6

Chapter 6

Conventional Financing

In This Chapter

Today, nearly half of all residential real estate lending is completed with conventional financing programs, and there are various financing tools available that have expanded the usefulness of these programs. In this chapter, we'll look at different types of conventional loans (e.g., 15-year, 30-year, conforming, nonconforming). In addition, we'll examine how private mortgage insurance and secondary financing options have expanded the availability of conventional lending. Government financing and nontraditional financing tools are covered in the following chapters.

At the end of this chapter, you will be able to:

- Identify the characteristics of a conventional loan.
- Define amortization.
- Identify different types of conventional loans.
- Discuss the use of private mortgage insurance.
- Contrast conforming and nonconforming loans.
- Discuss methods of secondary financing.

Key Terms

Amortization
Conforming Loan
Conventional Loan
Declining Market
Fixed Rate Loan
Jumbo Loan
Loan-to-Value Ratio (LTV)
Negative Amortization
Private Mortgage Insurance (PMI)
Secondary Financing
Self-Liquidating

Conventional Loans

Conventional financing refers to real estate that is paid for or financed with a **conventional loan**—one that is usually made by a bank or institutional lender and that is *not insured or guaranteed by a government entity or agency, such as FHA or VA.* Most conventional loans are, however, written to guidelines set by government-sponsored entities (GSEs), such as Freddie Mac and Fannie Mae, so that they may be sold in the secondary market. When a loan meets the criteria necessary to be sold in the secondary market, it is considered a **conforming** loan. Conventional loans may be conforming loans or nonconforming loans.

Since Fannie Mae and Freddie Mac are now under the conservatorship of the Federal Housing Finance Agency, you might be tempted to say that even conventional loans are "insured" by a government entity. However, for the purpose of this discussion, we will refer to conventional loans in the traditional sense. Just under half of all residential mortgages are handled as conventional financing. That percentage can certainly change depending on market conditions and consumer trends.

Traditional Conventional Loans

Traditional conventional loans are typically **long-term, fully amortizing, fixed rate real estate loans**. This is the type of loan with which borrowers are most familiar. According to the SAFE Act, any loan with terms other than 30-year fixed is defined as **nontraditional.**

Long-Term

Long-term real estate loans generally have total payments spread out over **25 to 30 years,** and even **40-year terms** are offered. While the long-term nature of conventional loans seems natural today, before the Federal Housing Administration (FHA) was formed in 1934, home loans were typically done for terms of five, seven, or ten years. Payments were often high with short loan terms, which required balloon payments to pay off the balance at the end of the loan term. This meant people had to refinance their loans frequently, posing problems for those who could not deliver the required balloon payment or whose qualifying situation may have changed at an inopportune time. Long-term loans give borrowers today a reasonable payment, and the security of a long-term loan that they can choose to refinance if and when the time is right.

Fully Amortizing

Amortization is the *reduction of the balance of the loan by paying back some of the principal owed on a regular basis*. Amortizing loans have payments applied to principal and interest (as opposed to interest-only loans with payments only applied to the interest on the loan). A **fully amortizing loan** is one for which *total payments over the life of a loan pay off the entire balance of principal and interest due at the end of the term.* This is also known as **self-liquidating**. Regular periodic payments reduce the loan by the end of the term, although different amounts are applied to interest and principal out of each regular payment.

Example: $100,000 loan @ 6%, 30-year term (figures approximate)					
Pymt. No.	Principal Balance	Total Pymt.	Interest Portion	Principal Portion	Ending Balance
1	$100,000.00	$599.55	$500.00	$99.55	$99,900.45
2	$99,900.45	$599.55	$499.50	$100.05	$99,800.40
3	$99,800.40	$599.55	$499.00	$100.55	$99,699.85
4	$99,699.85	$599.55	$498.50	$101.05	$99,598.80
5	$99,598.80	$599.55	$497.99	$101.56	$99,497.24

NOTE: A complete sample amortization schedule appears in the Appendix.

FIGURE 6.1: Amortization of $100,000 30-Year Loan at 6%.

This is very different from how mortgage loans were repaid before FHA, when loans were only partially amortizing or non-amortizing.

Negative amortization occurs anytime the monthly payment is not sufficient to cover the accrued interest from the previous month.

Fixed Rate

Fixed rate loans have *interest rates that remain constant for the duration of the loan.* This is both good and bad for the borrower and the lender. Of course, the biggest advantage is that a borrower doesn't need to worry that rates will increase. If rates decrease enough, the borrower can refinance. From the lender's perspective, there's a guaranteed rate of return, but the rate is locked in for 30 years, which benefits the borrower when rates go up.

15-Year Mortgage Loans

Lenders will often give a borrower a better interest rate on a 15-year mortgage because the shorter term means less risk for the lender. Over the life of the mortgage, the **total interest** paid on a 15-year, fixed rate mortgage is about **one-third less** than a 30-year mortgage at the same interest rate. An added benefit is that the borrower can attain full ownership in half the time it takes to pay off a 30-year mortgage.

Of course, there are *disadvantages* to 15-year mortgages:

- Payments are higher.
- Higher payments consume financial resources that might be invested other ways and earn a higher return than the interest rate paid on the mortgage.
- The borrower's income tax deduction declines more quickly because less interest is paid each year as the principal is paid sooner.

One way to get some of the benefits of 15-year mortgages (saving interest and paying less over the life of the mortgage) without the legal obligation is for the borrowers to get a 30-year mortgage and make additional principal payments each month. Of course, this takes discipline, but most mortgages allow it. A borrower can retire the debt earlier and save interest without having to worry about the contractual burden of higher payments.

15-YEAR MORTGAGE TO 30-YEAR MORTGAGE COMPARISON OF INTEREST PAID

Loan Amount	Term	Interest Rate	Monthly Payment	Total Interest Paid
$50,000 MORTGAGE	15YR	7%	$449.41	$30,894.54
	30YR	7%	$332.65	$69,754.45
$100,000 MORTGAGE	15YR	7%	$898.83	$61,789.09
	30YR	7%	$665.30	$139,508.90
$150,000 MORTGAGE	15YR	7%	$1,348.24	$92,683.63
	30YR	7%	$997.95	$209,263.35

Note: Typically, rates for a 15-year mortgage is lower than rates for a 30-year mortgage. The same rate was used here for both to illustrate a direct comparison of total interest paid.

FIGURE 6.2: 15-Year to 30-Year Mortgage Comparison.

Bi-Weekly Payment Plan

A mortgage with a **bi-weekly** payment plan is a version of a *fixed rate mortgage set up like a standard 30-year conventional loan calling for regular monthly payments determined by a monthly payment amortization schedule but on which payments are made every two weeks instead of every month*. This alternative payment plan can help a borrower reach a goal of paying off a mortgage earlier and saving interest, since 26 payments are made each year—equal to one extra monthly payment. Loans with bi-weekly payment structures are usually paid off in about 22.3 years, instead of 30 years. For example, with a $70,000 loan at 10.5% fixed-rate loan with 30-year amortization:

SCHEDULE	PAYMENT	# of PAYMENTS	TOTAL AMOUNT PAID
Monthly	$640.32	360	$230,515.20
Bi-Weekly	$320.21	532	$170,351.72

Bi-weekly payment structures do require more servicing for lenders. Most loans today do not have pre-payment penalties so lenders may also allow borrowers to make voluntary extra payments in lieu of a formal payment structure. Borrowers must review the terms of their note to see if partial principal reductions are permitted, how excess funds are applied, and whether or not there are any prepayment penalties.

Conforming versus Nonconforming Loans

Conforming loans *meet Fannie Mae/Freddie Mac standards, and therefore can be sold on the secondary market.* Lenders try to make as many of their loans as possible conforming loans, because they like the option of being able to **liquidate** (sell for cash) their real estate loans on the secondary market if they need more funds. In an earlier chapter, you learned that conforming conventional financing has traditionally used the following qualifying guidelines:

- **28%** total housing expense ratio
- **36%** total debt-to-income ratio

Remember that a borrower must typically qualify under **both** ratios. In addition, note that borrowers should have **5% of their own funds** for a down payment and **two months of reserves on deposit**. For some lenders, however, these guidelines may be less rigid when automated underwriting is used. For example, conventional loans underwritten through Desktop Underwriter® put greater emphasis on the back end, or debt-to-income, ratio to evaluate potential payment shock.

Nonconforming loans, on the other hand, do *not* meet these standards, and therefore *cannot be sold to Fannie Mae or Freddie Mac.* There are other secondary markets where nonconforming loans can be sold, however, and lenders that have the option of keeping loans in their own portfolio (mostly banks and S & Ls) can, within the limits of the law, deviate from the standards set by secondary markets.

There are two main reasons why a loan would be classified as nonconforming:

- **Size of the Loan.** So-called **jumbo loans** *exceed the maximum loan amount established by Fannie Mae and Freddie Mac for conforming mortgage loans.* In 2012, the single-family home conforming loan maximum is $417,000 ($625,500 for most locations in Alaska, Hawaii, Guam, and U.S. Virgin Islands). In addition, the conforming loan maximum can be even higher in specific counties or metropolitan statistical areas. For example, in Washington D.C. and surrounding counties, the maximum conforming loan for a single-family home is $729,750.
- **Credit Quality of Borrower.** You may see a borrower who does not meet the minimum standards established by Fannie Mae/Freddie Mac classified as a **B or C borrower**. This might be someone who has had a credit problem in the past, such as bankruptcy within the past seven to ten years, medical bills, or someone whose credit scores are low because he or she owns multiple investment properties or has been self-employed for too short a period of time. Lenders, such as neighborhood banks, may still offer loans to these borrowers, but the loans cannot be sold to Fannie Mae or Freddie Mac.

A-Minus Conventional Loans

In order to meet the increasing consumer demand and limit the loss of market share to the nonconforming lenders, many lenders instituted an **A-minus conventional loan** program. This loan program allows a borrower with less than perfect credit history, limited money for down payments, or higher debt-to-income ratio to get a loan that could be sold on the secondary market. With this loan, a borrower may be able to benefit from a variety of financing alternatives in order to obtain an interest rate that is much closer to conventional conforming rates. In the past, the only option for these consumers would have been much costlier financing terms, if they would have been able to get a loan at all.

It is important to note that final interest rate and fees are determined on basis of the risk factors present in the loan. So when working with this type of mortgage, mortgage loan originators need to double check the interest rate and all the fees charged so they quote the correct information.

Conventional Loan Programs

Conventional loan programs can be classified by the **percentage of down payment** that the borrower pays to get the loan. The conditions and standards presented here are the most typical, but keep in mind that there are many variations of these loan programs. Lenders are constantly offering innovative loan products and programs to meet the needs of customers and to attract business in a competitive environment. As these "typical" loan programs and "typical" down payments with private mortgage insurance (PMI) are reviewed, remember that some lenders offer high LTV loans where PMI is not necessary, but fees may be higher, or conditions and standards imposed.

80% LTV Conventional Loan

The **loan-to-value ratio** (LTV) refers to *the amount of money borrowed (the loan amount of a first mortgage) compared to the value of the property.* Lenders use LTV to determine how much they are willing to loan on a given property based on its value. The lender will always use the *lower* of the appraised value or the sale price in order to protect its interest. The lower the LTV, the higher the borrower's down payment, which means the loan is more secure.

For example, for years, the **80% conventional loan** was the standard conventional loan, so for a house with a sale price of $200,000, the most a borrower could borrow would be:

$200,000 x 0.8 = $160,000 loan amount

Subtracting the loan amount from the sale price indicates that the borrower would need a down payment of $40,000.

Class Activity: 80% Conventional Loan

Review the following scenario and discuss your responses with the class.

Bill wants to buy a house that is selling for $160,000, and the lender has approved him for an 80% conventional loan.

How much can Bill borrow?

What would be the required down payment?

If the house appraises for $150,000, how much can Bill borrow?

What other options does he have?

Higher LTV Loans

A borrower who does not have enough money for a 20% down payment but still wants a conventional loan can try to get a 90% conventional loan with a 10% down payment, a 95% conventional loan with a 5% down payment, or even a 100% conventional loan. Loans with a LTV higher than 80% are possible because of PMI and secondary financing, which will be covered later in this chapter.

The qualifying standards for higher LTV loans tend to be more stringent, and lenders adhere to those standards more strictly even if the loan is insured through private mortgage insurance (PMI). These loans may also have a higher interest rate, call for higher loan origination fees, or impose additional conditions and standards.

Lender and agency requirements determine if the property must be **owner-occupied** as a condition for obtaining the loan. Most conventional loans over 80%, as well as all FHA and VA loans, require the property to be owner-occupied. There may be exceptions to these guidelines for specific programs or investors.

90% Conventional Loan

For a **90% LTV loan**, at least half of the 10% payment (5%) must be made from personal cash reserves. The remainder of the down payment may be a gift from a family member, equity in other property traded to the seller, or credit for rent already paid under a lease/purchase.

95% Conventional Loan

A **95% LTV loan** requires owner occupancy of the property and the down payment must be made from personal cash reserves, without using secondary (owner) financing or gifts.

Loans for Special Needs

While there are loan products for people who have small down payments but excellent credit, there are people in the opposite situation: They can't pass a stringent credit review, but have a larger down payment. Or perhaps their credit is good, but they have a hard time proving the stability of their income because they are self-employed. To address issues related to prospective borrowers who are either unable or unwilling to supply the normal income documentation, lenders designed various types of mortgage products. These may be referred to as stated-income, no-ratio, low-doc, no-doc, NINA (no income/no asset verification), or "easy qualifier" mortgages.

Although these loans are rare in today's marketplace, lenders who do make these loans modify their qualifying standards or loan criteria based on the customer's needs. For example, lenders may require the same documentation as other conventional loans, but relax qualifying standards due to the increased equity the borrower is putting into the home. Or, the lender may relax income verification standards for borrowers with good credit and a down payment of at least 20%. While higher down payment loans tend to be less expensive, that is not always the case with these types of loans as lenders must look at other factors to determine the interest rate and, possibly, the fees charged.

Current market conditions will drive the availability of such loans. An increase in foreclosures and a stagnant real estate market, for example, tends to limit the number of lenders willing to offer these types of loans.

Private Mortgage Insurance (PMI)

Private mortgage insurance (PMI) is *offered by private companies to insure a lender against default on a loan by a borrower.* Prior to the advent of PMI, lenders would only lend 80% of the value of a property, assuming that the 20% down payment was the incentive needed for the borrower to keep mortgage payments current. Lenders also felt comfortable that, in the event of default, a foreclosure sale would yield 80% of the original sale price (or appraised value) and recover the loan amount.

PMI evolved to compensate the lender for the reduced borrower equity, thus making loans easier for borrowers and safer for lenders. Both Fannie Mae and Freddie Mac also require mortgage insurance—whether lender-paid or third party—on home loans with less than 20% down.

How Mortgage Insurance Works

When insuring a loan, the mortgage insurance company shares the lender's risk, but only *part of the risk.* The insurer does *not* insure the entire loan amount but rather the *upper portion of the loan* that exceeds the standard 80% LTV. The amount of coverage can vary, but is typically 20% to 25% of the loan amount.

Example: 20% coverage on a 90% loan

$100,000	Total Sale Price
x .90	LTV
$ 90,000	90% Loan
x .20	Amount of Coverage
$ 18,000	Amount of Policy

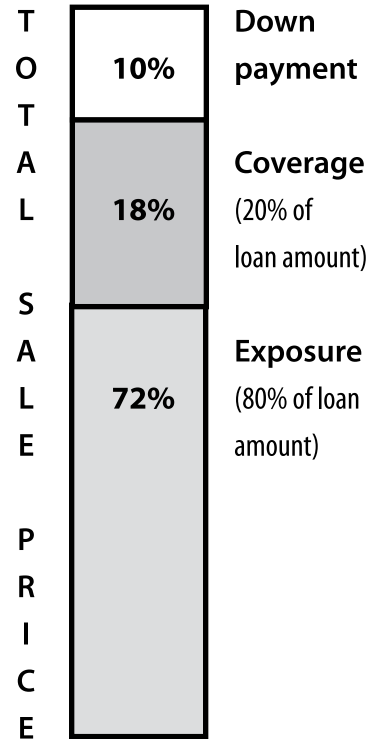

FIGURE 6.3: PMI Coverage Example.

Here, $18,000 is the maximum amount a lender can claim as a loss and collect from the private mortgage insurance company.

In the event of default, the insurer and the lender will negotiate how best to proceed in order to mitigate losses. For example, the insurer could purchase the loan for face value or some reduced value, then foreclose or allow the lender to foreclose. If the proceeds from the foreclosure action do not fully reimburse the lender for the principal balance, the lender will be able to make a claim against the insurer up to the policy limit. In this case, the insurer would probably require the lender to assign the note to the insurer. If the foreclosure sale does not yield enough to pay the outstanding loan balance and the cost of the foreclosure and sale, the holder of the note (either the lender or the insurer) may commence a proceeding to obtain a deficiency judgment against the borrower, co-borrower, and any other obligors.

PMI Premiums

There are actually three different ways that a borrower can pay for private mortgage insurance, each with advantages and disadvantages:

- First year's premium at closing and monthly escrow for the renewal premium
- One-time PMI premium
- Lender-Paid Mortgage Insurance (LPMI) through a higher interest rate on the loan throughout its life

Fee at Closing and Renewal Premium

The traditional way that private mortgage insurance companies charge for PMI is with a one time non-refundable fee at closing when the loan is made and a recurring fee, called a renewal premium, that's added to the borrower's monthly mortgage payment. These charges are often referred to as simply PMI. Each company that offers private mortgage insurance will provide rate cards that are used to determine the monthly PMI premium, as in this very simple example.

MONTHLY PMI PREMIUM		FIXED		TEMPORARY BUYDOWNS		ARMs	
		30-yr	15-yr	30-yr	15-yr	30-yr	15-yr
Base LTV	**PMI Coverage**	**1st month and renewal to Yr 10**		**1st month and renewal to Yr 10**		**1st month and renewal to Yr 10**	
95% to 90.01%	35%	1.06%	0.83%	1.21%	1.10%	1.25%	1.13%
	30%	0.94	0.81	1.04	0.92	1.08	0.95
	25%	0.84	0.70	0.90	0.77	0.94	0.81
90% to 85.01%	30%	0.69	0.54	0.84	0.71	0.89	0.77
	25%	0.62	0.48	0.73	0.60	0.78	0.65
	17%	0.49	0.33	0.56	0.36	0.61	0.44
85% & under	17%	0.43	0.30	0.44	0.30	0.49	0.36
	12%	0.38	0.26	0.39	0.27	0.44	0.31
	6%	0.34	0.24	0.36	0.25	0.40	0.28

FIGURE 6.4: Sample PMI Rate Card.

Class Activity: Mortgage Insurance

Walk through the following scenario and discuss your responses with the class.

If the sales price of a home is $100,000, on a 90% LTV 30-year fixed mortgage, we can calculate the PMI using the sample rate card. Let's use the Fannie Mae/Freddie Mac required 25% coverage, giving us a rate of 0.62%.

What is the loan amount?

What is the fee due at closing?

How much will be added to the borrower's monthly mortgage payment?

One-Time PMI Premium

Some private mortgage insurance companies offer a one-time mortgage insurance premium, with no renewal fee. Combining the initial premium and renewal premiums into one payment allows the borrower to finance the PMI premium. When the PMI premium is financed, monthly payments may still be lower than if the renewal premiums are added to the regular mortgage payment.

Lender Paid Mortgage Insurance (LPMI)

Lender paid mortgage insurance (LPMI) is actually *an interest rate adjustment made at the time of closing in exchange for the lender agreeing to "insure" the home loan themselves.* Basically, the borrower pays the lender a higher interest rate on the higher-risk loan. An advantage for the borrower is that this extra payment is treated like any other interest payment for the purpose of income tax deductions. However, unlike more traditional PMI, this higher payment will be in effect for the life of the loan; there is no cancellation.

PMI Cancellation

Lenders require mortgage insurance on high LTV, low down payment loans as protection against borrower default. Once the increased risk of loss from borrower default has been reduced (when the loan-to-value ratio is reduced to 80% or less), mortgage insurance has fulfilled its purpose. In the past, many lenders didn't cancel PMI even when the risk was reduced. The **Homeowners Protection Act of 1998 (HPA)** (12 U.S.C. 4901 et seq.) requires lenders to automatically cancel PMI when a home has been paid down to **78% of its original value**, assuming the borrower is not delinquent.

The law has some exceptions, such as for multi-family units, non-owner-occupied homes, mortgages on second homes, and second mortgages. As is often the case, though, the law sets a minimum, but the market moves the bar higher. For example, Fannie Mae and Freddie Mac:

- Have adopted rules that apply the 78% cancellation rule to *all* of their mortgages, even those closed before HPA's mandated date of July 1999.
- Have expanded the rules to cover investment properties and second homes.
- Will consider the *present value* of the home, not just the original value as required by the law. This effectively cancels PMI more quickly, assuming the home appreciates. Most lenders also now follow these guidelines.

The law also says that for loans closed *after July 29, 1999,* lenders must drop PMI coverage at a borrower's request if these conditions are met:

- A new lender-approved appraisal shows that the loan has been paid down to 80% or less of the home's original value, and
- The borrower shows a history of timely repayment over the past 12 months.
- Certification that the equity of the mortgagor in the residence securing the mortgage is unencumbered by a subordinate lien.

Again, Fannie Mae and Freddie Mac have gone a step further, allowing borrowers to use 80% of the home's current value if no payments have been more than 30 days late in the prior 12 months for fixed rate loans (or 24 months for ARMs). Fannie Mae and Freddie Mac also apply these rules to all loans, but can require up to five years of seasoning (outstanding age) on the loan before the rules apply.

Whether through automatic or borrower-requested cancellation, when PMI is terminated, the lender cancels the policy and reduces the monthly mortgage payment by the PMI amount. Note that the law and Fannie Mae/Freddie Mac rules do *not* apply to any upfront or one-time PMI premium paid.

Hot Topic: Underwriting PMI in Declining Markets

In recent years, most private mortgage insurance companies have added guidelines for considering the risks of insuring loans in markets where property values are declining. Many factors could go into determining whether or not a market area is declining. For example, the nation's leading provider of private mortgage insurance, Mortgage Guaranty Insurance Corporation (MGIC), has designated a number of urban areas and certain states as "restricted markets" by using objective data to evaluate home prices, changes in median home prices, and home price projections. While it may seem reasonable to be more cautious about standards in markets where property values are in decline, the label can create problems. For example, if an entire metropolitan area is labeled as "declining," it cannot account for specific neighborhoods where properties may be, for whatever reason, highly desirable.

While every company has its own standards for defining a declining market, the result is often that the loan is put in jeopardy. Some PMI providers may simply refuse to offer mortgage insurance in these markets, forcing the borrower to come up with a 20% down payment, for example. Or the insurer may raise the premiums for PMI in those markets, which could make the loan too expensive for the borrower.

Secondary Financing

Secondary financing is when *a buyer borrows money from another source to pay part of the purchase price or closing costs.* This is another way a borrower can get a conventional loan without a 20% down payment. With secondary financing, it may be the **seller** who carries the extra financing. In effect, the seller extends credit to the borrower, just as if the money had been borrowed from a finance company. When underwriting a loan that will have secondary financing, the primary lender will include that payment as part of the borrower's monthly housing expense and consider the total amount borrowed when determining the combined loan-to-value.

It's important to recognize that subordinate financing can be more than simply a second mortgage. Borrowers may have additional **junior liens**, such as with a down payment assistance program or even a third or fourth mortgage.

Combined Loan-to-Value (CLTV)

The **combined loan-to-value** (CLTV) is *the percentage of the property value borrowed through a combination of more than one loan,* such as a first mortgage and a second mortgage home equity loan. When a borrower chooses to use subordinate financing, this loan amount would also be included in the CLTV. The CLTV is calculated by adding all loan amounts and dividing by the home's appraised value or purchase price, whichever is lower. For example, a buyer purchases property valued at $100,000, taking out two loans: A first mortgage for $80,000 and a second for $10,000.

$$\frac{\$80{,}000 + \$10{,}000}{\$100{,}000} = 90\% \text{ CLTV}$$

But, remember that the **loan-to-value ratio** considers *only that first mortgage* and would therefore be just 80%: $80,000 / $100,000. That means that this borrower would *not* need to have private mortgage insurance. Both loan-to-value (LTV) and combined loan-to-value (CLTV) can be used to determine the amount of home equity a borrower has. So, that borrower with 90% CLTV has 10% equity in the property.

Conditions

For conventional loans, the primary lender will often insist on certain conditions with secondary financing from any source. Although individual lenders may impose additional or different specific conditions, the following are some typical examples:

- **Down Payment.** Borrower must make a **5%** down payment. For owner-occupied property, the CLTV must not exceed 95% of the appraised value or sale price, whichever is less. The borrower must pay the remaining 5% of the purchase price with personal funds. The first mortgage can't exceed 80% LTV.
- **Loan Terms.** Term of the second loan cannot exceed 30 years, or be less than 5 years. The term of the loan is the repayment period. The rationale is that a second mortgage should not take longer to pay off than the first mortgage.
- **Interest Rate.** The interest rate on a second mortgage could be fixed or adjustable. Note, however, that a borrower cannot have an adjustable rate on both the first mortgage and the second mortgage.
- **No Prepayment Penalty.** The second mortgage must be payable in full or in part at any time, without penalizing the borrower for paying the debt early.
- **Regularly Scheduled Payments.** Although payments must be due on a regular basis, they do not have to be monthly. Secondary finance payments can be monthly, quarterly, semi-annually, or any other regular schedule. Payments can fully or partially amortize the debt, or pay interest only.
- **No Negative Amortization.** The payments on the second mortgage must, at least, equal the interest on the loan. Loan balances cannot grow because of deferred interest.
- **Ability to Qualify.** Borrower must be able to afford payments on first and second mortgages. This means that the primary lender on the first mortgage will count both mortgages when qualifying the borrower for the mortgage debt.
- **Subordination Clause.** Most primary lenders require secondary financing to have a subordination clause to insure that the primary lender's lien will take priority, even if the second mortgage is recorded first.

Case in Point

Here's how secondary financing might work on a $120,000 home:

	Amount	Percent	Description
	$90,000	75%	**First Mortgage (primary lender)**
	$18,000	15%	**Second Mortgage (from seller)**
+	$12,000	10%	**Down Payment (from borrower)**
	$120,000	100%	**Total Sales Price**

Lender First and Lender Second

Keep in mind that it's *not always the seller* that carries a second mortgage. A second mortgage can be carried by any lender, investor, or financial institution. In fact, sometimes the same lender may finance the first and second mortgage. For example, one such arrangement is a so-called **conventional 80/20 loans** (essentially a 100% loan, as the same lender does both loans), which can be sold to Fannie Mae and Freddie Mac on the secondary market if the loans meet all standards and criteria. This allows the lender to charge a higher interest rate on the second mortgage—for example, the 80% first mortgage at 5.5% interest, and the 20% second mortgage at 9.25% interest—to reflect the riskier nature of the upper end of the loan amount. An 80/20 loan gives the lender, who will usually charge a fee for both loans, a better yield for taking on the increased risk. The advantage to a borrower is that this avoids both a down payment and PMI. When the upper portion of the loan represented by the second mortgage is paid off, the risk is gone and the borrower still has a first mortgage at a lower interest rate. In today's marketplace, such 80/20 loans are much less common than in years past.

The repayment plan is a matter of agreement between borrower and lender. As with any loan, there are various ways in which a second mortgage can be repaid:

- Fully amortizing
- Partially amortizing
- Interest only

Repayment Method Scenarios

The following example will be used to illustrate three repayment methods:

- A house costs $66,667. The buyer:
- Makes a $6,667 (10%) down payment.
- Gets a $50,000 (75%) first mortgage for 30 years at 6%.
- Gets a $10,000 (15%) second mortgage for five years at 7 7/8%.

Fully Amortizing Second Mortgage

A **fully amortizing** loan is one with the *total payments over the life of a loan paying off the entire balance of principal and interest due at the end of the term.* The shorter the term, the higher the payments. Using the example above:

	Amount	Description
	$ 299.78	**Payment on First Mortgage ($50,000, 6%, 30 yrs., fully amortizing)**
+	202.17	**Payment on Second Mortgage ($10,000, 7 7/8%, 5 yrs., fully amortizing)**
	$ 501.95	**Total Housing Expense (principal and interest only)**

After five years, the second mortgage is paid in full. The total monthly payment for the next 25 years is $299.78 on the first mortgage.

Partially Amortizing Second Mortgage

A **partially amortizing** loan has *payments applied to principal and interest, but the payments do **not** retire the debt when the agreed upon loan term expires.* Thus, a **balloon payment** is required as a *final payment at the end of the loan term* to pay off the entire remaining balance of principal and interest not covered by payments during the loan term.

To keep the payments low, the lender and borrower calculate the monthly payment *as if the borrower were going to pay off the entire debt over a longer period of time.* For example, the payments may be calculated as if the second mortgage would be repaid over 30 years, but the borrower agrees to make a balloon payment of the loan balance after five years. Using the example, the borrower's housing expense will be:

	$ 299.78	**Payment on First Mortgage ($50,000, 6%, 30 yrs., fully amortizing)**
+	**72.51**	**Payment on Second Mortgage ($10,000, 7 7/8%, amortized as 30 yrs.)**
	$372.29	**Total Housing Expense (principal and interest only)**

The smaller monthly payment makes the total housing expense less and, therefore, easier for the borrower to qualify for a loan. However, after five years, payments based on a 30-year amortization will have only reduced the original loan balance by a relatively small amount. If the second mortgage is to be paid at that time, there will be a substantial balloon payment due or the loan will have to be refinanced.

The following chart illustrates how a $10,000 second mortgage steadily declines over 30 years, if allowed to do so. It also shows the balloon payment due after five years. If all monthly payments are made on time, a 30-year, $10,000 loan at 7 7/8% will have a balance of about $9,496 after five years.

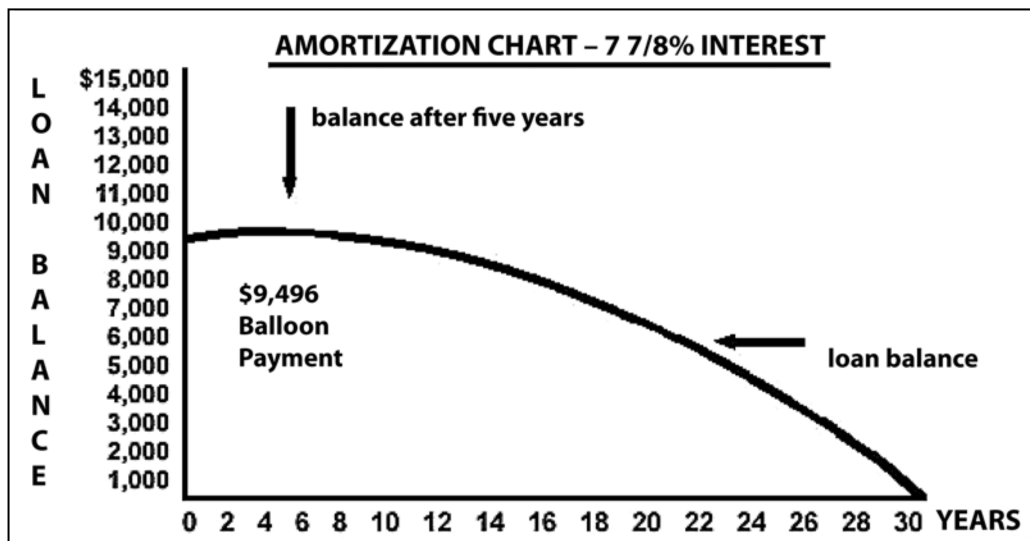

FIGURE 6.5: Partial Amortization Schedule.

Interest Only Second Mortgage

An **interest only loan** is one with *scheduled payments that pay only accrued interest, and not any portion of principal.* This reduces monthly payments even more. With interest only loans, no amortization occurs. A simple way to see how this works is to take the loan amount, multiply by the interest rate, then divide by 12 (months). In this case, the borrower's housing expense will be:

	$ 299.78	**Payment on First Mortgage ($50,000, 6%, 30 yrs., fully amortizing)**
+	**65.63**	**Payment on Second Mortgage ($10,000 x 0.07875 ÷ 12)**
	$ 365.41	**Total Housing Expense (principal and interest only)**

Comparing all of our examples, interest only gives the borrower the lowest housing expense. Of course, if no principal is paid during the loan term, the balloon payment will be the original amount borrowed (in this example, $10,000).

This example determined the payment on an interest only loan by evenly dividing the annual interest over 12 months. With some loans, for example, an open-end loan such as a home equity line of credit, lenders typically calculate the monthly payment of interest due using a daily rate, based on either a 360-day year or a 365-day year. The daily rate is multiplied by the number of days in the month to determine the payment. The terms of how interest is calculated can be found in the note.

Assumption of Conventional Loans

Assumption means that *one party takes over primary liability for the loan of another party, usually implying no change in loan terms.* When a buyer assumes the seller's mortgage, the seller remains secondarily liable unless the lender provides a release. Loan assumption is not always an option with loans written today as lenders try to protect their interests by being able to approve a new buyer. A new loan allows a lender to change interest rates, charge fees, or change loan terms for a new party.

A lender has several options in response to an assumption request:

- Accept the assumption and leave the loan terms intact
- Accept the assumption, but charge an assumption fee and/or increase the loan's interest rate
- Allow the assumption, but keep the original holder (seller) secondarily liable if the new owner defaults
- Not allow the assumption and exercise a call provision (i.e., demand full payment of the loan immediately); would need to be stated in the note or mortgage

Mortgage Exercise 6-1

A potential borrower is applying for a conventional loan to purchase a primary residence. Currently he pays $500 in rent, $420 for an auto loan, $170 toward his VISA bill, and $300 on a student loan each month. His gross monthly income totals $4,900, and his take-home pay after taxes is $3,700. *See the Appendix for answers to check your work.*

1. What is the maximum house payment—including principal, interest, taxes, and insurance—for which the borrower will qualify?

Mortgage Exercise 6-2

A borrower is seeking a fixed rate, conventional loan to purchase a home. The sale price is $189,500 and the property has been appraised at $191,500. The buyer will make a 10% down payment and finance the balance with a 75% conventional first mortgage at 6% interest for 30 years and a 15% second mortgage. The second mortgage bears interest at 11% and calls for a balloon payment after five years (amortized on the basis of a 30-year schedule). There will be a 1.5% loan fee on the first mortgage. To complete this exercise, refer to the Payment Rate Chart found in the Appendix. Note that the numbers there are rounded to the nearest cent. For a more precise total, you can use a financial calculator. *See the Appendix for answers to check your work.*

1. What will the loan amounts for the first and second loans be? What are the LTV and the CLTV?

2. How much will the buyer pay at closing for down payment and loan fees?

3. What is the monthly payment on the first mortgage, including principal and interest?

4. What is the total monthly payment for both loans?

5. The review appraisal just came back at $185,000. What happens now?

Chapter 6 Summary

1. **Conventional** loans are not insured or guaranteed by a government agency. Traditional conventional loans are long-term, fully amortizing, and have a fixed rate. An amortizing loan has payments that applied both to principal and interest. A **fixed rate, fully amortizing** loan has regular payments that are substantially equal in amount so as to fully retire the debt at the end of the term. Conventional loans may be 15- or 30-year, conforming or nonconforming. A **15-year** loan retires sooner and saves interest, but requires higher payments. A **bi-weekly** payment structure allows borrower to make equivalent of one extra monthly payment each year so balance is paid faster, saves interest. **Conforming** loans meet Fannie Mae/Freddie Mac standards and can be sold on the secondary market. Qualifying standards are **28%** for housing expense and **36%** for total debt-to-income. **Nonconforming** loans do not meet these standards and cannot be sold to Fannie Mae/Freddie Mac, but may be sold on the secondary market to other buyers. Nonconforming can be due to credit quality or loan size (jumbo loans exceed Fannie Mae/Freddie Mac maximum loan amount).

2. Conventional loan programs include 80%, 90%, 95% and some loans for special needs. For example, an 80% conventional loan means the **loan-to-value ratio** (LTV) is 80% of the appraised value or sale price of property, whichever is less. For an 80% loan, the borrower must make a 20% down payment; for a 90% loan, the borrower must make a 10% down payment with 5% from personal cash reserves (no gifts, loans, etc.); for a 95% loan, the borrower must make a 5% down payment, all from personal monies. Interest rates and fees may be higher on higher LTVs and PMI is required. Loans with LTV above 80% generally require the property to be owner-occupied.

3. **Private mortgage insurance (PMI)** insures lenders against borrower default, compensating lenders for lower borrower equity, and shares partial risk (upper part) with the lender. PMI can be fee paid at closing and as a renewal premium, one-time PMI premium, or no PMI premium but with a higher interest rate. Federal law says that loans after July 1999 must drop PMI when LTV is **78%** of original property value and the borrower is not delinquent, or if the borrower requests and the appraisal is **80%** of original property value. Fannie Mae/Freddie Mac rules require a drop of PMI if LTV is 78% (or borrower-paid appraisal is 80%) of property's current value.

4. **Secondary financing** is when the buyer borrows money for part of the purchase price or closing costs. To determine the **combined loan-to-value ratio** (CLTV) when there is more than one loan, add all loan amounts and divide by the home's appraised value or purchase price, whichever is lower. Typical conditions for secondary financing: 1. Borrower must make a 5% down payment; 2. Term of second loan must be five to 30 years; 3. No prepayment penalty; 4. Scheduled payments due on a regular basis; 5. No negative amortization; 6. Borrower must be able to afford payments on first and second mortgages; and 7. Required subordination clause.

5. A second mortgage can be **fully amortizing, partially amortizing** with a balloon payment, or **interest only** with a balloon payment. Partial amortization is when payments are scheduled as if the loan term is longer (e.g., 30 years), but the balance is due sooner (e.g., in 5 years). Partially amortizing and interest only loans have smaller payments than fully amortizing loans, so they may help a borrower qualify. Such loans generally have payments that are regular and equal (if fixed) or recomputed regularly (if adjustable) with a final, larger balloon payment at the end of the term that will fully retire the debt. One lender can provide both loans at different interest rates.

6. **Assumption** means that one party (buyer) takes over primary liability for the loan of another party (seller). When trying to assume a loan: 1. Lender can accept assumption and leave loan terms intact; 2. Lender can accept assumption and charge a fee or increase the interest rate; or 3. Lender will not allow assumption and call the note payable immediately. Always consult the original lender or a lawyer concerning assumptions.

Chapter 6 Quiz

1. ***What is the term that describes a second mortgage holder agreeing to accept a second position in a refinance transaction?***
   - A. alienation
   - B. assumption
   - C. subordination
   - D. subrogation

2. ***A loan that is repaid with periodic payments of both principal and interest so that the entire loan amount is paid in full at the end of the loan term is a(n)***
   - A. annualized loan.
   - B. conventional loan.
   - C. fully amortizing loan.
   - D. partially amortizing loan.

3. ***Which statement about 15-year mortgages is FALSE?***
   - A. There's an earlier loss of interest deduction for income tax purposes.
   - B. Higher interest rates are usually charged.
   - C. They have higher monthly payments.
   - D. They result in less interest owed.

4. ***You are pre-qualifying a buyer for a conventional loan on a house with the purchase price of $160,000. She states she does not want to pay PMI on the loan. In that case, what is the maximum loan amount she can receive (assuming no lender-paid PMI)?***
   - A. $32,000
   - B. $128,000
   - C. $136,000
   - D. $144,000

5. ***Which type of mortgage is traditionally defined as NOT being insured or guaranteed by the government?***
   - A. conventional mortgage
   - B. FHA mortgage
   - C. rural home mortgage
   - D. VA mortgage

6. ***When seeking an 80% conventional loan with the seller taking back a second mortgage, the buyer***
   - A. can expect to pay a higher interest rate than with a 90% loan.
   - B. may choose which mortgage (first or second) will have lien priority.
   - C. must make at least a 5% down payment from personal funds.
   - D. must make at least a 20% down payment from personal funds.

7. ***Which would likely have the highest PMI cost?***
   - A. 80% loan
   - B. 90% loan
   - C. 95% loan
   - D. house purchased for cash

8. ***PMI must be cancelled***
   - A. anytime the borrower requests it.
   - B. only if the lender is satisfied that the borrower is no longer a credit risk.
   - C. when a home has been paid down to 78% of its original value and the borrower is current.
   - D. whenever a new appraisal is ordered, regardless of the value.

9. ***Lenders are often willing to charge lower interest rates for 15-year mortgages because the***
   - A. borrower is always a better risk.
   - B. interest rate is fixed for a longer period of time.
   - C. loan funds will be repaid more quickly.
   - D. loan qualifications are much more stringent.

10. ***A buyer is paying $200,000 for a house. He makes a $30,000 down payment, gets a first mortgage for $160,000, and a second mortgage to cover the balance. What is his CLTV?***
    - A. 70%
    - B. 80%
    - C. 85%
    - D. 90%