your bond would have to decline so someone could buy it at a discount (below $1,000), so he or she could make a profit on the lower price paid and get back $1,000 at maturity.

As interest rates increase, stock prices also tend to decrease for the following reasons:

- Dividends are less attractive. Thus, there tends to be a sale of stocks.
- It makes it more costly to buy stock on margin (credit) discouraging investment in stocks.
- It results in higher cost to business of financing, decreasing profits and inhibiting expansion.

Real estate is pretty sensitive to interest rate changes.

How Would Inflation Affect Your Investment?

Inflation is an increase in price for goods and services over a short time period. A rapid increase in inflation will cause interest rates to rise, and bond and stock prices to fall. Recommendation:

Avoid fixed income securities. Consider buying real assets such as real estate since they are generally considered inflation hedgers. Investments doing well or poorly in inflation are given below.

Investment Performance In Inflation

Good Performance in Inflation:

- Real estate
- Precious metals (gold and silver)
- Collectibles
- Mutual funds specializing in mining stocks

Bad Performance in Inflation:

- Bonds
- Short-term securities (T-bills and CDs)
- Mortgage-backed securities

What Are Some Investment Guidelines To Follow?

Investment tips follow:

- If you want to speculate do it in stock where the gains can be significant, not in corporate bonds.
- You are better off buying a high quality bond issue.
- Purchase stocks when they are undervalued and hold for the long-term.
- Do not invest in a tax shelter unless it appears to be a good investment.
- Do not invest too heavily in precious metals because of volatility.
- Buy into a mutual fund that shows a consistent long-term performance (e.g., five or ten year period) and did well in both good and bad markets. A mutual fund may show great performance only in one year because of luck, unusual circumstances, or the risky stocks bought shot up.

Warning: Avoid selling short, buying options, and investing in commodities because these are short-term, risky investment strategies and if you are wrong on timing and market direction, you may suffer significant losses.

- Buy real estate in good locations and hold for 5-7 years.

Borrowing Money To Invest

You may want borrow money to make investments. This is known as leverage. You can drastically increase the yield on an investment otherwise made entirely from your own funds. This increase occurs when the return on investment exceeds the cost of borrowing. You can achieve maximum return:

- By buying stocks on margin
- Through options or futures contracts
- By putting down as little money as possible (or sometimes no money down) in real estate.

Chapter 2 Review Questions – Section 1

1. Which of the following is NOT one of the best possible sources for investing?

   A. Discretionary income (money available for saving or spending)
   B. Credit card borrowing
   C. Home equity
   D. Life insurance (whole-life or variable life)

2. Which of the following items is NOT a factor to be considered in investment decisions?

   A. Safety, return and risk
   B. Inheritance potential
   C. Stability of income
   D. Marketability and liquidity

3. Which security is most often held as a substitute for cash?

   A. Treasury bills
   B. Common stock
   C. Gold
   D. AAA corporate bonds

4. ________________________ is NOT one of intangible financial investment vehicles.

   A. Common stock
   B. Real estate
   C. Mutual funds
   D. Commodities

5. Investments can be viewed as financial or real assets. What is an example of a real asset?

   A. Common stock, options and warrants
   B. Collectables, gems and precious metals
   C. Treasury bills and government bonds
   D. Commodity and financial futures

6. An investor is currently holding income bonds, debentures, subordinated debentures, first-mortgage bonds, and floating rate notes. Which of these securities traditionally is considered to have the least risk?

A. Mortgage bonds
B. Income bonds
C. Debentures
D. Subordinated debentures

7. What are debentures?

A. Income bonds that require interest payments only when earnings permit
B. Bonds secured by the full faith and credit of the issuing firm
C. Subordinated debt and rank behind convertible bonds
D. Mortgage bonds secured by a lien on specific assets of the firm

8. Preferred shares are securities with characteristics of both common shares and bonds. Preferred shares have ____________ like common shares and ____________ like bonds.

A. A maturity date, A fixed periodic payment
B. No maturity date, No fixed periodic payment
C. A maturity date, No fixed periodic payment
D. No maturity date, A fixed periodic payment

9. How do preferred and common stock differ?

A. Failure to pay dividends on common stock will not force the firm into bankruptcy while failure to pay dividends on preferred stock will force the firm into bankruptcy.
B. Preferred stock has a higher priority than common stock with regard to earnings and assets in the event of bankruptcy.
C. Common stock dividends are a fixed amount while preferred stock dividends are not.
D. Preferred stock dividends are deductible as an expense for tax purposes while common stock dividends are not.

10. Which of the following is a marketable investment example as opposed to a liquid investment?

A. Savings account
B. Real estate
C. Money market funds
D. Certificates of deposit

11. Which of the following items is an investment with bad performance during inflation?

A. Real estate
B. Gold and silver
C. T-bills, CDs and bonds
D. Collectibles

Understanding Return and Risk

To be successful as an investor, you need an understanding of investment risk and realistic expectations of reward. Also, an understanding of the tradeoff between the return you are expecting from an investment and the degree of risk you must assume to earn it is perhaps the most important key to successful investing. This chapter discusses:

- Return and how it is measured.
- Types of risk and how to reduce risk.
- Investment alternatives and their relationship to risk.

What Is Return?

Return is a key consideration in the investment decision. It is the reward for investing. You must compare the expected return for a given investment with the risk involved. The return on an investment consists of the following sources of income:

a. Periodic cash payments, called current income.
b. Appreciation (or depreciation) in market value, called capital gains (or losses).

Current income, which is received on a periodic basis, may take the form of interest, dividends, rent, and the like. Capital gains or losses represent changes in market value. A capital gain is the amount by which the proceeds from the sale of an investment exceed its original purchase price. If the investment is sold for less than its purchase price, then the difference is a capital loss.

The way you measure the return on a given investment depends primarily on how you define the relevant period over which you hold the investment, called the holding period. We use the term holding period return (HPR), which is the total return earned from holding an investment for that period of time. It is computed as follows:

$$\text{HPR} = \frac{\text{Current Income} + \text{Capital Gain (or loss)}}{\text{Purchase Price}}$$

EXAMPLE 1

Consider the investment in stocks A and B over a one period of ownership:

	Stock	
	A	**B**
Purchase price (beginning of year)	$100	$100
Cash dividend received(during the year)	$13	$18
Sales price (end of year)	$107	$97

The current income from the investment in stocks A and B over the one-year period are $13 and $18, respectively. For stock A, a capital gain of $7 ($107 sales price - $100 purchase price) is realized over the period. In the case of stock B, a $3 capital loss ($97 sales price - $100 purchase price) results.

Combining the capital gain return (or loss) with the current income, the total return on each investment is summarized below:

	Stock	
Return	**A**	B
Cash dividend	$13	$18
Capital gain (loss)	7	(3)
Total return	$20	$15

Thus, the return on investments A and B are:

$$\text{HPR (stock A)} = \frac{\$13 + (\$107 - \$100)}{\$100} = \frac{\$13 + \$7}{\$100} = \frac{\$20}{\$100} = 20\%$$

$$\text{HPR (stock B)} = \frac{\$18 + (\$97 - \$100)}{\$100} = \frac{\$18 - \$3}{\$100} = \frac{\$15}{\$100} = 15\%$$

Table 1 shows the rates of return in ranking order by type of investment for the period 2008-2013.

Table 1 Rates of Return in Ranking Order
2008-2013

Rank	Investment
1	Stocks
2	Metals
3	Portfolios
4	Real Estate
5	T-bills
6	Bonds

Risk And The Risk-Return Trade-Off

Risk refers to the variability of possible returns associated with a given investment. Risk, along with the return, is a major consideration in investment decisions. The investor must compare the expected return from a given investment with the risk associated with it. Higher levels of return are required to compensate for increased levels of risk. In general, there is a wide belief in the risk-return trade-off. In other words, the higher the risk undertaken, the more ample the return, and conversely, the lower the risk, the more modest the return.

What Are The Types Of Risk?

Risk refers to the variation in earnings. It includes the chance of losing money on an investment. There are different types of risk. These risks affect various investment alternatives, such as stocks, bonds, or real estate, differently. All investments are subject to risk.

1. Business risk. Business risk is the risk that the company will have general business problems. It depends on changes in demand, input prices, and obsolescence due to technological advances.
2. Liquidity risk. It represents the possibility that an asset may not be sold on short notice for its market value. If an investment must be sold at a high discount, then it is said to have a substantial amount of liquidity risk.
3. Default risk. It is the risk that the issuing company is unable to make interest payments or principal repayments on debt. For example, there is a great amount of default risk inherent in the bonds of a company experiencing financial difficulty. The marketable securities with the lowest default risk are those issued by the federal government because they are backed by the full faith and credit of the U.S. Agency securities are issued by agencies and corporations created by the federal government, such as the Federal Housing Administration. They are backed by a secondary promise form the government.
4. Market risk. Prices of all stocks are correlated to some degree with broad swings in the stock market. Market risk refers to changes in the price of a stock that result from changes in the stock market as a whole, regardless of the fundamental change in a firm's earnings power. For example, the prices of many stocks are affected by trends such as bull or bear markets.
5. Interest rate risk. It refers to the fluctuations in the value of an asset as the interest rates and conditions of the money and capital markets change. Interest rate risk relates to fixed income securities such as bonds and real estate. For example, if interest rates rise (fall), bond prices fall (rise).
6. Purchasing power risk. This risk relates to the possibility that you will receive a lesser amount of purchasing power than was originally invested. Bonds are most affected by this risk since the issuer will be paying back in cheaper dollars during an inflationary period.
7. Systematic risk. This risk is the relevant risk of a security is its contribution to the portfolio's risk. It is the risk that cannot be eliminated through diversification. The relevant risk results from factors, such as recession, inflation, and high interest rates that affect all stocks.

Conclusion

Risk and return are two major factors you should consider in making financial and investment decisions. You must compare the expected risks and returns of each investment. Always remember that the higher the return, the higher the risk. In order to reduce the risk, you might want to diversify your investment holdings by constructing a portfolio of different investments.

The chapter covered a wide range of tools and measures associated with return and risk. The need for an understanding of different types of risks was emphasized.

Chapter 2 Review Questions – Section 2

12. Which of the following items is NOT included in the total return on an investment?

A. Periodic cash payments
B. Current income
C. Capital gains or capital losses
D. Sales price

13. If a stock's dividend income for one year is $15, purchase price is $200, and sales price is $217, what is the holding period return on the investment (HPR)?

A. 7.5%
B. 8.5%
C. 16%
D. 18%

14. Business risk is the risk inherent in a firm's operations that excludes financial risk. It depends on all of the following factors EXCEPT:

A. Amount of financial leverage
B. Sales price variability
C. Demand variability
D. Input price variability

15. What is the investment risk that refers to the fluctuations in value of an asset as the interest rates and conditions of the money and capital markets change?

A. Liquidity risk
B. Default risk
C. Interest rate risk
D. Purchasing power risk

16. _____________ is the risk that that cannot be eliminated through diversification.

A. Systematic risk

B. Default risk
C. Interest-rate risk
D. Purchasing-power risk

17. What is the marketable security with the least amount of default risk?

A. Federal government agency securities
B. U.S. Treasury securities
C. Repurchase agreements
D. Commercial paper

18. What is the relevant risk of a security?

A. Company-specific risk
B. Systematic risk
C. Diversifiable risk
D. Total risk

19. What is the risk that securities cannot be sold at a reasonable price on short notice called?

A. Liquidity risk
B. Default risk
C. Interest-rate risk
D. Purchasing-power risk

Chapter 3:

Housing: The Cost of Shelter

Learning Objective

After completing this section, you should be able to:

1. Identify the benefits and disadvantages of buying vs. renting.
2. Identify factors of the real estate purchase price and different loan types.

Homeownership is perhaps the most sizable investment you will ever make in your life. Further, your home is a tax shelter. There are many questions surrounding homeownership. In this chapter, you will find the answers to the following important questions:

- Should you buy or rent?
- How to price a home?
- How much can you afford to pay for a house?
- How to shop for an adjustable rate mortgage?
- Should you refinance your home?
- Should you pay off your mortgage early?
- How good is your homeowners' policy?
- How to get top dollar for your house?
- How to sell your home yourself?

Homeownership

Buy a Home or Rent?

For many people, the decision to buy a home is more emotional than economic. But if you are wondering about whether or not to go on renting, here are some questions to help you answer when renting is right:

- Do you have enough money to put down to buy a home? The initial cost of home ownership can be substantial. For example, for a $100,000 house you should figure on having anywhere between $10,000 to $20,000 (10% to 20%) for the down payment, $3,000 to $6,000 (3% to 6%) for closing costs and a $2,000 cushion for contingencies. Thus, at the time of purchase you will need to pay cash of anywhere between $15,000 and $28,000.
- Are you the roving kind? If you stand a good chance of being relocated in a few years it doesn't make sense to buy because of high borrowing, closing, and commission costs.
- Do you live in an area where renting makes sense? In regions where there is a housing glut and rent controls and values are flat or falling, renting ends up being a bargain.
- Are you lazy or a born renter? Can you deal with maintenance and lawn mowing? Or would you rather leave it up to a landlord by renting? Are you enjoying the appeal of community living and access to amenities such as swimming pools and tennis courts?

The disadvantages of renting are primarily financial and economic. Owning a home is still the best tax-shelter there is. The renter does not receive any federal tax-deductible benefit from rent payments. Also, the rent payment does not contribute to building your equity, you are at the mercy of rent increases and the landlord.

Homeownership has the following advantages:

- You are building equity due to the appreciation in the value of the home.
- Interest and property taxes are deductible on the tax return.
- Usually less costly than renting.
- You may enjoy extra living space and privacy.
- Single-family homes are usually in better locations than apartments.
- You will have a sense of stability and roots in the community.
- You will enjoy pride of ownership.

Note: The disadvantages of homeownership tend to be the advantages of renting and vice-versa.

In comparing rental and purchase costs, the worksheet in Table 1 can be useful:

Table 1
Comparison Of Rental And Purchase Costs

Rental Cost	
Annual rental cost ($850 x 12)	$10,200
Purchase Costs (assuming a 30% tax bracket):	
Add:	
Mortgage Payment ($100,000 @ 10%, 30 years	10,608
Principal = $608 (approximate)	
Interest = $10,000 (approximate)	
Property Taxes	1,300
Property Insurance	250
Maintenance	400
Cost of lost interest on $20,000 @ 5% (after-tax rate of return)	1,000
Subtract:	
Principal reduction in loan balance	(608)
Tax savings due to mortgage interest deduction ($10,000 * .3)	(3,000)
Tax savings due to property tax deduction ($1,300 * .3)	(390)
Net annual after-tax purchase costs	$9,560
Annual Benefit of Buying	$640*

*Note that the annual benefit does not include appreciation in the value of your home.

What Price To Pay?

After you found the house you like, you must decide what price to pay for it. In most cases, there is room between the price sellers ask and the price that they are willing to accept. Make sure that you are not paying more for a property than its market value. To determine the maximum price to pay for the property is not an easy task. Two methods are widely used in practice.

Have your real estate agent run "comparative-sales.

The computer should be able to give you recent history of sales in the neighborhood. The price that a subject property can bring must be adjusted upward or downward to reflect the difference between the subject property and comparables. Since this particular approach is based on selling price, not asking prices, it can give you a good idea about the market.

Use an expert. You might want to hire a professional real estate appraiser for a fee.

Appraisal is not a science, but a complex and subjective procedure that requires good information about specific properties, their selling prices, and applicable terms of financing. The use of an expert may well be worth the cost if you worry about the possibility of paying too much.

How Much to Spend for Housing?

An accurate way to determine what kind of house you can afford is to make two basic calculations: How much can you pay each month for the long-term expenses of owning a home (e.g., mortgage payments, maintenance and operating expenses, insurance and property taxes)? And, how much cash do you have to spend for the initial costs of the purchase (e.g., the down payment, points and closing costs)?

Many lenders use various rules of thumb to determine a borrower's housing affordability. They include:

- 35-Percent Rule of Thumb. A borrower can afford no more than 35 percent of monthly take-home pay.

EXAMPLE 1

Your gross annual income is $33,000 per year and take-home pay is $2,095 per month. At 35 percent, you could afford a monthly payment of $733. Using this amount, the mortgage rate (variable or fixed), the mortgage term, and a mortgage payment schedule, the lender can determine how much you can qualify for. For example, say, an interest rate of 13 percent and a 30-year term, you could borrow $66,300. Assume that your budget has already provided for property taxes, insurance, and maintenance expenses and you have $20,000 available for a down payment (after point charges and closing costs). You could buy a house that costs about $86,300 ($20,000 + the $66,300 mortgage)

- Multiple of Gross Earnings Rule. The price should not exceed roughly 2 to 2 1/2 times your family's gross annual income.

EXAMPLE 2

If your annual gross income is $40,000, the maximum price you could afford would be $80,000 (2 x $40,000) to $100,000 (2.5 x $40,000).

- Percent of Monthly Gross Income Rule. Your monthly mortgage payment, property taxes and insurance should not exceed 25% to 28% of your family's monthly gross income, or about 35% for a Federal Housing Administration (FHA) or Veterans Administration (VA) mortgage. The National Association of Home Builders (NAHB) assumes that a family can afford to spend 28 percent of its gross income on housing; this is a conventional assumption in the lending industry.

EXAMPLE 3

You and your spouse have gross income of $60,000 ($5,000 a month). Under this rule, your monthly mortgage payment, property taxes and insurance should not exceed $1,250 (25% of $5,000) to $1,400

(28% of $5,000). That means you could qualify for a 30-year fixed rate loan (with 10-20% down) at less than a 12% rate.

- Your debt payments on loans of 10 months or longer, including your mortgage, should not exceed 36% of your gross income, 50% for an FHA or VA loan.

EXAMPLE 4

You and your spouse have gross income of $60,000 ($5,000 a month). If you have a monthly debt load of $500 or less, you might look for a $120,000 house with total monthly housing payments of about $1,300, since total debt payments of $1,800 ($1,300 + $500) equals or is close to 36% of $5,000 monthly gross income). That means you could most likely qualify for a 30-year fixed rate loan (with 10-20% down) even if rates hit 12%.

Refinancing a House

Whether refinancing is worthwhile depends on the costs of refinancing and the time required to recoup those costs through low mortgage payments. The costs of refinancing are the closing costs, which can vary widely. Closing costs include;

- Title search
- Insurance (such as hazard, title, and private mortgage insurances)
- Lender's review fees
- Buyer's loan points
- Re-appraisal fees
- Credit report
- Escrow fees
- Lawyer fees
- Document preparation fees, judgment reports, notary fees, and recording fees.

To get a rough estimate of the closing costs, take the costs of refinancing (3 to 6 percent of the outstanding principal) and multiply it by the amount of the loan.

EXAMPLE 5

If the loan amount is $100,000 and the cost is, say, 5 percent, the closing costs are $5,000.

Rule of thumb: To refinance successfully, you should plan on staying in the house for at least three years and should be able to reduce the rate paid on the mortgage by at least two percentage points.

- If you are a fixed-rate mortgage holder, you might look for another fixed-rate home loan at least two to three percentage points below the mortgage currently held.
- If you have an adjustable loan, you might consider what the expected rate on the adjustable rate mortgage (ARM) will be several years hence. If the current rates on fixed mortgages are substantially below the expected rate on the ARM, it might pay to refinance.

Rule of thumb: The factor to consider when refinancing is the amount of time it will take to recoup the costs of refinancing.

EXAMPLE 6

Assume that refinancing is $100,000. A 4 percent mortgage involves closing fees of $2,000, and the new interest rate is 4 percent. At the new rate of 4 percent, the monthly payment on a 30-year fixed loan would be $477. That is a savings of $123 from the monthly payment of $600 required on a 6 percent loan. Dividing the total refinancing cost of $2,000 by $123 gives a recovery period of about 16 months. Table 2 below illustrates the monthly and yearly savings from refinancing to a 4 percent 30-year fixed-rate mortgage for 100,000.

Table 2
Savings From Refinancing

Present Mortgage Rate	*Current Monthly Payment*	*Monthly Payment @ 4%*	*Monthly Savings @ 4%*	*Annual Savings @ 4%*
5.0%	$536.82	$477.42	$59.41	$712.88
5.5%	$567.79	$477.42	$90.37	$1,084.48
6.0%	$599.55	$477.42	$122.14	$1,465.62
6.5%	$632.07	$477.42	$154.65	$1,855.83
7.0%	$665.30	$477.42	$187.89	$2,254.65
8.0%	$733.76	$477.42	$256.35	$3,076.19

Shopping for an Adjustable Rate Mortgage

An ARM is a mortgage where the interest rate is not fixed but changes over the life of the loan. ARMs are often called variable or flexible rate mortgages. Adjustable rate mortgage (ARM) often feature attractive starting interest rates and monthly payments. But you face the risk that your payments will rise. Pluses of ARMs include:

- You pay lower initial interest (often 2 or 3 percentage points below that of a fixed rate) and lower initial payments, which can mean considerable savings. This means that ARMs are easier to qualify for.
- Payments come down if interest rates fall.
- Loans are more readily available and their processing time is quicker than fixed-rate mortgages.
- Many adjustables are assumable by a borrower, which can help when it comes time to sell.
- Many ARMs allow you to prepay the loan without penalty.

Some of the pitfalls of ARMs include:

- Monthly payments can go up if interest rates rise.

- Negative amortization can occur. Note: Negative amortization occurs when the monthly payments do not cover all of the interest cost. The interest cost that is not covered is added to the unpaid principal balance. This means after making many payments you could owe more than you did at the beginning of the loan balance.
- The initial interest rates last only until the first adjustment, typically six months or one year. And the promotional or tease rate is often not distinguished from the true contract rate, which is based on the index to which the loan is tied.

Tip: It pays to get an ARM if you are buying a starter home or expect to move or be transferred in two to three years.

Recommendation: You should consider a fixed rate loan over an ARM if you

- Plan to be in the same home for a long time.
- Do not expect your income to rise.
- Plan to take sizable debts, like auto or educational loans.
- Prize the security of constant payments.

When you shop for an ARM (or for any other adjustable rate loan), you should carry the following checklist of questions to ask lenders:

- What is the initial loan rate and the annual percentage rate (APR)? What costs besides interest does the APR reflect? What are the points?
- What is the monthly payment?
- What index is the loan tied to? How has the index moved in the past? Will the rate always move with the index?
- What is the lender's margin above the index? Tip: The margin is an important consideration when comparing ARM loans, because it never changes during the life of the loan. Remember: Index rate + margin = ARM interest rate.

EXAMPLE 7

You are comparing ARMs offered by two different lenders. Both ARMs are for 30 years and amount to $200,000. Both lenders use the one-year Treasury index, which is 3%. But Lender A uses a 2% margin, and Lender B uses a 3% margin. Here is how the difference in margin would affect your initial monthly payment:

	Lender A	*Lender B*
ARM Interest Rate	5%	6%
Monthly Payment	$1,073.64 @ 5%	$1,199.10 @ 6%

- How long will the initial rate be in effect? Will there be an automatic increase at the first adjustment period, even if the index has not changed? What effect will this have on monthly payments?
- How often can the rate change?
- Is there a limit on each rate change and how will the limit affect monthly payments?
- What is the "cap," or ceiling on the rate change over the life of the loan?
- Does the loan require private mortgage insurance (PMI) and how much does it cost per month?
- Is negative amortization possible?
- Is the loan assumable?
- Is there prepayment penalty?

Paying off a Mortgage Early

Suppose you have decided to refinance your home with a lower fixed rate mortgage. You should consider the term of the loan. Although the standard 30-year mortgage is still very much alive and well, you might want to consider the loan with a shorter term such as a 15-year fixed rate loan. The overall savings in interest paid to the lender over the life of the 15-year mortgage can be quite substantial, yet the monthly payment is not significantly higher. Recommendation: Even if you decide to stay with your current 30-year mortgage, you might be able to save a bundle by paying off more in each month, treating the 30-year loan as if it were a 15-year loan.

EXAMPLE 8

Suppose you currently have a new $250,000 30-year fixed rate mortgage at 6 percent. Your monthly payment for principal and interest is $1,498.88. You have decided to refinance your home because you found a bank with much better rates using a no-cost fixed-rate loans at a lower rate percent. You have two options available: 30-year loan at 5 percent or a 15-year loan at 4 percent. Look at Table 3 for comparison regarding monthly payment and total interest over the life of the loan. Note: In the refinance case with the new 30-year 5% loan, the monthly payment is less than the older 6% percent mortgage by $157 per month, and you pay less interest over the life of the loan. When evaluating between the new 5% 30-year and 4% 15-year loans, however, the monthly payment increases about 37.8%, while the savings in total interest payments over the life would be about 64%. From this example, you learn some valuable lessons:

1. It is clearly a good idea to refinance from the 30-year 6 % loan to the 30-year 5% loan because your payments drop.
2. It may be a good decision to refinance your home with the 15-year loan if paying off your mortgage is important to you, and you have the financial resources to afford the higher monthly payments:
    a. You would be able to save $150,279 in total interest payments by election of a 15-year loan over the life of the loan (not including the time value of money).

b. Among other things, you will be a 100 percent equity holder in your home within 15 years instead of 30 years.

Table 3

Comparison Of 30-Year Vs. 15-Year Fixed Rate Mortgage

	A	*B*	*C*		
	30-Year @ 6%	***30-Year @ 5%***	***15-Year @ 4%***	***$ Increase (Decrease) B vs C***	***% Increase (Decrease) B vs C***
Principal	$250,000	$250,000	$250,000	--	--
Rate	6%	5%	4%	--	--
Monthly Payment	$1,498.88	$1,342.05	$1,849.22	$507.17	37.8%
Total Payments	$539,595	$483,139	$332,860		
Total Interest	$289,595	$233,139	$82,860	($150,279)	(64.4%)

Homeowners Policies

All homeowners' policies do not offer equal protection. When a loss occurs, it is painfully easy to find out too late that a small extra premium could have saved you a large sum of money. You also may be missing out on money savings discounts that have come along in recent years. Time to find out is before something happens. Here are some tips:

- Determine your insurance needs. The best figure to use is the replacement value, the amount it would cost to rebuild, excluding land. Your minimum protection should be 80% of replacing your house.
- Know the basic policy from the broad policy. Look for the broadest coverage for the dollar. But for maximum peace of mind, choose the "all risk" form. Compare the cost of each form.
- Find out if in case of loss, you will be paid based on book value or replacement cost. Do not be surprised when you file a claim only to learn that policies that promise "actual cash value" are actually referring your original cost minus depreciation over years of use.
- Make sure potential calamities are covered. Fire and storm damage will be included, but damage from ice and snow may not be.
- Look into a floater policy for furs, jewelry, silver, personal computers--theft protection for such valuables may be limited.
- Consider an umbrella liability policy. A lawsuit over an accident on your property or away from home could wipe you out.

Note: Umbrella protection is written over an underlying homeowners' policy and an auto policy. It takes over when the liability limits on these policies are reached.

EXAMPLE 9

If your homeowners' policy covers liability up to $50,000, an umbrella policy can cover you from losses in excess of $50,000. -You can achieve substantial savings by accepting a higher deductible (e.g., $250 or $500 instead of $100).

- Realize discounts by installing dead-bolt locks, smoke detectors, and fire extinguishers. See what other discounts they can offer you in what ways.
- Keep pictures of your valuables and personal belongings.
- Review your insurance at least once a year, to make sure your coverage is keeping pace with inflation.

When You Have To File A Claim...

- Report any theft or vandalism to the police.
- Immediately call your insurance agent.
- Protect your property from further damage.
- Save all receipts for reimbursements.
- Make a list of damaged articles.
- Review the settlement steps outlined in your policy. In case there is a significant difference between what the insurer offers and what you believe you are entitled to, submit the dispute to arbitration.

Recommendation: If you are unhappy with your experience with the insurance carrier (e.g., delay in receiving payment. inadequate reimbursement), "shop around" for another insurance company.

Getting Top Dollar For a House

Getting top dollar for your house when you sell hinges upon a number of factors. They are:

- Ask the right price. Get several brokers to look at your house. Have them do "comps" on their computer.
- Sell by July. Statistics show that of all home sales, over 70% occur in just four months, April through July. Most buyers want to move before school starts for their children.
- Put some cosmetics on your house. It is usually worth investing some money to put a pretty face on your house.
- Pick a top sales agent. See if you can find a Realtor of the Year type because he or she is a performing broker.
- Don't be stingy on the standard commission. A full-price broker may give up some portion of the commission to clinch your sale.
- Sign up for a shorter term listing (like no more than 90 days).
- Take advantage of a multiple listing.
- Do not oversell. Sit back and let the broker do the talking. You don’t want to point out too many things (such as a fireplace) about your house.

- Avoid any offer that is contingent on the buyer's selling his or her own house. Avoid any chance the deal may fall through.

Conclusion

In this chapter, various issues surrounding homeownership have been addressed. Questions that may come up at various stages of homeownership involving purchase, refinancing, maintaining, and sale of your home were covered.

The purchase of a home is your largest single investment. Homeownership is an "American Dream." But are you really prepared to buy a home? Purchasing a home is a serious matter. But even after purchase, many considerations have to be taken into account. When your house goes up in value (i.e., your equity is building up) or a mortgage rate goes down, you might want to consider refinancing. Does it pay? You might want to sell your house and move to better quarters. Ways to get the most for your house were discussed.

Chapter 3 Review Questions

1. Which of the following is NOT a home ownership advantage?

    A. Building up equity
    B. Interest and property taxes are deductible of tax return
    C. Owning is less costly than renting
    D. Less living space

2. Homeowner expenses EXCLUDE which of the following items?

    A. Rent control expenses
    B. Mortgage payments
    C. Maintenance expenses
    D. Operating expenses (utilities)

3. Which of the following is NOT a rule to determine a borrower's housing affordability?

    A. 35% of monthly take home pay
    B. 45% of taxable income
    C. The price should not exceed 2-1/2 times your family's annual gross income
    D. Monthly payments should not exceed 25% to 28% of gross income

Chapter 4:

Investing In Real Estate

Learning Objective

After completing this section, you should be able to:

1. Identify the advantages and disadvantages of real estate investing.
2. Recognize the characteristics of REIT's.
3. Identify ways to calculate returns for real estate investment.

Investing in real estate is considered an inflation hedge. Real estate investing still provides tax shelters to many investors. The advantages of homeownership as an investment was discussed in the previous chapter. In this chapter our primary concern is with real estate that is not your principal residence. Such real estate includes income-producing properties and pooling arrangements such as Real Estate Investment Trusts (REITs).

Real Estate Investing

Investing In Real Estate Is An I.D.E.A.L. Situation

It has often been said that real estate is the I.D.E.A.L. investment. Each of the five letters in IDEAL stands for an advantage to real estate as an investment.

- "I" stands for interest deduction. The mortgage interest paid on the first and second residential homes are tax deductible. On the average, real estate is a good hedge against inflation because property values and the income from properties rise to keep pace with inflation. "I" could mean income. Successful real estate investments usually produce an income stream that typically increases over time.

- "D" stands for depreciation. The building on your land depreciates in book value each year and you can deduct this depreciation from your gross income. This is only true for investment property and not residential. This provides a tax shield.
- "E" is for equity buildup. You build equity through repayments of the principal or remaining balance of the loan(s) taken to purchase the property. This equity buildup is like money in the bank. As you amortize a mortgage, the value of your equity investment will steadily rise. In the case of income-producing property, this amortization could mean that your tenants help you build your estate.
- "A" is for appreciation. Your property value goes up every year, hopefully. Appreciation can result from inflation or increases in demand for property or improvement to the property . As the income potential is increases, the price that the property can command in the marketplace rises.
- "L" is for leverage. When you buy a house you make a down payment, say, 10 percent and you borrow the balance, say, 90 percent. You get the benefit of all 100 percent even though you put up only 10 percent of your own money. You can maximize return with other people's money (OPM). The use of mortgage and OPM means that you can use small amounts of cash to gain control of large investments and earn large returns on the cash invested. Besides I.D.E.A.L., you could add the following advantages of investing in real estate:
- Tax-free refinancing. Mortgage proceeds even from refinancing are not taxable income to you. Therefore, refinancing is a way to recover your cash investment and, in some cases, you profit tax free.
- Pride of ownership. You may find greater personal satisfaction in owning property than stock certificates.
- Investment and consumption. Certain types of real estate, such as land and vacation homes, can serve both as investments and as sources of pleasure through use.

The Disadvantages With Real Estate

Real estate investing is not free from problems. Watch out for the following:

- High transaction costs, such as brokerage commissions and closing expenses. These costs eat up short-term profits. Warning: If you might need your money out in a hurry, do not invest in real estate.
- Negative cash flow with little down (too much leverage). In jargon, we call it an alligator.
- Balloon payment due. Note: The balloon payment is the unpaid balance of a mortgage loan that is paid off in a lump sum at the end of the loan term. This is typically a large amount. You may be unable to make the final payment, default the payment, and lose your property.
- Limited marketability. Lack of a central market or exchange to make real estate investments more liquid.

- Management headache, such as unreliable tenants, or otherwise high professional management fees.

Types of Real Estate Investments

Kinds of real estate you can invest include:

- Undeveloped land
- Residential rental property (e.g., single family houses for rental, and multi-unit apartments)
- Commercial property (e.g., office buildings, shopping centers, and industrial property)
- Real Estate Investment Trusts (REITs)

Factors To Be Considered Regarding A Real Estate Investment

- Location
- Method of financing the purchase of the property
- Before-tax cash flow
- After-tax cash flow
- Vacancy rate for rental property
- Gain or loss for tax purposes
- Management problems

Real Estate Investment Trusts (REITs)

Real estate investment trusts (REITs) are corporations that operate much like closed-end mutual funds, investing shareholders' money in diversified real estate or mortgage portfolios instead of stocks or bonds. Their shares trade on the major stock exchanges or over-the-counter.

By law, REITs must distribute 95 percent of their net earnings to shareholders, and in turn they are exempt from corporate taxes on income or gains.

REIT Yields

Since REIT earnings are not taxed before they are distributed, you get a larger percentage of the profits than with stocks. REIT yields are typically high, and can range above 5%.

Types of REITs

There are three types of REITs: Equity REITs invest primarily in income-producing properties; mortgage REITs lend funds to developers or builders; and hybrid REITs do both. Experts feel that equity REITs are the safest.

Factors for REITs

Pluses

- Dividend income with competitive yields (however, most REIT distributions are considered non-qualified dividends, which means they do not qualify for the capital gains tax rate.)
- Potential appreciation in price
- A liquid investment in an illiquid area
- Means of portfolio diversification and participation in a variety of real estate with minimal cash outlay

Minuses

- Possible glut in real estate or weakening demand
- Market risk: possible decline in share price

Safety

- Low

Liquidity

- Very high: shares traded on major exchanges or over-the-counter and therefore sold at any time

Taxes

- Income subject to tax upon sale. Most dividends taxed at non-qualified rate.

Selecting a REIT

Before buying any REIT, be sure to read the latest annual report, The Value Line Investment Survey or Audit Investment's Newsletter, Realty Stock Review. For more on REITs, visit National Association of Real Estate Investment Trusts (www.nareit.com/mynareit.cfm).

Check the following points.

- Track record: how long in business as well as solid dividend record
- Debt level: make sure that the unsecured debt level is low
- Cash flow: make sure that operating cash flow covers the dividend.
- Adequate diversification: beware of REITs investing in only one type of property
- Property location: beware of geographically depressed areas
- Type of property: nursing homes, some apartment buildings, shopping centers presently favored; "seasoned" properties preferred
- Aggressive management: avoid REITs that do not upgrade properties.
- Earnings: monitor earnings regularly; be prepared to sell when the market of property location weakens.

Determining Cash Flow For Real Estate

A necessary task in analyzing an income-producing property is determining the before-tax cash flow. When you know the cash flow, you can figure your return on your investment, calculate the tax shelter, and evaluate the investment, in other ways. You don't need to be a real estate expert to determine a property's cash flow, common sense and some uncomplicated research will provide you with a base figure.

EXAMPLE 1

John Smith recently calculated the cash flow of a property offered to him for investment. We will go through his analysis, step by step, as an example of the process and format which you can follow. Mr. Smith is considering a duplex apartment. The property is located in an attractive suburb. The cost of the building is $219,000 and a $175,000, 30-year mortgage at 7% fixed rate is anticipated. The projected figures are based on the first full year of operation.

Step 1. Figuring gross income

The building has two three-bedroom apartments. To judge how much the apartments could rent for, Mr. Smith compared his building to ones in the area which were similar in quality of location and construction. He studied advertisements and questioned area real estate brokers. After weighing this information, he decided the three-bedroom could rent for $950. Thus, the total maximum yearly rental income was $22,800.

2*$950 = $1,900
$1,900 * 12 = $22,800

Additional income of $800 from laundry fees would make the possible total gross income $23,600.

Step 2 Vacancy and credit losses

To estimate the reduction in gross income caused by vacancies and bad debts, Mr. Smith looked at the result of the survey conducted by the local realtors and apartment associations. He estimated that the vacancy and bad debt rate would be 2% of possible gross income or $472 (2% of $23,600). Please refer to Table 1 (Annual Property Operating Data).

Step 3 Operating expenses

For estimates of operating expenses, Mr. Smith carefully examined the record of previous costs by category. He came up with the cost figures as shown in the chart, which are basically the previous costs plus adjustments for inflation.

Step 4 Net operating income

The projected operating expenses totaled $4,510 or 19.50% of gross operating income ($23,128). This left a net operating income (NOI) of $18,618 ($23,128 - $4,510). Now we proceed to calculating before-tax cash flow:

Step 5 Debt service (principal and interest payments)

Payments at 7% on a $175,000, 30-year fixed-rate mortgage would be $1,164 per month or $13,968 annually (principal amount in the first year is $1,778)

Step 6 Before-tax cash flow

The estimated before-tax cash flow was $4,650 ($18,618 - $13,968) on an investment of $44,000 ($219,000 - $175,000).

TABLE 1 ANNUAL PROPERTY OPERATING DATA (12 months – projected)				
	Gross Scheduled Income			$22,800
	+ Other Income			800
Total Gross Income				23,600
	- Vacancy/Credit Losses (2%)			472
Gross Operating Income (GOI)				23,128
Operating Expenses (with percent of GOI)				
	Property insurance	1.93%	$446	
	Real Estate Taxes	13.22%	3,058	
	Repairs and Maintenance	1.45%	335	
	Sewer and Water	2.90%	671	
Total Operating Expenses (19.50%)				4,510
Net Operating Income (80.50%)				18,618
	- Debt Service (Principal and Interest)			13,9681
Before-Tax Cash Flow				$4,650

In order to compute after-tax cash flow, we have to add principal payments and deduct annual depreciation as follows:

Before-Tax Cash Flow	$4,650
Less: Depreciation	5,575*
Taxable Income (loss)	($925)
Your Income Tax Rate	* .35
Value of Taxable Loss	($324)

*Assumption: The depreciable base of the building is 70% of $219,000=$153,300. Annual depreciation is therefore $5,575 ($153,300/27.5 years by straight line).

Then your after-tax cash flow is:

Before-Tax Cash Flow	$4,650
Add: Value of Taxable Loss	324
Principle	1,778
After-Tax Cash Flow	$6,752

Note: Due to the deductibility of interest payments and annual depreciation for income tax purposes, after-tax cash flow is changed by a substantial amount (In this example, after-tax was $6,752 as compared to before-tax of $4,650. Don't forget: We did not even take into account the potential appreciation of the property. The return on your investment in this building should be calculated on the basis of both annual after-tax cash flows and the selling price of the property at the end of the holding period.

Determining Value for an Income Producing Property

There are several rule of thumb methods to arrive at the estimated value of an income-producing property. They include:

Gross Income Multiplier. Gross income multiplier is calculated as: Purchase price/gross rental income

EXAMPLE 2

In Mr. Smith's example, the gross income multiplier is:

$219,000 / $23,600 = 9.28

A duplex in the similar neighborhood may be valued at "8 times annual gross." Thus, if its annual gross rental income amounts to $23,600, the value would be taken as $188,800 (8 x $23,600). Warning: This approach should be used with caution. Different properties have different operating expenses which must be taken into account in determining the value of a property.

Net Income Multiplier. Net income multiplier is calculated as: Purchase price/net operating income (NOI)

In Mr. Smith's example, the net income multiplier is:

$219,000 / $18,618 = 11.76

Capitalization rate. Capitalization rate is almost the same as the net income multiplier, only used more often. It is the reciprocal of the net income multiplier. That is:

Net operating income (NOI)/purchase price

EXAMPLE 3

Let us go back to Mr. Smith's example. The duplex's capitalization rate is $18,618/$219,000 = 8.5%. Whether it is over-priced or not depends on the rate of the similar type property derived from the market place. Suppose the market rate is 10%. That means the fair market value of the similar duplex is \$18,618/10% =\$186,180. Mr. Smith may be overpaying for this property.

Using Leverage When Investing In Real Estate

Leverage means use of other people's money (OPM) in an effort to increase the reward for investing. To a lot of people, it means risk. The fact of the matter is, using leverage in real estate investing is an exciting way to earn big yields on small dollars, and you should not fear taking a chance. When you are building real estate wealth, leverage will help you grow quickly without involving too much risk (as long as you watch out for some pitfalls, which will be discussed later). High-leveraged investing in real estate is especially powerful when inflation is in full swing. High-leverage investors have numbers going for them because property values rise faster than the interest charges on their borrowed money.

To see the full power of high-leverage investing, take a look at the following example:

EXAMPLE 4

You pay a seller \$100,000 cash for a piece of property. During the next 12 months, the property appreciates 5 percent and grows in resale value to \$105,000. The \$5,000 gain equals a 5 percent yield on your investment. But suppose you had put down only 10 percent (\$10,000) in the property and mortgaged the balance. Now, your return on investment leaps to an astonishing 50 percent! (\$5,000/\$10,000). Another way of looking at the result is: Since you only put down \$10,000 on \$100,000 worth of property, you actually control the asset 10 times the value of your actual cash outlay. This means 5% x 10 times = 50%. (In this example, for simplicity, we've omitted mortgage interest costs as well as the return on the \$10,000 you would have invested somewhere else, plus any rental income you would have earned from the property).

Let us expand the scenario to further see the impact of leverage.

EXAMPLE 5

Instead of putting 100% down (\$100,000), you put down 10% (\$10,000) and bought nine more pieces of property, each costing \$100,000, and each bought with 10% down (\$10,000). Again assume that they appreciate at the rate of 5 percent. Therefore, your wealth increases: \$5,000 a piece x 10 pieces = \$50,000. All that in one year.

Tip: Tying up your wealth in one property (\$100,000) cost you \$45,000 (\$50,000 - \$5,000). Conversely, by spreading your funds over more properties and leveraging the balance, you would multiply your earnings 10 times.

Remember: The lower the amount of cash invested, the higher your return (from value appreciation and/or rental income). On the other hand, the larger your cash investment, the lower your return. Also, remember, a higher appreciation will greatly increase earnings on your leveraged investment.

Pitfalls Of High-Leveraged Real Estate Investing

High-leverage real estate investing sounds real good as long as you watch out for some of the pitfalls. They are:

- Property values can go down as well as up. Some types of real estate and some parts of the country are experiencing value declines.
- Select the property carefully.
- Anticipate a rising market due to a lower mortgage rate or a high inflation rate before you jump in a high-leverage world.
- Look out for negative cash flow. Income from highly leveraged property may be insufficient to cover operating expenses and debt payments. Do not overpay for property and underestimate costs. Warning: Buying for little or nothing down is easy. The difficult part is making the payments. You should try to avoid negative cash flow (Note: losses are tax deductible, however).
- Watch out for deferred maintenance. Deferred maintenance can create lots of problems down the road. You can avoid hidden costs and potential future expenditure by bargaining for a fair (or less than market) price and reasonable terms. In any case, over-repair is poison to the high-leverage investor.

Conclusion

When you are investing in tangibles (as opposed to stocks and bonds), you are looking towards both reward and enjoyment. Real estate investing has been the most popular. Income-producing properties such as multi-family units, retail and office buildings provide not only current income in the form of rental income but also tax savings and capital appreciation. Leverage plays a significant role in real estate investing, which magnifies risk and return. You should be careful about the pitfalls of high-leveraged investing.

Chapter 4 Review Questions

1. What is the cash value of your home that a lender is willing to make you a loan known as?

   A. Discretionary income
   B. A form of an annuity
   C. Home equity
   D. Profit-sharing

2. Which of the following is a disadvantage of real estate investing?

   A. High transaction costs
   B. Interest deductions
   C. Depreciation
   D. Appreciation

3. What is an example of commercial real estate?

   A. Multi-unit apartments
   B. Real estate investment trusts
   C. Shopping centers
   D. Undeveloped land

4. Which one is NOT the kind of real estate you can invest in?

   A. Undeveloped land
   B. Residential rental property
   C. Federal protected lands
   D. Commercial properties

5. Before investing in Real Estate Investment Trusts (REITs) you must consider all the following, EXCEPT:

   A. Prior owners
   B. Profitability
   C. Annual cash flow
   D. Degree of leverage

Glossary

Acknowledgment

A personal declaration before a notary, judge, or other official that a certain act is one's own. The act of signing certain documents is often required to be so acknowledged in order to make certain the identity of the person signing the document.

Adjustable-Rate Mortgage (ARM)

A mortgage that permits the lender to adjust its interest rate periodically on the basis of changes in a specified index.

Amortization

A provision made in advance for the gradual liquidation of a future obligation by periodic charges against the capital account or by the creation of a money fund sufficient to meet the obligation when due. As applied to finance, a reduction in the cost of a bond bought at a PREMIUM to reduce the cost to the par at maturity. Annual amortization is the amount of the premium divided by the number of years to maturity.

Annual Percentage Rate (APR)

The cost of a mortgage stated as a yearly rate; includes such items as interest, mortgage insurance, and loan origination fee (points).

Appraisal

A formal valuation of property, especially for levying property taxes or customs duties, made by a competent authority.

Appreciation

A more or less permanent increase in value because of an upward change in the market price or because of inherent qualities that enhance the desirability thereof.

Assignee

One to whom a title, interest, or right of some kind has been transferred. The person from whom the transfer is received is the assignor.

Assignment

The formal transfer of any property or right from one person to another.

Balloon Payment

The bulk payment that retires a loan when minimal previous payments have not fully amortized it.

Biweekly Payment Mortgage

A mortgage that requires payments to reduce the debt every two weeks (instead of the standard monthly payment schedule). The 26 (or possibly 27) biweekly payments are each equal to one-half of the monthly payment that would be required if the loan were a standard 30-year fixed-rate mortgage, and they are usually drafted from the borrower's bank account. The result for the borrower is a substantial savings in interest.

Borrowing

Obtaining funds through loans, the evidence of indebtedness taking the form of promissory notes, bonds, or other credit instruments.

Bridge Loan

A short-term loan collateralized by the borrower's present home (which is usually for sale) that allows the proceeds to be used for closing on a new house before the present home is sold. Also known as "swing loan."

Call Loan

A loan payable on demand.

Cash Flow Position

The presence or absence of surplus cash for recycling into business operation (sometimes known as "positive" or "negative" cash flow).

Chattel

Almost any kind of personal property; this may include an interest in real estate which is less than a freehold, as a lease.

Chattel Mortgage

An instrument in which personal property earmarked as security for a debt or other obligation and pledged in such a way that if the debtor fails to meet the terms of the contract, the creditor can take possession of the property.

Certificate Of Eligibility

A document issued by the federal government certifying a veteran's eligibility for a Department of Veterans Affairs (VA) mortgage.

Certificate Of Reasonable Value (CRV)

A document issued by the Department of Veterans Affairs (VA) that establishes the maximum value and loan amount for a VA mortgage.

Collateral

Property, or evidence thereof, deposited with a creditor to guarantee the payment of a loan.

Commercial Bank

A bank, the principal function of which is to receive deposits subject to check, and to make loans to its customers. Besides these primary banking functions a commercial bank performs a variety of incidental functions. It keeps the community supplied with various kinds of legal currency, acts as a collection agent for promissory notes, drafts, and similar COMMERCIAL PAPER, and transmits funds to distant points upon request. It may offer its vaults for the safekeeping of valuables, offer interest for TIME DEPOSITS, and perform the functions of a TRUST COMPANY. Commercial banks may be NATIONAL BANKS, or STATE BANKS. All national banks are commercial banks.

Commercial Credit

Short-term loans furnished a business undertaking for temporary needs.

Commercial Paper

Checks, promissory notes, bills of exchange, and other negotiable paper used in business.

Conforming Loans

Loans that conform to Federal Home Loan Mortgage Corporation (FHLMC) and Fannie Mae (FNMA) requirement(s) and do not exceed the maximum loan amount and loan-to-value (LTV) limitations established by FNMA or FHLMC. Effective with the November 2008 release of the conforming loan limits, two sets of limits are provided for first mortgages -- general conforming loan limits, and high-cost area conforming loan limits.

Compound Interest

Interest added to a principal sum at uniform intervals over a period, the accumulated interest and the principal sum at any given interval providing the basis for calculating succeeding interest payments. For example, a principal sum of $1,000 at 6 percent interest, compounded annually over a three-year period, amounts to $1191.02, as computed by a spreadsheet.

Consumer Credit

Credit extended to consumers for the purchase of consumer goods and services. Consumer credit may be extended by means of charge accounts, an installment purchase plan, or through money loans.

Contract

A legally binding agreement between two or more parties in which, for a consideration, one or more of the parties agree to do or not to do a certain thing.

Conventional Mortgage

A mortgage that is not insured or guaranteed by the federal government. Contrast with "Government Mortgage."

Credit

1. A promise of future payment in kind or in money given in exchange for present money, goods, or services. 2. The reputation as a risk which a borrower enjoys with an actual or potential lender.

Credit Rating

A rating given a business establishment by a mercantile agency indicating that establishment's record of performance in meeting its financial obligations and its ability to meet such obligations in the future.

Debt

Whatever is owed to one person or organization by another. The obligation may involve money, goods, or services.

Debt Service

Payment of the interest on a debt and of such installments of the principal as are legally due.

Deed

A written document setting forth an agreement, particularly an agreement involving the transfer of property, the document having been duly signed, sealed, and delivered. Commonly the term refers to a document transferring the ownership of real property.

Deficit

A deficiency usually expressed in money. On books of account it is the amount necessary to balance an asset and liability statement when the liabilities exceed the assets.

Depreciation

In accounting, calculation, by one of various standardized methods, of the decline in value of an asset.

Discount

A deduction made from a debt or charge, such as an amount deducted from a bill for prompt payment.

Discount Rate

The percentage of discount charged by banks and similar institutions for purchasing loans or commercial paper in advance of the date of maturity and providing the owner with the net proceeds (face value less the discount charge).

Draft

A written order for a definite sum of money, originating with a creditor and naming a debtor, customarily forwarded to a bank for collection. Upon receipt of a draft, the bank presents it to the debtor for payment. If paid the original document is retained by the debtor as a receipt. Sight drafts are payable at once. Time drafts are payable at some future time specified on the document.

Entrepreneur

A person who, in the course of production, assumes the responsibilities of organization, management, and risk.

Equal Credit Opportunity Act (ECOA)

A federal law that requires lenders and other creditors to make credit equally available without discrimination based on race, color, religion, national origin, age, sex, marital status, or receipt of income from public assistance programs.

Escrow

Property placed by one person in the hands of a second person, usually a trust company, for delivery to a third person upon the fulfillment by the latter of certain specific obligations.

Estate

Specifically, the nature and extent of a person's ownership of real property. The term is frequently broadened, however, to include personal property.

Exchange

1. The payment of debts by negotiable drafts or bills of exchange, without actual transfer of money. 2. A bill of exchange. 3. A fee paid for settling accounts or collecting a draft, bill of exchange, etc. 4. An exchanging of a sum of money of one country or of a depreciated issue for the equivalent in the money of another country or of a current issue. 5. The rate of exchange; value of one currency in terms of the other; difference in value between currencies. 6.The checks, drafts, etc. presented for exchange and settlement between banks in a clearinghouse. 7. In finance, to pass in exchange: as, the currency of this country *exchanges* at par.

Factor

As used in commerce, a firm or other organization which, under a continuous contract with a client, purchases his accounts receivable, with or without recourse, advances funds on open credit or on the security of inventories or fixed assets, and offers auxiliary services in such areas as marketing, sales analysis, and management. Before 1930, factoring was confined largely to the textile industry where it was customarily combined with selling services. Currently, it is being used by an increasing number of concerns in various lines of business.

Factorage

The commission received by a FACTOR.

Fair Credit Reporting Act

A consumer protection law that regulates the disclosure of consumer credit reports by credit reporting agencies and specifies procedures for challenging errors on a credit record.

Federal Housing Administration

A unit of the U.S. Department of Housing and Urban Development which insures private lending institutions against loss on loans secured by residential mortgages and loans advanced for repairs, alterations, and improvements which may be secured by collateral.

Federal National Mortgage Association

A public corporation, popularly called Fannie Mae, chartered originally in 1938 and now part of the Department of Housing and Urban Affairs. It lends funds, secured by mortgages, to public and private agencies for the construction of low rental housing units. Its principal aim is to maintain the liquidity of the mortgage market and to that end, from time to time, it purchases or guarantees mortgages. It also is responsible for the management of its own rather sizable mortgage portfolio. Under the Housing and Urban Development Act of 1968, the agency became a "government-sponsored" private corporation.

FICO Score

A computer-generated numerical grade that predicts a lender's risk in doing business with a borrower. Your FICO can change from day to day depending on what information shows up in your credit report.

Fiduciary

A person who holds property in trust for the benefit of others. Guardians and trustees act in the capacity of a fiduciary.

Financial Crisis:

(1) A situation in which the supply of money is outpaced by the demand for money. This means that liquidity is quickly evaporated because available money is withdrawn from banks (called a run), forcing banks either to sell other investments to make up for the shortfall or to collapse.

(2) The global financial crisis of 2008–2009 emerged in September 2008 with the failure, merger, or conservatorship of several large U.S.-based financial institutions, such as investment banks, insurance firms, and mortgage banks, consequent to the subprime mortgage crisis and spread with the insolvency of additional companies, governments in Europe, recession, and declining stock market prices around the globe.

Financial Index

An index is a number to which the interest rate on an adjustable rate mortgage (ARM) is tied. It is generally a published number expressed as a percentage, such as the average interest rate or yield on U.S. Treasury bills. A margin is added to the index to determine the interest rate that will be charged on ARMs. This interest rate is subject to any caps associated with the mortgage.

The interest rate changes on an ARM are tied to some type of financial index. Some of the most common type of indexed ARMs are:

-- Treasury-Indexed ARMs

-- CD-Indexed ARMs (Certificate of Deposit)

-- Cost of Funds-Indexed ARMs (COFI)

-- LIBOR-Based ARMs

When comparing ARMs, look at how the index

Foreclosure

As applied to mortgages, a sale under a judgment held when a mortgagor fails to make payments on the debt secured by a mortgage, the right to redemption being retained by the mortgagor. If the mortgagor fails to redeem the property upon notice, he is forever barred from exercising any such right.

Free And Clear

The absence of any liens or other legal encumbrances on property.

Garnish

In law, to bring garnishment proceedings against; garnishee.

Garnishee

In law, a person who has money or other property of a defendant in his possession, and is ordered not to dispose of it pending settlement of the lawsuit.

Garnishment

In law, a summons to a person other than the litigants to appear in a lawsuit; a notice ordering a person not to dispose of a defendant's property or money in his possession pending settlement of the lawsuit.

Going Business

Viable firm conducting its regular business; a going concern. See GOOD WILL.

Good Faith

Observance of honorable intent in business relations and avoidance of any attempt to deceive or mislead in assuming and discharging contractual obligations.

Good Will

As used in an asset and liability statement, the value imputed to a name or reputation. Presumably an established name or favorable reputation assures a certain amount of continuing business which a new establishment would not enjoy. This probability of continued business is an asset, and its value is usually considered when a GOING BUSINESS is sold.

Grace Period

A period - usually 3 days - after a debt falls due, during which the debtor may occasionally be permitted to delay fulfillment of his obligation without incurring a penalty or other liability. Commonly referred to as "days of grace."

Gross Income

The term may refer to the total receipts of an enterprise or it may refer to the total receipts less certain expenses. Modern income or profit-and-loss statements customarily group expense accounts into certain broad classifications such as cost of goods sold, selling expenses, operating expenses, etc. In such statements the term "gross income" is frequently used to indicate the amount remaining after the total "costs of goods sold" only has been deducted from the total sales. Other expenses are then deducted until the NET INCOME is finally computed. In the accounts required of some public-utility companies, the term is used to indicate the amount remaining after all the expenses have been deducted except debt charges and a few other items.

Holding Company

A corporation which holds a sufficient quantity of the stock of some other corporation, usually an operating company, to permit it to direct its affairs. Sometimes referred to as a controlling company.

Home Equity Line Of Credit

A mortgage loan, which is usually in a subordinate position, that allows the borrower to obtain multiple advances of the loan proceeds at his or her own discretion, up to an amount that represents a specified percentage of the borrower's equity in a property.

Hypothecate

The act of pledging and depositing property to secure a loan. The property in question is then said to be hypothecated.

Income

The money or other gain periodically received by an individual, corporation, etc. for labor or services, or from property, investments, operations, etc.

Interest

A sum paid or calculated for the use of capital. The sum is usually expressed in terms of a RATE or percentage of the capital involved, called the interest rate.

Jumbo Loan

A loan that exceeds mortgage amount limits. Also called a nonconforming loan.

Lease

A contract for the possession of specified property for the life of the party to whom the property is conveyed or for a period specified in the contract.

Leaseback

A transaction involving the sale of assets such as real estate or equipment, the purchased property then being leased to the original owner for a term of years. The prime purposes of the transaction are to provide the seller with more liquid assets for the expansion of his business and to permit him to charge off the rental on his tax return as a business expense.

Letter Of Credit

A document, usually issued by a bank, in which the issuer agrees to accept drafts, under conditions set forth in the document, to be charged against credit previously established. The main types of letters of credit may be classified according to the extent of the liability assumed by the bank issuing a letter, and again by the use to which the letter is put. Widely used terms indicating the bank's liability are as follows:

(a) *Confirmed letter of credit*; a letter in which the payment of all drafts drawn against it is guaranteed.

(b) *Irrevocable letter of credit*; one that cannot be canceled until a certain stipulated period expires.

(c) *Revocable letter of credit*; one that may be canceled at any time.

(d) *Straight letter of credit*; one that is confirmed and irrevocable.

(e) *Unconfirmed letter of credit*; one for which credit has been established, but for which the issuing bank does not itself guarantee payment.

There are also terms indicating the use of letters of credit:

(a) A *circular letter of credit* is one not directed to any particular person, concern, or bank. When the beneficiary wishes to use it, he must find some agency willing to negotiate a draft.

(b) An *open letter of credit* contains no special stipulations. It is used, for example, when payments are desired without any documents being submitted with the draft drawn against the letter.

(c) A *revolving letter of credit* is one in which credit is automatically renewed as drafts are drawn against it. It is used frequently to facilitate payments by purchasing agents traveling abroad.

(d) A *traveler's letter of credit* is directed to any one of a number of correspondent banks, a separate list of which is given to the beneficiary. He may then call upon any bank named on the list, identify himself by a signature card given him by the issuing bank, and draw on the credit previously established. A record of the amount drawn is then noted on the letter of credit.

Loan

As generally used in business, a sum of money borrowed from a commercial bank at the prevailing rate of interest. When bonds are sold by a borrower or when a borrower pledges a mortgage as security, the term may be qualified as long-term loan or mortgage loan. The term generally refers to a money transaction, the terms hire, rent, or lease customarily being used when goods are borrowed.

Loan-To-Value (LTV) Ratio Or Percentage

The relationship between the principal balance of the mortgage and the appraised value (or sales price if it is lower) of the property. For example, a $100,000 home with an $80,000 mortgage has a LTV percentage of 80 percent.

Mortgage

1. A conditional conveyance of property as security for the payment of a debt or the performance of some other obligation. 2. A contract specifying that certain property is hypothecated for the payment of a debt or for the performance of some other obligation.

Mortgage Banker

A company that originates mortgages exclusively for resale in the secondary mortgage market.

Mortgage Broker

An individual or company that brings borrowers and lenders together for the purpose of loan origination. Mortgage brokers typically require a fee or a commission for their services.

Mortgagee

A person who grants a loan secured by a mortgage and to whom the mortgage is given. See also

Mortgagor

A person who gives a mortgage on his property as security for a loan.

National Bank

1. A bank which manages and controls the finances of a nation. 2. In the United States, a bank chartered by the Federal government and under certain controls by the Federal Reserve System, of which it is a member: national banks formerly issued bank notes secured by government bonds.

Net Lease

A lease requiring the tenant to pay the taxes and insurance and the cost of repairs, maintenance, alterations, and improvements on the leased property.

Net Worth

In accounting, total assets minus total liabilities, the difference being what would accrue to stockholders or other owners in the event of liquidation.

Non-Recourse Loans

A loan, security for which is limited to the value of pledged collateral and for which, indeed, the only repayment may be the money equivalent which the lender obtains for the pledged collateral. The term is particularly applicable to the federal government's loans to farmers on surplus commodities, the farmers' obligation to the government lending agency being limited to the commodities pledged for the loan.

Note

A credit instrument having general or limited negotiability, issued by an individual, a private corporation, or a governmental body, and consisting of a promise to pay a sum of money to a named creditor or to the bearer either on demand or at a specified time.

Operating Profit

As used in accounting, an increase in wealth resulting from the regular activities of an enterprise, as distinguished from any activities foreign to that business. For example, income or other gain from financial investments of a mercantile establishment would not be a part of the operating profits of that establishment.

Personal Property

A right or interest in things other than real property; for example, such things as money, clothing, and household furnishings, as well as bonds, stock mortgages, and other evidences of interest or debt.

PITI

Principle, interests, taxes and insurance (PITI) are the four components of a monthly mortgage payment.

Power Of Attorney

Authority granted to one person to act on behalf of attorney authorizes the agent to act for the principal in all matters. A special power of attorney limits the agent's acts to specific matters.

Premium

1. An additional amount paid or charged; specifically:
    a. An amount paid for a loan in addition to interest;
    b. An amount paid, as for stock, above the nominal or par value.
2. A payment; specifically:
    a. The amount payable or paid, in one sum or periodically, for an insurance policy;
    b. A fee paid for instruction in a trade, etc.
    c. A fee paid by a borrower of stock to the lender.
3. In economics, the amount by which one form of money exceeds another (of the same nominal value) in exchange value, or buying power.

Profit

1. A financial or monetary gain obtained from the use of capital in a transaction or series of transactions. 2. The ratio of this to the amount of capital invested. 3. The proceeds from property or the like. 4. In economics, the net income, as of a business, or the difference between the income and the costs, direct and indirect.

Promissory Note

A written promise to pay a specific amount of money to some person at a given place and time with interest at a specific rate, or without interest, as the case may be.

Property

1. The right to possess, use, and dispose of something; ownership: as, *property* in land. 2. A thing or things owned; holdings or possessions collectively; especially, land or real estate owned. 3. A specific piece of land or real estate.

Purchase-Money Mortgage

A mortgage given wholly or in part in lieu of cash for the purchase of tangible property.

Rate

1. A fixed ratio; proportion: as, the rate of exchange. 2. A price or value; specifically, the cost per unit of some commodity, service, etc., e.g. insurance *rate*.

Ratio

In finance, the relative value of gold and silver in a currency system based on both.

Real Estate Investment Trusts (REIT)

Corporations that operate much like closed-end mutual funds explained previously, investing shareholders' money in diversified real estate or mortgage portfolios instead of stocks or bonds. Their shares trade on the major stock exchanges or over-the-counter.

Real Property

A right or interest in land or whatever is attached to that land in such a way that it cannot be readily moved. The term is used in contradistinction to PERSONAL PROPERTY. See PROPERTY.

Risk Capital

See VENTURE CAPITAL.

Secured Debt

A debt for which collateral has been pledged.

Security

1. A document establishing a right to some form of property; for example, a corporate stock certificate, a bond, or a mortgage. 2.Property pledged as collateral. 3. Insurance against risk.

Simple

Interest calculated on a principal sum but not on any interest that has INTEREST been earned by that principal sum.

Small

As defined by the U.S. Small Business Administration: wholesalers BUSINESS with annual sales of not more than $10 to $15 million; retailers with annual sales of not more than $5 million; manufacturers with from 250 to 1,000 employees. These limits often depend upon the nature of the business.

State Bank

A bank controlled or chartered by a state.

Subprime Mortgages

Mortgages for people with credit scores under 620; also called non-prime mortgages. Many such homeowners found themselves unable to pay off their mortgages as interest rates rose and house values sank.

Truth-In-Lending Act

An act of Congress, 1968, requiring that a consumer borrower be informed of the true cost of a loan. Among specific regulations in the act are:

(a) the interest rate on revolving charge accounts must be disclosed;

(b) the true annual interest rate on home mortgages must be revealed;

(c) the actual interest rate must be given in a credit advertisement if the advertisement is in figures;

(d) the cost of credit life insurance on a loan must be stated; and

(e) a specific limitation, effective in 1970, is placed on the power to GARNISH wages.

Underwriting

The process of evaluating a loan application to determine the risk involved for the lender. Underwriting involves an analysis of the borrower's creditworthiness and the quality of the property itself.

Unsecured Debt

A debt for which no specific collateral has been pledged.

Usury

Interest in excess of a maximum established by laws applicable to various types of loan transactions. In popular speech the term is frequently applied to any rate of interest considered to be unfair and unjust.

Venture Capital

Capital subject to a considerable risk; hence, also called *risk capital*. Capital invested in a new business, where the chances of success are uncertain, is an example.

Working Capital

Current assets of an enterprise less the amount of the current liabilities. That part of the current assets which is equal to the current liabilities must be reserved to meet the enterprise's short-term debts. What remains of current assets is available for other uses in the business and hence is working capital.

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Review Question Answers

Chapter 1 Review Questions – Section 1

1. Which of the following is NOT part of the loan process for real estate financing?

A. Incorrect. It becomes necessary for the lender to qualify both the credit and the financial ability of the borrower to repay the loan.
B. Incorrect. The loan process also includes: qualifying the borrower and the title.
C. Incorrect. So as to determine the lien position of a mortgage given on a piece of property, the lender seeks to qualify the title.
D. **Correct.** The location of the property is a consideration in the loan process, but not the address of the property per se.

2. The title closing process has many names, but which of the following is NOT one of them?

A. Incorrect. The terms *title closing* and *closing* are used interchangeably.
B. Incorrect. Settlement is an alternative term to closing.
C. Incorrect. Escrow means property placed by one person in the hands of a second person, usually a trust company, for delivery to a third person upon the fulfillment by the latter of certain specific obligations. In California title closing is conducted by an escrow agent who is a neutral third party mutually selected by the buyer and seller to carry out the closing.
D. **Correct.** Ownership transfer is only a part of the title closing process.

3. What is name for type of laws found in many states that limit the interest rate that private lenders can charge individual borrowers?

A. **Correct.** Usury is the maximum interest rate that can be charged to individuals borrowing money in that state.
B. Incorrect. Truth-in-lending requires lenders to make meaningful credit disclosures to borrowers.
C. Incorrect. Regulation Z applies to advertising as well as making credit disclosures to borrowers.
D. Incorrect. Usury is the correct answer.

4. What does the National Consumer Protection Act’s (Truth-in-Lending Act) Regulation Z require?

A. Incorrect. Regulation Z does not apply to sales persons.

B. **Correct.** National Consumer Protection Act's (Truth-in-Lending Act) Regulation Z requires lenders to make meaningful credit disclosures to individual borrowers for certain types of consumer loans.

C. Incorrect. Regulation Z does not apply to broker/salesperson.

D. Incorrect. Regulation Z does not apply to real estate transactions.

5. Truth-in-lending is one form of price standardization that, since the adoption of the Consumer Credit Protection Act on July 1, 1969, has been provided by U.S. government regulations. What is the purpose of this legislation?

A. Incorrect. The Consumer Credit Protection Act merely requires disclosure. It does not regulate interest rates.

B. Incorrect. The act had nothing to do with wage garnishment.

C. **Correct.** The Truth-in-Lending Act applies to creditors that extend consumer credit to individual debtors (not organizations) in amounts of $25,000 or less. For a closed-end credit transaction, e.g., the typical car loan, the total finance charge, annual percentage interest rate, amount financed, late charges, security interest held by the creditor, the number and mounts of payments, due dates, and the total amount of payments must be disclosed. Open-end credit transactions, such as those involving credit cards, also have specific, detailed disclosure requirements.

D. Incorrect. The Consumer Credit Protection Act merely requires disclosure. It does not regulate interest rates.

6. ____________________ is NOT part of information that must be disclosed by lenders.

A. Incorrect. The law requires a lender to make several types of credit information disclosures. Two important disclosures include the finance charge and the annual percentage rate (APR).

B. Incorrect. The APR, the yearly cost of a loan, including interest, insurance, and the origination fee (points), expressed as a percentage, must be disclosed.

C. **Correct.** The rate of return is not required. Two important disclosures include the finance charge and the annual percentage rate (APR). The finance charge includes a disclosure of the following: interest, finder and origination fees, discount points, service charges, credit report fees and other charges paid by the consumer directly or indirectly which are imposed as an incident to the extension of credit.

D. Incorrect. One important disclosure includes the finance charge which includes finder and origination fees.

7. What does the Equal Credit Opportunity Act prohibit?

A. Incorrect. Regulating the action of credit bureaus that give out erroneous information to consumers is part of the Fair Credit Reporting Act.
B. Incorrect. Redlining and disinvestments in central city areas is part of the Community Reinvestment Act.
C. **Correct.** The Equal Credit Opportunity Act prohibits discrimination by lenders on the basis of sex or marital status.
D. Incorrect. Providing insurance coverage for those people suffering both real and person property losses as a result of floods is part of the National Flood Insurance Act.

8. What does the Equal Credit Opportunity Act require?

A. Incorrect. You cannot ask about a person's intention to bear children.
B. Incorrect. It is not required of a spouse to co-sign except in states with community property laws.
C. **Correct.** Under the Act, lenders furnish credit information in the names of both spouses for the purpose of establishing a credit history in each name, if both are participating in the loan.
D. Incorrect. You cannot use age in evaluating an applicant's credit worthiness.

Chapter 1 Review Questions – Section 2

9. Which of the following is NOT a financial source for real estate?

A. Incorrect. Primary sources are one of the four major sources used for borrowing funds.
B. Incorrect. Financial middlemen are one of the four major sources used for borrowing funds.
C. **Correct.** The common financial sources are divided into four groups: (1) primary sources, (2) financial middlemen, (3) other sources, and (4) the secondary mortgage market.
D. Incorrect. Other sources and the secondary mortgage market is one of the major four sources uses for borrowing fund.

10. Which of the following is NOT a common practice that most savings and loan associations (S&L) follow in their lending policies?

A. Incorrect. Making the bulk of their mortgages for single-family residences is a common lending practice of most S&L's.
B. Incorrect. Providing both VA and FHA financing is a common lending practice of S&L's .
C. **Correct.** Most state chartered S&Ls set their interest rates regardless of federal regulations. S&Ls handling VA mortgages are subject to federal interest ceiling rates.
D. Incorrect. Making the majority of their loans locally is a common lending practice of S L's.

11. Which of the following is a financial middleman?

A. Incorrect. Savings & Loan Associations are primary sources.
B. Incorrect. Commercial banks are primary sources.
C. **Correct.** Mortgage brokers and mortgage bankers are financial middlemen.
D. Incorrect. Life insurance companies are primary sources.

12. What is a pool of money from many investors for the purchase of real estate, such as a mutual fund does with stocks and bonds?

A. Incorrect. A credit union is a member-owned financial co-operative. These institutions are created and operated by its members and profits are shared amongst the owners.
B. **Correct.** REITs pool the money of many investors for the purchase of real estate, much as mutual funds do with stocks and bonds. There are three types of REITs. An equity trust invests their assets in acquiring ownership in real estate.
C. Incorrect. A pension fund is a fund established by an employer to facilitate and organize the investment of employees' retirement funds contributed by the employer and employees. Under a contractual arrangement, the pension fund can be run by a REIT.
D. Incorrect. A financing company is a commercial lender.

13. There are three types of REITs. ________________________ that invests their assets in acquiring ownership in real estate.

A. **Correct.** An equity trust is the one that invests their assets in acquiring ownership in real estate. Their income is mainly derived from rental on the property.
B. Incorrect. A mortgage trust invests in acquiring short-term or long-term mortgages. Their income is derived from the interest they obtain from their investment portfolio.
C. Incorrect. A combination trust combines the features of both the equity trust and the mortgage trust. Their income comes from rentals, interest, and loan placement fees. REIT shares trade on the major stock exchanges or over the counter.
D. Incorrect. REITs pool the money of many investors for the purchase of real estate, much as mutual funds do with stocks and bonds. There are three types of REITs. An equity trust invests their assets in acquiring ownership in real estate.

14. What is an agency of the U.S. Department of Agriculture that administers two loan programs for rural housing?

A. Incorrect. The FMHA (Farmers Home Administration) administers two loan programs for rural housing.
B. **Correct.** The Farmers Home Administration is an agency of the U.S. Department of Agriculture that runs two loan programs for rural housing.
C. Incorrect. The FMHA (Farmers Home Administration) administers two loan programs for rural housing.
D. Incorrect. The FMHA (Farmers Home Administration) runs two loan programs for rural housing.

15. The secondary mortgage market does NOT include which of the following agencies?

A. incorrect The Federal Home Loan Mortgage Corporation (FHLMC) or "Freddie Mac" (www.freddiemac.com/) was created as a wholly owned subsidiary of the Federal Home Loan Bank System. Freddie Mac was established as a secondary mortgage market for savings and loan associations who are members of the FHLBS.
B. Incorrect. Federal National Mortgage Association (FNMA), known as "Fannie Mae," is the largest and best known buyer of existing mortgages
C. Incorrect. Referred to as "Ginnie Mae," Government National Mortgage Association (GNMA) is a participant in the secondary mortgage market.
D. **Correct.** Savings And Loan Association is a primary source of mortgages. Traditionally, they have been the largest supplier of single-family owner-occupied residential permanent financing, although S&Ls are not limited solely to this type of financing.

Chapter 1 Review Questions – Section 3

16. What are first mortgages that have superior rights of subsequent lenders with low risk and low interest rates known as?

A. **Correct.** First mortgages that have superior rights of subsequent lenders with low risk and low interest rates are known as senior instruments.
B. Incorrect. A straight-term mortgage is a payment method not a first mortgage.
C. Incorrect. Fully amortized mortgages are a payment method not a first mortgage.
D. Incorrect. Budget mortgages are a payment method not a first mortgage.

17. What is a method of payment that requires interest, principal and a certain percentage on annual property taxes and property insurance?

A. **Correct.** Budget mortgage is a method of payment that requires interest, principal and a certain percentage on annual property taxes and property insurance.
B. Incorrect. On a straight-term mortgage only the interest is paid but the principal is not paid until the last day of the loan.
C. Incorrect. On a fully amortized mortgage the monthly payments include both principal and interest.
D. Incorrect. On a partially amortized mortgage periodic payments of interest and partial principal are paid and the remaining balance is referred to as a final balloon payment.

18. What is a conventional loan that is insured by a private (non-governmental) insurance company known as?

A. Incorrect. FHA is the Federal Housing Administration Insured Mortgages.
B. Incorrect. VA is the Veterans Administration Loan Guaranty Program.
C. **Correct.** The Mortgage Guaranty Insurance Corporation, or MAGIC (MGIC) for short, was established to insure a conventional loan.
D. Incorrect. CAL-VET is the California Farm and Home Purchase Program.

19. Which of the following is an example of a junior instrument (second mortgage)?

A. Incorrect. A conventional mortgage is a first mortgage.
B. **Correct.** As its name implies, a wrap-around mortgage (or deed of trust) is a junior mortgage that wraps around an existing first mortgage.
C. Incorrect. Federal Housing Administration Insured Mortgage (FHA) is a first mortgage.
D. Incorrect. A Veterans Administration Loan Guaranty is for a first mortgage.

20. What is a flexible financing technique for older people who have little or no debt on their property?

A. Incorrect. A Reverse Annuity Mortgage is a flexible financing technique for older people who have little or no debt on their property.
B. Incorrect. This is a graduated payment mortgage developed to overcome the negative amortization aspects of the Graduated Payment Mortgage (GPM).
C. **Correct.** This is a good financing technique for older people who have little or no debt on their property. Under this arrangement, the lender pays the borrower a fixed annuity based on a percentage of the property's value. The loan is not repaid until sale of the property or the death of the borrower when it is settled through normal probate procedures.
D. Incorrect. Under a variable rate mortgage, the interest rate charged by the lender can vary according to some reference index not controlled by the lender, such as the interest rate on 1-year United States T-bills or the 11th District Cost of funds Index.

21. What is the most popular and traditional mortgage that involves making regular payments on a fixed interest rate?

A. Incorrect. On a negative amortization the monthly payments fall short of what the borrower must pay to cover the interest and principal.
B. Incorrect. Under ARM, the interest rate charged by the lender can vary according to some reference index not controlled by the lender
C. **Correct.** The most popular and traditional mortgage is the fixed-rate, which involves making regular payments based on a fixed interest rate.
D. Incorrect. With a graduate payment mortgages (GPM), monthly mortgage payments start at an amount less than would be required under a level annuity payment and increase periodically over the life of the mortgage.

22. In qualifying a buyer and determining the cash available for the down payment of a prospective buyer, you do NOT need to which of the following activities?

A. Incorrect. You need to estimate all the available cash from the sale of assets other than a previous owned home if applicable.
B. Incorrect. In your estimate, include the amount of cash you netted from the sale of previous home.
C. Incorrect. Total amount of cash available minus estimated closing costs would be the amount available for the down payment for a new home.
D. **Correct.** The housing-expenses-to-income ratio is unrelated to the estimate of down payment. It is used to determine the amount of housing affordability.

23. Points and closing costs can raise the true cost of a loan significantly. What can these fees include?

A. Incorrect. Building trust and rapport is qualifying the loan.
B. **Correct.** Points and closing costs can raise the true cost of a loan significantly. These fees assume a variety of names: fees for recording of mortgage, lender's inspection fee, lender's points, and prepaid interest. If you prepare buyers for such fees and familiarize them with their purpose, they can be better shoppers and find out for themselves, the true cost of a loan--the actual annual percentage rate (APR).
C. Incorrect. Matching the housing needs and life style of the borrower is qualifying the loan.
D. Incorrect. Establishing the gross and net income of the buyer/buyers (husband & wife) is qualifying the loan.

Chapter 2 Review Questions – Section 1

1. Which of the following is NOT one of the best possible sources for investing?

- **A.** Incorrect. Discretionary income is money after expenses are paid and available for investing.
- B. **Correct.** The following are the possible sources of money available for investing: Discretionary income; Home equity; Life insurance; Profit sharing and pension; Gift from your parent or rich uncle; OPM (other people's money).
- C. Incorrect. Home equity is a source of money for investing by using a home equity loan.
- D. Incorrect. Life insurance has a cash value that can be used as a source for investing.

2. Which of the following items is NOT a factor to be considered in investment decisions?

- **A.** Incorrect. Safety and return and risk are factors to be considered in making investment decisions.
- B. **Correct.** Consideration should be given to safety, return and risk, stability of income, and marketability and liquidity.
- C. Incorrect. Stability of income is a factor to consider when making investment decisions.
- D. Incorrect. Marketability and liquidity are two important factors for investment decision making.

3. Which security is most often held as a substitute for cash?

- A. **Correct.** A Treasury bill is a short-term U.S. government obligation that is sold at a discount from its face value. A Treasury bill is highly liquid and nearly risk-free, and it is often held as a substitute for cash.
- B. Incorrect. Common stock is not quite a cash substitute. It can also be quite risk investments.
- C. Incorrect. Gold lacks the liquidity necessary to be a cash substitute.
- D. Incorrect. AAA corporate bonds are actively traded, but lacks the liquidity. It is still not as safe as cash.

4. _______________________ is NOT one of intangible financial investment vehicles.

- **A.** Incorrect. Common stock is an example of intangible financial investments.
- B. **Correct.** Real estate is an example of tangible investments.
- C. Incorrect. Mutual funds are an intangible financial investment.
- D. Incorrect. Commodities are a tangible investment.

5. Investments can be viewed as financial or real assets. What is an example of a real asset?

- **A.** Incorrect. Common stock, options and warrants are examples of financial investments.
- B. **Correct.** Collectables, gems and precious metals are examples of real assets.
- C. Incorrect. Treasury bills and government bonds are financial investments.
- D. Incorrect. Commodities and financial futures are financial assets.

6. An investor is currently holding income bonds, debentures, subordinated debentures, first-mortgage bonds, and floating rate notes. Which of these securities traditionally is considered to have the least risk?

- A. **Correct.** A mortgage bond is secured with specific fixed assets, usually real property. Thus, under the rights enumerated in the bond indenture, creditors will be able to receive payments from liquidation of the property in case of default. In a bankruptcy proceeding, these amounts are paid before any transfers are made to other creditors, including those preferences. Hence, mortgage bonds are less risky than the others listed.
- B. Incorrect. Income bonds pay interest only if interest is earned.
- C. Incorrect. Debentures are unsecured bonds.
- D. Incorrect. Subordinated debentures are subordinated to other debt.

7. What are debentures?

- **A.** Incorrect. Debentures must pay interest regardless of earnings levels.
- B. **Correct.** Debentures are unsecured bonds. Although no assets are mortgaged as security for the bonds, debentures are secured by the full faith and credit of the issuing firm. Debentures are a general obligation of the borrower. Only companies with the best credit ratings can issue debentures because only the company's credit rating and reputation secure the bonds.
- C. Incorrect. Debentures are not subordinated except to the extent of assets mortgaged against other bond issues. Debentures are a general obligation of the borrower and rank equally with convertible bonds.
- D. Incorrect. Debentures are not secured by mortgages on specific assets.

8. Preferred shares are securities with characteristics of both common shares and bonds. Preferred shares have ____________ like common shares and ____________ like bonds.

- A. Incorrect. Preferred shares do not have a maturity date.
- B. Incorrect. Preferred shares have fixed periodic dividend payments.
- **C.** Incorrect. Preferred shares do not have a maturity date, but do have fixed periodic dividend payments.

D. **Correct.** Like common shares (but unlike bonds), preferred shares have no maturity date. Like bonds (but unlike common shares), preferred shares have a fixed periodic payment. The fixed payment is in the form of a stated dividend in the case of the preferred shares and interest payments in the case of bonds. However, preferred dividends, unlike interest, do not become an obligation unless declared.

9. How do preferred and common stock differ?

A. Incorrect. Failure to pay dividends will not force the firm into bankruptcy, whether the dividends are for common or preferred stock. Only failure to pay interest will force the firm into bankruptcy.
B. **Correct.** In the event of bankruptcy, the claims of preferred shareholders must be satisfied before common shareholders receive anything. The interests of common shareholders are secondary to those of all other claimants.
C. Incorrect. Preferred dividends are fixed.
D. Incorrect. Neither common nor preferred dividends are tax deductible.

10. Which of the following is a marketable investment example as opposed to a liquid investment?

A. Incorrect. Savings accounts are liquid assets just like cash.
B. **Correct.** Real estate is correct. Marketability should be distinguished from liquidity. Marketability means you can find a ready market if you want to sell the investment. Liquidity means the investment is not only marketable, but also has a highly stable price.
C. Incorrect. Money market funds are often called "short-term parking" because its liquidity.
D. Incorrect. The term of a CD generally ranges from one month to five years.

11. Which of the following items is an investment with bad performance during inflation?

A. Incorrect. Real estate has good performance during inflation.
B. Incorrect. Gold and silver have good performance during inflation.
C. **Correct.** Bad Performance in inflation: bonds, short-term securities (T-bills and CDs), and mortgage-backed securities.
D. Incorrect. Collectibles have good performance during inflation.

Chapter 2 Review Questions – Section 2

12. Which of the following items is NOT included in the total return on an investment?

A. Incorrect. Total return also includes appreciation (or depreciation) in value (capital gains or losses).
B. Incorrect. Total return is includes current income such as dividend income and interest income.
C. Incorrect. Total return also includes appreciation (or depreciation) in market value, called capital gains (or losses).
D. **Correct.** Total return includes a change in value, i.e., sales price minus purchase price of an investment. The sale price is only the final value of the asset.

13. If a stock's dividend income for one year is $15, purchase price is $200, and sales price is $217, what is the holding period return on the investment (HPR)?

A. Incorrect. The holding period return on the investment (HPR) is higher than 7.5%. 7.5% would be the return if the stock sold for the original price.
B. Incorrect. The value of 8.5% does not include the dividend in the holding period return on the investment (HPR).
C. **Correct.** The holding period return on the investment (HPR) = [$15 + ($217-$200)] / $200 = $32 / $200 = 16%.
D. Incorrect. The value of 18% exceeds the HPR for the investment.

14. Business risk is the risk inherent in a firm's operations that excludes financial risk. It depends on all of the following factors EXCEPT:

A. **Correct.** Business risk is the risk of fluctuations in operating income when the firm uses no debt. It depends on factors such as demand variability, sales price variability, input price variability, and the amount of operating leverage. Financial leverage affects financial risk and is not a factor affecting business risk.
B. Incorrect. Demand variability and input price variability are also factors affecting business risk.
C. Incorrect. Sales price variability and input price variability are also factors affecting business risk.
D. Incorrect. Sales price variability and demand variability are also factors affecting business risk.

15. What is the investment risk that refers to the fluctuations in value of an asset as the interest rates and conditions of the money and capital markets change?

A. Incorrect. Liquidity risk is the possibility an asset may not be sold on short notice for its market value.
B. Incorrect. In a default risk the issuing company is unable to make interest payments or principal payments on the debt.
C. **Correct.** Interest rate risk refers to the fluctuations in the value of an asset as the interest rates and conditions of the money and capital markets change. Interest rate risk relates to fixed income

securities such as bonds and real estate. For example, if interest rates rise (fall), bond prices fall (rise).

D. Incorrect. Purchasing power risk it the possibility that you will receive a lesser amount of purchasing power than was originally invested.

16. ____________ is the risk that that cannot be eliminated through diversification.

A. **Correct.** Systematic risk is the risk that cannot be eliminated through diversification. The relevant risk of a security is its contribution to the portfolio's risk. It results from factors, such as recession, inflation, and high interest rates that affect all stocks.
B. Incorrect. Default risk is the risk that a borrower will not pay the interest or principal on a loan.
C. Incorrect. Interest-rate risk is the risk to which investors are exposed because of changing interest rates.
D. Incorrect. Purchasing-power risk is the risk that inflation will reduce the purchasing power of a given sum of money.

17. What is the marketable security with the least amount of default risk?

A. Incorrect. Securities issued by a federal agency are first backed by that agency and secondarily by the U.S. government.

B. **Correct.** The marketable securities with the lowest default risk are those issued by the federal government because they are backed by the full faith and credit of the U.S. Agency securities are issued by agencies and corporations created by the federal government, such as the Federal Housing Administration. They are backed by a secondary promise form the government.

C. Incorrect. Repurchase agreements could become worthless if the organization agreeing to make the repurchased goes bankrupt.

D. Incorrect. Commercial paper is unsecured.

18. What is the relevant risk of a security?

A. Incorrect. Company-specific risk can be eliminated through portfolio diversification.
B. **Correct.** The relevant risk of a security is its contribution to the portfolio's risk. It is the risk that cannot be eliminated through diversification. The relevant risk results from factors, such as recession, inflation, and high interest rates that affect all stocks.
C. Incorrect. Diversifiable risk can be eliminated through diversification.
D. Incorrect. Only the systematic component of total risk is relevant to security valuation.

19. What is the risk that securities cannot be sold at a reasonable price on short notice called?

A. **Correct.** An asset is liquid if it can be converted to cash on short notice. Liquidity (marketability) risk is the risk that assets cannot be sold at a reasonable price on short notice. If an asset is not liquid, investors will require a higher return than for a liquid asset. The difference is the liquidity premium.
B. Incorrect. Default risk is the risk that a borrower will not pay the interest or principal on a loan.
C. Incorrect. Interest-rate risk is the risk to which investors are exposed because of changing interest rates.
D. Incorrect. Purchasing-power risk is the risk that inflation will reduce the purchasing power of a given sum of money.

Chapter 3 Review Questions

1. Which of the following is NOT a home ownership advantage?

A. Incorrect. With home ownership you are building equity due to the appreciation in the value of the home.
B. Incorrect. Interest and property taxes are deductible on the home owner's tax return.
C. Incorrect. With home ownership owning is less costly than renting.
D. **Correct.** Homeownership has the following advantages: 1) You are building equity due to the appreciation in the value of the home; 2) Interest and property taxes are deductible on the tax return; 3) Usually owning is less costly than renting; 4)You may enjoy extra living space and privacy.

2. Homeowner expenses EXCLUDE which of the following items?

A. **Correct.** Rent control expenses are associated with renting. Homeowner expenses can include mortgage payments, maintenance expenses, and operating expenses (utilities).
B. Incorrect. Homeowner expenses include mortgage payments.
C. Incorrect. Homeowner expenses include mortgage payments, maintenance expenses, and operating expenses (utilities).
D. Incorrect. Homeowner expenses include operating expenses (utilities).

3. Which of the following is NOT a rule to determine a borrower's housing affordability?

- **A.** Incorrect. A borrower should avoid spending more than 35 percent of monthly take-home pay.
- B. **Correct.** The rules to determine a borrower's housing affordability include: 1) 35% of monthly take home pay; 2) the price should not exceed 2-1/2 times your family's annual gross income; 3)monthly payments should not exceed 25% to 28% of gross income
- C. Incorrect. The rules to determine a borrower's housing affordability include: the price should not exceed 2-1/2 times your family's annual gross income.
- D. Incorrect. The rules to determine a borrower's housing affordability include: monthly payments should not exceed 25% to 28% of gross income

Chapter 4 Review Questions

1. What is the cash value of your home that a lender is willing to make you a loan known as?

- A. Incorrect. Discretionary income is after tax money that you can save, invest or spend.
- **B.** Incorrect. A pension plan or insurance policy is a form of annuity.
- C. **Correct.** Home equity is the market value of your home minus your mortgage balance.
- D. Incorrect. Profit sharing is a company benefit that employees are eligible for in some companies.

2. Which of the following is a disadvantage of real estate investing?

- A. **Correct.** Disadvantages include high transaction costs, such as brokerage commissions and closing expenses, negative cash flow with little down (too much leverage), and limited marketability
- B. Incorrect. Interest deductions are an advantage to invest in real estate because they create tax savings.
- C. Incorrect. Depreciation is an advantage for real estate investing by providing non-cash consuming deductions with tax returns.
- D. Incorrect. Appreciation is one of the strongest advantages for real estate investing, and is key to the buy and hold strategy.

3. What is an example of commercial real estate?

- A. Incorrect. Multi-unit apartments are residential rental property.
- **B.** Incorrect. Real investment trusts are corporations that trade on the stock exchanges and invest shareholders money in real estate.
- C. **Correct.** Kinds of real estate you can invest include: Undeveloped land; Residential rental property (e.g., single family houses for rental, and multiunit apartments); Commercial property

(e.g., office buildings, shopping centers, and industrial property); Real Estate Investment Trusts (REITs)

D. Incorrect. Undeveloped land is a source of investment other than commercial property.

4. Which one is NOT the kind of real estate you can invest in?

A. Incorrect. Undeveloped land is a popular vehicle for real estate investing.
B. Incorrect. Residential rental property is a popular method for first-time investors in the real estate market.
C. **Correct.** Federal protected lands are nor for sale to the public.
D. Incorrect. Commercial property is a good real estate investment, especially for experienced investors looking to diversify between residential and other property.

5. Before investing in Real Estate Investment Trusts (REITs) you must consider all the following, EXCEPT:

A. **Correct.** The factors such as profitability and cash flow are more important than who owned the properties.
B. Incorrect. The factors such as profitability and location are more important. In selecting REITs, one must consider: Profitability; Annual cash flow; Condition of properties; Location of properties, good or bad areas; Nature of property (e.g., residential, commercial); Degree of leverage; Years REIT has been in existence; Dividend history
C. Incorrect. Annual cash flow is a major determinant of profitability.
D. Incorrect. The degree of leverage measures the amount of debt used to finance a REIT's assets. A REIT with significantly more debt than equity is considered to be highly leveraged. Leverage magnifies both gains and losses.