

California Real Estate Finance
Chapter 5
Conventional, Insured and Guaranteed Loans

Chapter Purpose

This chapter is the first of four chapters that addresses the questions of *What kinds of loans are available?* Included in this chapter is information pertinent to conventional, insured and guaranteed loans.

The conventional lender is held to the standards adopted and amended from time to time by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) now known as “Fannie Mae” and “Freddie Mac.” These secondary market operators dictate how the conventional lenders will act because inevitable, these lenders will seek to sell their loans to them.

Conventional loans are so named because they are generally written without any third party guarantees. Thus, the lender has to exercise caution in their underwriting since the lender is directly at risk in the event of a default. However, if the conventional loan is issued at greater than 80% of the collateral property’s value, the Fannie Mae and Freddie Mac guidelines require that they be insured by a private mortgage insurance company.

This chapter also presents a review of the various FHA programs. Finally, the activities of the DVA are examined. Both the FHA and DVA have expanded into huge bureaucracies and have begun to introduce new products in order to preserve their market positions. But conventional lenders are moving aggressively into the low down payment arena and have taken a large lead in numbers of loan originations.

Suggestions to the Instructor

This is the time to invite an experienced mortgage broker or banker to lead the class in a comprehensive exercise in securing a conventional, FHA and DVA loan. Not only should the presentation cover the terms and conditions of these loans, but an analysis of various loan applications should be made as to a borrower’s ability to make payments.

Learning Objectives

Upon completion of this chapter, the student should be able to:

1. describe the concept of loan-to-value (L/V) ratios;
2. understand the underwriting guidelines established by Fannie Mae and Freddie Mac of lenders who want to sell their loans in the secondary market;
3. differentiate between conforming and nonconforming conventional loans;
4. define conventional guaranteed mortgages;
5. understand the organization and purposes of the FHA;
6. identify the FHA programs;
7. describe how an FHA loan may be secured;
8. define the loan limitations of both FHA and DVA loans;
9. determine the FHA and DVA loan income level requirements;
10. analyze an adjustable rate loan and a graduated payment mortgage.

Presentation Outline

- I. Conventional Real Estate Loans
 - A. Loan-to-value ratios (L/V)
 1. 65% for land acquisition
 2. 75% for land development
 3. 80% for multifamily and commercial properties
 4. 85% for one-to four-family properties
 - B. Fannie Mae and Freddie Mac conventional loan guidelines
 1. At least 5% down when L/V exceeds 80%
 2. Private mortgage insurance on any loan with greater than 80% L/V ratio
 3. Borrowers income qualifications are 28% for loan payments, 36% for payments plus other monthly costs
 4. Buydowns allowed except for adjustable rate loans
 5. Sellers' contributions to closing costs may not exceed 6% of loan amount
 6. Gifts may be used for settlement, but borrowers in some cases must have invested at least 5%
 - C. Conforming and nonconforming conventional loans
 1. Conforming loan limits (see text)
 2. Establish maximum loan limits for conformity to collateralize as mortgage pools
 3. Changed annually by prescribed formula
 4. Must follow limits to sell loans to Fannie Mae or Freddie Mac
 5. Nonconforming loans are usually California held for lender's portfolio

- D. Interest rates
 - 1. Depend on interplay between supply and costs of money in the general economy
 - 2. Influenced by actions of the Fed and Treasury
 - 3. Interest rates for all loans now set in market
 - E. Fixed-rate loans
 - 1. Conventional loans are mostly fixed-rate loans
 - 2. Loan payments are uniform throughout loan period
 - 3. 30-year terms vs. 15-year terms
 - F. Adjustable-rate loans
 - 1. Interest rates adjusted over term of loan
 - 2. Adjustments made according to prescribed loan amounts
 - 3. Adjustments usually made annually
 - 4. Adjustments usually have annual and life-time caps
 - G. Private mortgage insurance
 - 1. Insures the portion of a loan in excess of 80% L/V
 - 2. Premiums paid by borrower in full at loan's inception or monthly together with payments
 - 3. Premiums cease when L/V ratio reduced to 80%
- II. The Federal Housing Administrations (FHA)
- A. Organization and requirements
 - 1. Under HUD
 - a. ten regional offices, California is Region 9
 - b. offices in Los Angeles, San Diego, Santa Ana, Fresno, San Francisco and Sacramento
 - 2. Lenders must grant long-term, self-amortizing loans at market interest rates
 - 3. All properties must meet minimum standards of acceptability as revealed by appraisal report
 - B. Program summary
 - 1. FHA issues mortgage insurance protecting lenders
 - 2. Eliminates lenders' risks
 - 3. Stabilizes mortgage markets
 - C. Contributions to real estate finance
 - 1. Instituted standards for qualifying borrowers
 - 2. Instituted standards for appraising property
 - 3. Introduced long-term, self-amortizing loans
 - 4. Provided basis for enhancing national secondary market in real estate loans
 - D. Advantages of FHA loans
 - 1. High L/V ratios
 - 2. Large variety of loan types eligible for FHA insurance
 - 3. Most loans assumable
 - 4. No prepayment penalties

- E. Underwriting guidelines
 - 1. Borrowers' income qualifications
 - a. 29% of gross income for payments
 - b. 41% of gross income for payments, maintenance and other debts
 - 2. Maximum loan limits
 - a. \$144,336 standard
 - b. Higher in various parts of the country
 - c. California maximum is \$261,609
 - 3. Down payment requirements
 - a. 1.25% for properties \$50,000 or less
 - b. 2.25% for properties more than \$50,000 up to the maximum loan amount
 - c. The purchaser must provide three percent of the purchase price to be used for the down payment and/or closing costs
 - 4. Loan settlement costs
 - a. May be added to loan
 - b. Seller may pay but only up to 6% of the loan amount
 - 5. Mortgage insurance premiums
 - a. Currently 1.5% of loan amount
 - b. Plus 0.5% annual fee paid monthly
 - 6. Second mortgages and buydowns
 - a. FHA allows second mortgages under conditions listed in text
 - b. FHA allows buydowns, but the borrower must qualify at the note rate
 - 7. Assumptions
 - a. FHA loans are fully assumable without any interest rate adjustments
 - b. New buyers must qualify under the 29/41% rule
 - c. Investors cannot assume existing FHA loans
 - 8. Selected major FHA programs
 - a. Section 203(b) Home Mortgage Insurance
 - b. Section 203(b)(2) VET
 - c. Section 221(d)(2) Homeowners Ass. Program
 - d. Section 245 Graduated Payment Program
 - e. Title I Home Improvement Loans
 - f. FHA Adjustable Rate Mortgage (ARM)
 - (1) indexed to Treasury bills rates
 - (2) 1% per year cap
 - (3) 5% lifetime cap
 - 9. Direct endorsement and coinsurance
 - a. Loans can be underwritten by approved lender
 - b. Loans can be processed by approved lender
- F. FHA foreclosure sales
 - 1. HUD holds weekly sealed bids on foreclosed properties
 - 2. Some sold "as is"

- III. The United States Department of Veterans Affairs (DVA) Real Estate Loan Guarantee Program
 - A. Program application
 - 1. Program managed by 55 regional offices in major communities throughout country
 - 2. Guarantees the top 20% portion of a loan made to eligible veterans
 - B. Eligibility/entitlement
 - 1. 90 days of continuous active duty in wars
 - 2. 181 days of continuous active duty after wars
 - 3. 24 months continuous active duty in peacetime
 - 4. 6 years continuous active duty as reservist
 - 5. Unremarried spouses also eligible
 - 6. Limited to owner-occupied single-family homes and up to four multi-units
 - 7. Veteran secures Certificate of Eligibility upon discharge from service
 - C. Schedule of guarantees
 - 1. 50% up to \$45,000
 - 2. \$22,500 from \$45,001 to \$56,250
 - 3. The lesser of \$36,000 or 40% from \$56,251 to \$240,000
 - 4. The lesser of \$60,000 or 25% of loan \$240,001 or more
 - 5. Partial entitlement available to veteran who has used guarantee in the past (see loan guarantee periods in text)
 - 6. An official appraisal known as a Certificate of Reasonable Value must be secured to establish maximum loan amount
 - D. Interest
 - 1. Established in the market
 - E. Income qualifying requirements
 - 1. Only one ratio: 41% of borrowers' total monthly gross income
 - 2. Includes principal, interest, taxes, insurance, utilities, maintenance and other debt payments
 - 3. Residual income test also applied
 - F. Closing costs
 - 1. Paid in cash by buyer or seller
 - 2. Not included in loan amount
 - 3. Also pro-ration of interest and taxes and prepayment of impound funds
 - G. Funding fee
 - 1. May be paid in cash or included in loan amount
 - 2. See schedule in text
 - H. Second liens allowed when:
 - 1. Documents must be approved by DVA
 - 2. Total loans may not exceed value of property
 - 3. Interest rate on second may not exceed first
 - 4. No prepayment penalty or balloon payment
 - 5. Amortized at least five years
 - I. Buydowns allowed
 - 1. Only on loans with level payments
 - 2. Borrower qualifies at first year's payment rate

- J. Assumptions
 - 1. Loans made prior to March 1, 1988, fully assumable with no prequalifications
 - 2. Subsequent loans require DVA credit approval
 - K. Release of liability and novation
 - 1. Borrowers' liability ends when loan repaid
 - 2. Liability may be released with DVA accepting credit of new buyer but does not reinstate veteran's entitlement
 - 3. Assumption by another qualified veteran can reinstate full entitlement: called novation
 - L. DVA Graduated Payment Mortgage: no longer available
 - M. DBA Adjustable Rate Mortgage
 - 1. One percent override on initial interest rate
 - 2. Adjustments indexed to average weekly Treasury securities yield
 - 3. Capped at 1% per year and 5% overall same as FHA 245
- IV. California Veterans Farm and Home Purchase Program
- A. Funding and title
 - 1. Revenue and general obligation tax-exempt bonds
 - a. must be approved by legislature and public
 - b. repaid by borrowers
 - 2. Department takes title to real estate
 - a. resells to eligible veteran under land contract
 - b. buyer receives full title when loan paid
 - B. Eligibility requirements
 - 1. All veterans are eligible
 - 2. 90 days active service
 - 3. Honorable discharge
 - 4. Unremarried spouses also eligible
 - C. Qualifying procedures
 - 1. Property values
 - a. \$250,000 maximum single family homes and mobile homes on owned lots
 - b. \$70,000 maximum mobile homes in approved parks
 - c. \$387,360 maximum self-supporting farms and ranches
 - 2. Loans cannot exceed 95% of appraised value
 - 3. Most loans amortized over 30 years
 - 4. Fixed and variable rate loans available
 - 5. Insurance against floods and earthquakes required
 - D. Special conditions
 - 1. Construction loans and permanent financing okay
 - 2. Some refinancing may be possible
 - 3. Junior financing allowed if total loans less than 90% L/V ratio
 - 4. Borrower must maintain occupancy until loan repaid
 - 5. No assignment of loan without department's consent