Real Estate Finance

Lesson 6

Mortgage Loans: Structures and Types

45 Hour Louisiana Post-Licensing

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Loan Types and Structures Designed to Meet the Needs of Lenders and Their Customers

Introduction

In structuring loan agreements, several alternatives may be designed to offer differing loan re-payment plans that benefit both lenders and borrowers. The payment plans may be designed to establish a pattern of continuity that gives borrowers a level of certainty with respect to their financial obligation. In periods of rising borrower's loan qualification, prospects from conventional institutional lenders can result in either a postponement of the purchase decision or entry into some form of seller-financing arrangement, which may not be a good alternative due to some inherent risks associated with financing mechanisms, such as installment sales or contracts for deed. To circumvent these limitations, the real estate financial sector developed a variety of alternative mortgage instruments which help both borrower and lender to move forward with a transaction. Although the range of AMI's have been constrained more recently by new and expanding regulations, several still exist and remain a standard component of the mortgage loan offerings made available by many lenders. The most popular, by far, is the Adjustable Rate Mortgage (ARM), which has many variants and has evolved over the past 20 or so years. The following lesson is a brief discussion of the most common loan types and structures that may be used in typical residential mortgage transactions.

Term Loans

Term Loans are more common in business and commercial lending, but they have found acceptance in some residential lending in certain circumstances and in response to certain market conditions. In fact, prior to the advent of the long term level annuity loan in the 1930's, this was a dominant structure for residential and farm loans. A straight or term loan is characterized by periodic payments of interest, followed by a single lump sum re-payment of the loan principal at the end of the term. The lump sum due at the term's end is called a balloon note payment. Extending existing terms is referred to as "rolling over" the loan. Terms may be as short as one month, or one quarter, but usually not longer than five years. Term loans are typically for one year periods.

Fixed Rate Level Annuity Loans

Fixed Rate Level Annuity Loans have been and will, in all likelihood, continue to be the "bread and butter" of the mortgage lending industry. It is the mortgage type that has facilitated home ownership since the 1930's, and presents a form and manner of payment that best enables borrowers to budget monthly expenses due to the contractual certainty of the amortization schedule. This is one reason why this "old standard" of the home lending business is sometimes referred to as a Budget Loan. This name has nothing to do with affordability, but everything to do with predictability. Consequently, it has been the loan of choice by an overwhelming majority of home buyers, assuming they could meet affordability and qualification guidelines. When this becomes an issue, borrowers and lenders both seek alternative means of accomplishing the same goal: making it to the closing table. These alternative means will be discussed a little later. However, suffice it to say that, at this point, any loan form which is considered an alternative or Alternative Mortgage Instrument (AMI) is an alternative to the old standard fixed rate fully amortizing level annuity loan.

A fully amortizing loan is characterized by a series of constant or level (annuity) payments over the life of the loan. A portion of each payment goes toward paying down the loan balance, while the other portion represents a payment of interest at the contract rate on the outstanding loan balance. In economic terms, this is the "rent" paid by the borrower to use the lender's money for each period the loan remains outstanding. In a fully amortizing loan, payments remain unchanged for each period for the amortization period of the loan. The amount of interest paid as a part of the periodic payment is highest in the initial periods, and declines thereafter. By the end of the amortization period, the outstanding loan balance will have declined to zero. The level annuity loan was introduced along with the Federal Housing Administration (FHA) to make housing affordable to the working class, encourage home ownership, and drive the economy to recovery from the Great Recession on the back of the construction industry. The volatility and generally upward drift of interest rates during the inflationary cycle of the mid to late 1970's and early 1980's, along with relatively rapid rates of house price inflation, pushed affordability out of the reach of large segments of the population. The response to the problem of affordability by the industry was AMI's, such as the ARM and GPM. At this point in economic history, with record low interest rates fueled by massive FED intervention in the financial markets, the need for many AMI products has sharply lessened. However, when (not if) rates for home mortgages begin to rise, many of the more reliable and acceptable alternative mortgage products will become more accepted, and possibly even necessary to facilitate many real estate transactions. Many AMI's have been redesigned to address criticisms and regulatory mandates linked to consumer abuses practiced by some lenders in originating these loan products. And in some cases, the AMI has either been banned, or severely restricted, by regulation and lack of acceptance by the secondary mortgage market.

Traditionally, the standard fixed rate level annuity loan was based on a thirty year amortization period. This was saleable in the secondary market as a conventional loan product and, from the consumer's and lender's viewpoint, was directly competitive with payment periods offered by non-conventional products such as FHA and VA loans. It was also the payment period that structurally produced the greatest affordability for typical home buyers (particularly first timers), and it generally paralleled economic useful life expectations for the assets taken as collateral. Although a 30 year term creates interest rate risk issues for depository lenders, the ability to sell these loans into the secondary market helps to off load this risk to investors, including Fannie and Freddie. However, as interest rates fall, borrowers' incomes rise and outstanding loan balances decline, shorter term amortization periods become more attractive and possible as a means of accomplishing two goals: building equity faster and reducing the overall interest carry costs on the loan. To many homeowners, this makes 10 to 15 year amortization periods more attractive and opens the possibility of lowering not only the total cost of interest over the loan's life, but also that of securing a lower contract interest rate on the loan itself. Due to the term structure of the interest rate yield curve, lenders are more inclined to offer lower rate to borrowers who want to shorten their loan payout. This is particularly true for existing customers with demonstrated loan repayment histories, strong net worth and significant accumulated equity in their homes. Shortening payment periods allow the lender to retain the loan as an asset (i.e., book and not sell the loan) while minimizing or mitigating interest rate risk. This is a win-win strategy for both lender and borrower. Of course, its success depends on the borrower's income qualification and the lender's willingness to be flexible in providing good customer service.

Two other forms of amortization are also typically possible. These are partially amortized loans, and loan characterized by negative amortization. Both are a consequence of how the loan is legally structured to accomplish the mutual goals and intents of the lender and borrower. One, the partially amortized loan has more or less seen a standard of commercial real estate lending for many years, and is sometimes referred to as a Renegotiable Rate Mortgage (RRM), or a Balloon Loan. The second is largely an outgrowth of the creativity of the lending industry, particularly the creation of AMI's deigned to accommodate income qualification and affordability guidelines in the loan origination process. Loan products resulting in negative amortization have been financially damaging to borrowers, lenders and secondary market investors, and have come under significant regulatory scrutiny, particularly since the most recent 2007/2008 financial markets meltdown.

- **Partially Amortized** loans are structured with amortization payment periods of, say 20 to 30 years, but with a due date term of, say 3 to 5 years. Contractually, the periodic payments of principal and interest are calculated as if the loan would pay out fully over a 20 or 30 year period. However, the lender, with concurrence of the borrower, has built into the loan a provision that makes the total outstanding loan balance due and payable at the end of the third year (36th month) or fifth year (60th month), or whatever is agreed upon. The amount due at the end of this term is called a balloon note (thus the name balloon loan), which can be refinanced at the same, or different loan terms by the lender currently holding the mortgage, or by another lender who may offer the borrower better terms and conditions. This type of loan gives both parties the option to review their arrangement with each other and to either continue on, or part company in a mutually agreeable fashion. Again, this is a structure fairly common in commercial real estate lending, although it has found its way into the residential sector at various points over the past twenty to thirty years.

- **Negative Amortization** is somewhat an insidious "disease" that creeps into a loan by virtue of the loan's structuring. It is, for the most part, a periodic increase in the outstanding loan balance, due to the fact that payments being made by the borrower are insufficient to both fully pay the contract rate of interest and contribute to reducing the outstanding loan balance. With every payment, the borrower's outstanding loan amount is actually increasing, as opposed to decreasing, as it is supposed to do in the full amortizing level annuity loan. This creates several problems for both the lender and the borrower, particularly if home values are stagnant or falling. In such an environment, it might not take long for a loan to go "underwater", leaving the borrower with little or no equity buildup in the property, and the lender with an impaired asset. This is truly a lose-lose scenario, and one which has unfortunately played itself out in past real estate cycles, including the most recent.

  Historically, negative amortization has been evident in certain ARM products, Graduated Payment Mortgages (GPM) and other varieties of interest buy-down loan instruments. Recent regulatory changes and secondary market pronouncements are going to make negatively amortizing loans more difficult to originate and then sell. New Consumer Financial Protection Bureau (CFPB) guidance requires loan originators to make specific and very detailed disclosures about qualified loan products, resulting in negative amortization. This is an outgrowth of the CFPB's implementation of the "ability to repay" provisions of the Dodd-Frank Act (DFA). In response, Fannie and Freddie have announced they will no longer purchase loans subject to the "ability to pay" rule if, among other things, the loan is not fully amortizing. This will greatly limit the availability of products such as GPM's and similar rate buy down loans that structurally include negative amortization by design. This is not necessarily an issue now, but could very well become one for the housing industry if mortgage interest rates begin to climb.

Alternative Mortgage Instruments (AMI)

Alternative Mortgage Instruments (AMI) became the weapons of choice in real estate and home mortgage finance in the late 1970's and early 1980's, when interest rates on 30 year fixed rate level annuity mortgages rose to 17% and 18%, and stayed at those levels for what seemed like an eternity for those who made their living building and selling homes, originating loans, and providing services to those doing all of the above. At mortgage rates of 17% to 18%, relatively few households in the U.S. could qualify to purchase a median-priced home, much less anything priced higher. When faced with this dilemma, one quick solution would be to simply lower prices far enough until consumers could afford 17% to 18% mortgage rates. Of course, this is not necessarily the best solution, and one which inevitably creates a myriad of problems and issues for the real estate industry. Lower prices translate to lower sales commissions for real estate agents and brokers, as well as lower profit margins for builders and unhappy buyers who paid the higher price. Lower prices also imply lower values, which then impairs the loan portfolios of lenders, as well as secondary market investors. The solution: develop a menu of loan instruments which "artificially" make higher interest rates affordable, at least in the short run. In theory, what happened in the longer run was not the lender's, the builder's or the real estate agent's problem. Very often, however, the imbedded financial "traps" in some of the more exotic AMI's did become the lender's problem, as well as a problem for secondary market investors and the ratings agencies or insurance companies that provided underlying assurances for these instruments.

Adjustable Rate Mortgages (ARM's)

Adjustable Rate Mortgages (ARM's) were among the first variety of AMI's to emerge on the mortgage lending field during the 1980's, and it is the AMI product that has generally lasted longest and accounted for the most significant volume of home lending among those products not of the fixed rate level annuity variety. ARM's remain popular during periods of rising or volatile interest rates, since borrowers are very often qualified for the loan based on payments using the initial or "teaser" rate. The teaser rate is called that for a good reason: it is lower than rates offered on standard fixed rate level annuity loans, and usually represents a significant increase in possibility of receiving loan approval, particularly for applicants "at the margin". The teaser rate is also a strategy for lenders to attract (some would say lure) customers into a loan agreement in which they are now sharing some of the risks associated with uncontrollable movements of interest rates in money markets. This, in essence, shifts some, usually not all, of the interest rate risk on a 30 year amortizing loan from the lender to the borrower. This helps avoid rate shock trauma to the balance sheets of lenders who retain most of their loans and provides additional incentives for secondary market investors attempting to shield themselves from rate and yield volatility. ARM's became a standard product of home mortgage lending in 1981 when they were formally authorized by the Federal Home Loan Bank Board (FHLBB), which also established guidelines for their use in all federally-related loan transactions. This set in motion the ability of the FHA and VA to offer similarly structured loan products within their respective insured and guaranteed loan programs.

ARM's have evolved from their earliest versions (initially called Variable Rate Mortgages or VRM's), and have been subjected to several iterations of modification to satisfy regulatory pronouncements focused primarily on consumer protection. The basic structure and elements that define and describe an ARM have remained largely unchanged. The following describes the various elements of an ARM and how they are used in structuring a loan:

- **The Initial or Teaser Rate** is the interest rate charged for the initial pre-adjustment period of the loan, which typically ranges from one to five years, and possibly seven, depending on how aggressively lenders want to market ARM products to attract customers. The initial rate usually represents a significant discount from rates at the same time for fixed rate level annuity loans. This could be as much as 250 to 350 basis points lower than the fixed rate loan of equivalent maturity. Although some lenders offer a deep discount teaser rate for one year (with the rate adjusting annually, thereafter), many lenders will offer slightly higher teaser rates for 3, 5 or 7 years, with the rate adjusting thereafter for the remaining term of the loan. These are typically referred to as 3/1, 5/1, or 7/1 ARM's, and can be very popular for many borrowers, particularly if their home ownership horizon is three, five or seven years. This could certainly apply to first time buyers planning to trade up quickly, buyers who hope to "flip" a home and take advantage of generous capital gains treatments, or those expecting a job transfer. For these buyers, ARM's are usually a very good financial fit.
- **The Index** is the starting point for calculating a new note rate once the adjustment intervals arrive, and a new monthly payment must be calculated. The Index is typically selected by the lender and fully disclosed to the borrower. The Index chosen typically reflects a security term structure that closely matches the adjustment interval of the ARM. This is typically one year, but could also be two or even three years. These intervals are rare and are usually included in loans originated that do not conform to secondary market standards. Indexes are drawn from sources that are reliable in terms of measuring interest rate movements and are readily available in either print form (i.e. Wall Street Journal, Barron's, etc.) or on the Internet. Among the most commonly used are U.S. Treasury rates for T-Bills and securities; the 11th District Cost of Funds Rate; the Federal Home Loan Bank Rate; and the London Interbank Offered Rate (LIBOR). Once the Index is chosen, the lender is prohibited from changing to another measure for the duration of the loan agreement.

- **<u>The Margin</u>** is a gross profit factor added to the Index, which determines the new note rate. The margin can range from 200 to 400 basis points, depending on the lender, and is a factor which borrowers can use in shopping for the loan which is in their financial best interest. Different lenders will offer different margins, but due to competitive market pressures, there is typically a relatively tight range of margin offerings. In most cases, it is best to secure a loan with the lowest possible margin, since this is fixed for the duration of the loan agreement, while the Index is subject to potentially wide swings in market interest rates, particularly in periods of economic uncertainty.

- **<u>The Note Rate</u>** is the result of combining the Index and the margin. It is the rate that is used to determine the monthly payments due for each internal adjustment period over the remaining life of the loan. Depending on the movement of interest rates and thus, the indexes, monthly payments will fluctuate up or down until the loan is either paid off, refinanced, or converted to a fixed rate level annuity payment loan. In very early versions of ARM loans, payment and rate shock were not uncommon, particularly if money markets had proven to be more volatile than anticipated. In some cases, new note rate payments rose significantly, thus putting financial stress on the borrower. In best case scenarios, lenders would work with borrowers to lessen the pain and mitigate the risk of default and foreclosures. However, in more than a few instances, the worst case scenario unfolded with borrowers finding themselves in default and, very shortly thereafter, losing their home to foreclosure. The latter scenario's occurrence was significantly heightened when economic conditions became strained and unemployment rates crept up. In an attempt to mitigate and reduce the risk of payment shock induced defaults, ARM product offerings were modified to incorporate CAPS on both adjusted rates and their resulting payments.
    - **<u>Caps</u>** come in two varieties for ARM products. One is a <u>Rate Cap</u> and the other is a <u>Payment Cap</u>.
        - The **Rate Cap** is the most commonly used of the two and is designed to protect the borrower from unlimited interest rate increases from one interval to the next. The most commonly quoted Caps are "2 and 6". This means that the most the interest rate on the loan will adjust from the Initial Rate on the loan for each interval is 2%, or 200 basis points, while over the life of the loan; the rate adjustment will never exceed 6% or 600 basis points. These Caps provide a level of protection for the borrower, and allows the lender to evaluate the loan's risk profile even under a worst case scenario. For most lenders and borrowers, having to face the prospect of a 600 point sudden movement of interest rates, is relatively remote. At the same time, the Caps allow the borrower to find some comfort in budgeting forward their loan payments at least for two to three years from when the rate adjustments begin. Rate Caps are all subject to full disclosure by the lender; become fixed for the duration of the loan; and do not create a situation in which the loan becomes subject to negative amortization (which is not the case with Payment Caps).
        - **Payment Caps** are structured so that after application of the appropriate Index and Margin, the new resulting payment cannot increase more than some specified percentage, typically 6% to 7%. If the resulting payment increases by more than the Cap allows (say $200), this amount of uncollected payment due (as per the Margin and Index) is added to the outstanding loan principal, thus producing negative amortization. Because of negative amortization, the use of Payment Caps has largely given way to reliance on Rate Caps. This does not necessarily fully protect lenders from the full extent of rate movements possible from one interval to the next, but has created a more sound mortgage instrument for the borrower, as well as secondary market investors.

- **The Adjustment Interval**, as previously mentioned, can take a number of forms. The most typical is a one year adjustment interval, although these are loan products that adjust every two or three years as well. At the other end of the adjustment period are loans with six month, or even monthly, intervals. These are most commonly offered in periods of high rate volatility and extreme uncertainty in the economy and money markets. They are typically difficult to sell to borrowers, and for good reason. They give the borrower very little stability in terms of payment expectations, and effectively shift all of the interest rate risk from the lender to the borrower.

- **Convertability** is a provision built into the ARM that gives the borrower an option to convert the loan to a fixed rate at certain points during the duration of the mortgage agreement. It is a provision that lenders may build into the loan, but at a cost to the borrower. The conversion rate is very often set at a level slightly higher than the market rate existing at the time of conversion. It may, however, be an attractive alternative for borrowers expecting a decrease in income, which could make qualifying for a new loan or refinancing difficult. In most cases, borrowers choosing this option are not required to qualify for the new conversion rate, although it may be advisable for the lender to review their credit status, and possibly make other adjustments to the loan agreement to provide greater assurance of its underlying integrity.

Bi-Weekly Loans

Bi-Weekly loans are a variant of a fixed rate level annuity loan, which simply increases the frequency of payment, while in the process of reducing the loan's overall interest carry costs. This type of loan may be particularly useful and beneficial for borrowers who are paid every other week, since this payment method might be easier to budget. The calculation for such a payment amount is simply one-half of a monthly payment, paid bi-weekly. For example, if the monthly payment for a 20 year loan amounts to $1,000, the borrower would pay $500 every other week. This amounts to 26 bi-weekly payments over the span of one year, amounting to $13,000. This compared to 12 monthly payments amounting to $12,000. The additional payments applied to principal reduction in the bi-weekly plan will help pay off the loan in about 17 to 20 years, depending on the contract rate of interest. This type of loan has been approved for purchases by Fannie Mae, thus loan originators can offer this kind of loan and be assured of it being saleable in the secondary market. Many lenders who offer this loan product may require direct drafts of the bi-weekly payments from the borrower's checking account.

Growing Equity Mortgage (GEM)

A Growing Equity Mortgage (GEM) is another method that can be used to shorten a loan and thus reduce interest costs, and is sometimes referred to as a graduated equity mortgage produce. Many variations are available, but the basic pattern is for the borrower to voluntarily make certain increased payments each period. The entire amount of the increased payment is applied to repayment of the principal. Depending on the interest rate and the amount of increase in periodic payments, terms on a 30 year amortizing loan can be reduced by 40% to about 18 to 20 years. In many instances, the comparable trade- off for the borrower in terms of interest savings would be to secure a 15 year loan. However, such a loan would lock the borrower into higher monthly payments, while the GEM retains the lower payments associated with the longer amortization period. Some borrowers would be reluctant to give up the flexibility to roll back their monthly payments, particularly if their incomes could be subject to unforeseen variability. The GEM is a loan of convenience for borrowers, which many lenders encourage by not including pre-payment penalties in the loan agreement. Loans such as these are also approved by both FHA and VA. For FHA, this is accomplished within its Section 245 home mortgage insurance program for loans with varying rates of amortization.

Shared Appreciation Mortgages (SAM)

Shared Appreciation Mortgages (SAM) is a loan product that was popular and became practical when interest rates reached record highs in the early 1980s and values were rising at a healthy pace in many regions of the U.S. While current conditions make its use somewhat impractical, the concept is another alternative mortgage method that resurfaces from time to time. In this loan product, a portion of the collateral's appreciation is accepted by the lender as "contingent interest". When home values were appreciating and interest rates were in the 12 to 15 percent range, some lenders found it profitable to take a portion of the expected return of their money from the collateral's appreciation upon sale or refinancing. Some lenders active in this type of lending had problems obtaining title insurance with the proper endorsement for appreciation coverage and the accrual of equitable interest when loans such as these have gone into foreclosure. If interest rates rise sharply, this is another AMI which could be resurrected to facilitate transactions in challenging circumstances.

Shared Equity Mortgage (SEM)

A Shared Equity Mortgage (SEM) is sometimes confused with shared appreciation mortgage, but the two are quite different in both structure and underlying intent. In a shared appreciation mortgage, a lender or other investor subordinated to the mortgagee holds a claim, or lien, on that portion of the property value that represents an increase from the time of loan origination. This claim is granted in return for their consideration in making the loan, for contributing to the down payment and, in some cases, for both. The shared equity loan may be used in a family situation where a parent helps a child or relative purchase a house or by an employer trying to attract a new employee at a time when starting salaries are insufficient to purchase houses in a high-cost area. Alternatively, a shared equity loan might be used as an incentive to encourage an employee to move to a remote or less desirable area. Typically, the employee in most cases is given an option to buy out the employer's share within a limited number of years. In case of a transfer, the employer would typically agree to purchase the entire property at fair market value. This, too, is a mortgage instrument of convenience used to facilitate particular types of transactions, and it has been used successfully in that regard. Recent regulations, however, in the form of the 2010 Health Care and Education Reconciliation Act, created potential tax issues for some who may benefit from this type of loan. As such, consultation with a tax advisor is highly recommended before utilizing the SEM.

Graduated Payment Mortgages (GPM)

Graduated Payment Mortgages (GPM) shares the potential drawbacks of some ARM products regarding negative amortization. They also share the same underlying motivation of reducing initial period monthly payments to enhance qualification prospects. However, unlike ARM's, which are less predictable from one interval to the next with regard to payments, GPM's step up the monthly payments at a pre-determined pace until the loan is then amortized at fixed, level payments. The payments are graduated from a discounted level in the initial year over a three to five year period. At the beginning of, say, the sixth year, the loan is then fully amortized at a note rate of interest for the remaining loan term. Because the loan has accumulated negative amortization and the term remaining is now 3 to 5 years shorter, the remaining payments very likely are higher than they otherwise would have been in the initial years if the loan payments were more at market rates. It, too, assumes gradual increases in household income and stable to rising property values.

The GPM product, which is sometimes referred to as a buy down loan, was first tested by the FHA as a method of allowing home buyers to pay lower initial monthly payments in the earlier years of a mortgage term, with payments rising in successive years to a level sufficient to amortize the loan within a 30 year term. With a lower initial monthly payment, the buyers with lower incomes might be better able to qualify for a loan, or allow others to buy a larger home with the same income. In qualifying applicants for this type of loan, it is necessary for them to show reasonable expectations of increases in annual income so as to meet the required increases in monthly payments. Since making such estimates is difficult at best for many borrowers, the basic foundation of most GPM products could be easily undermined. Inherent with the GPM is that even a constant level payment, long term mortgage loan allows very little money to be paid on principal in early periods. So, with only a modest reduction in the payment amount, any allocation to principal is easily eliminated, along with a portion of the interest payment due. As a result, there is an accumulation of unpaid interest (*accrued interest*) in the early years of the mortgage term producing a situation where the borrower ends the year with larger principal balance than when the loan was first originated. As mentioned previously, this is *negative amortization,* since the loan balance increases, rather than decreases with each payment. To avoid the possibility that the increasing amount of the loan balance might exceed the initial value of the property serving as collateral, GPMs generally require higher down payments than may be necessary for constant level-payment plan. Down payments for this type of loan are calculated so the loan balance will not exceed the limits permitted, which is 95 percent of the initial property value for conventional loans carrying private mortgage insurance (PMI), and 97 percent of the initial value for FHA insured loans under the fairly popular Section 245 program.

Buydown or Temporary Buydown Mortgages

Buydown or Temporary Buydown Mortgages are an older variant of GPM's, which have been used successfully to sell homes and complete transactions when more conventional products were rendered unaffordable by high market interest rates. This loan is also referred to as a mortgage differential allowance program that permits the seller of a property to place a portion of the sale proceeds at closing with the lender in an escrow account. These funds are used to reduce the effective interest costs and monthly payments for the first two or three years of the loan. The buyer makes the offer to purchase, contingent on the seller establishing a mortgage differential account in the purchaser's name, at the time of closing. The account is established so that it has sufficient funds to effectively reduce the purchaser's monthly payment to reflect a lower interest rate for the first few years of the purchaser's loan. The buyer signs the note and mortgage at the current interest rate, but the seller is prepaying interest for the buyer. The differential is placed in a savings account in the purchaser's name, with the lender who makes the loan and draws on this account to equate actual interest payments with those that would have otherwise been received without the buydown.

A 3-2-1 buydown program, for example, offer the buyers a three percent reduction of the first year's rate, a two percent reduction of the second year's rate, and one percent off the third year's rate. These buydowns may be used with almost any type of mortgage, whether VA, FHA, or conventional. Borrowers may qualify at the first-year rate if they put down 10 percent, or carry no more than a 90 percent loan-to-value (LTV) mortgage. The borrower is required to qualify at the end of note rate on all conventional buydowns if the LTV is greater than 90 percent. Buydowns can also be used in six month or one year periods, depending on the particular situation of the buyer and the willingness of the seller to subsidize monthly interest payments. Buydown programs, in effect, reduce the net proceeds for a seller and are considered a cost of doing business for homebuilders during periods of high interest and tight credit. As such, buydown costs reduce a builder's profitability, but help to sell inventory and reduce interest carry costs.

Construction Loan

A Construction Loan is a form of an Interim Loan which is used to cover the costs associated with building, as well as renovating and rehabilitating property. The term "interim" can be applied to other variations of short or intermediate term loans, but in real estate, it's most prevalent use is in association with loans secured by builders or developers to carry out some specific set of tasks which create new, or rehabilitate or adapt existing space. By definition, and in reality, this is a complex process requiring a wide range of skills, talents and materials, all of which expect to be compensated for their efforts. The construction loan is typically the means of providing the funds necessary to pay all of these contributors to the process, along with some equity capital that may have been assembled by the developer/builder. Construction loans differ from other mortgage loans in that they are funded through periodic advances as construction progresses. The loan may be funded one of two different ways: (1) after certain stages of construction are completed (i.e., foundation, framing, plumbing, electrical, etc.), or (2) over certain time periods (such as monthly) for work completed up to that point. It takes close oversight by the lender to ensure that funds are released as building progresses. Following this process of loan inspection and advances, the value of the building used as collateral should be increasing about the same rate as the amount of the loan outstanding. The major risk of construction loans; however, is in the ability of the borrower/builder to complete the project within the budget, and according to plans and specifications. Failure to complete the building precludes release of a permanent loan which will pay off the construction loan. Should this occur, the construction loan could be extended by the lender by negotiating what some call a Mini Perm loan. This loan carries the property until a Permanent Loan can be secured, and may also be referred to as a Bridge or Gap loan. These are, in effect, loans to facilitate a transaction that might otherwise fail and force the lender to foreclose and take the collateral. Since most lenders would prefer to avoid this possibility, these other forms of interim lending provide an alternative.

Construction loans come in two basic varieties: one-time closings and two-time closings. One-time closings are offered by many lenders that originate construction loans. These loans are also called "construction-to-permanent loans" because the loan rolls over from a construction loan to a permanent mortgage once construction is completed. The one loan means one application and one set of closing fees. Two-time closing construction loans involve originating a construction loan as an interim loan, where borrowers pay only the interest accrued on the cost of construction. Upon completion, the borrower, if the same as the end-user, must re-qualify and pay the closing costs associated with securing a permanent mortgage on the total value of the property.

Funding of a permanent mortgage after construction is typically guided by the terms of a Takeout Commitment dictated by the lender. The builder/developer typically secures the takeout commitment as a prerequisite to securing an interim construction loan. The reason for this is fairly simple: interim lenders want to remain short to intermediate providers of credit and want to be assured that another funding source has been secured to pay out their loan in full upon the building project's completion. Prospective construction/interim lenders will review the terms of the takeout commitment very carefully to determine if the borrower has the ability and experience to fully satisfy every condition within the specified period of time. If they have any serious reservations in this regard, the lender will deny the application for the construction loan. Construction lenders can mitigate their risks by linking their approval to a sound takeout letter from a reputable permanent lending source. They cannot, however, guard against every negative possibility that could arise over the construction and development period. As such, many will either not offer construction loans as part of their product/service portfolio, or charge interest risk premiums that encourage prospective borrowers to look elsewhere. Additionally, lenders must be wary of the regulatory "watchful eye" which treats construction loans as a high risk, no matter the deal structure or the nature of the borrower. As such, too many construction loans on an institution's balance sheet can, and usually does, have negative effects on regulator assessments of asset quality, one of the important CAMELS scoring criteria previously discussed.

Piggyback Loan

A Piggyback Loan is a residential mortgage financing option in which a property is purchased using more than one mortgage from one or more mortgages. Very often, a second mortgage is secured from a lender different from the one providing the first mortgage. However, some lenders offer piggybacks involving maximum FNMA/FHLMC loans as the first, with a HELOC (Home Equity Line of Credit) in second position funding the balance of the acquisition price or refinance amount target. These loans typically work well for and accommodate upper income borrowers with strong net worth positions and earnings potential. Again, this is a loan product designed to meet the needs of specific borrowers engaged in a particular transaction that proves to be beneficial to both parties.

Home Equity Lines of Credit (HELOC's)

Home Equity Lines of Credit (HELOC's) are forms of equity loans which allow borrowers to secure funding on an as needed basis, rather than a lump sum, up to an approved ceiling or maximum LTV. In essence, this provides the consumer with a revolving Line of Credit that can be used for any purposes desired, including making home improvements, but also purchasing consumer goods, taking vacations, fund education and the like. From a practical standpoint, the borrower has converted home equity into an ATM cash drawer to be used whenever "needed".

Wraparound Loans

Wraparound Loans, or simply Wraps, became popular during the high interest rate era of the late 1970's to early 1980's. It was another of many creative mortgage structures designed to facilitate transactions for the benefit of everyone involved, but particularly homebuyers and sellers. However, it only works if there is an assumable loan on the property being sold. At this time, this mostly limits its use to properties encumbered by either an FHA or VA loan. In most other conventional loans, the alienation or due on sale clause in the promissory note would preclude its use. In essence, the wraparound mortgage is two or more mortgages consolidated into one payment, and is usually designed to allow the buyer to purchase with a smaller down payment, with the added benefit of a below market interest rate first mortgage. The sellers receive all of their cash at the time of closing, while the lender wraps new money around an existing assumable loan. If, in the future, the borrowers have sufficient resources available, they could pay off the wrap loan and default to the original low interest mortgage for the rest of the loan's life.

Reverse Annuity Mortgage (RAM's)

Reverse Annuity Mortgage (RAM's) are products designed to have the lender pay the borrower, rather than the other way around. This loan product was first authorized for use by the Federal Home Loan Bank Board (FHLBB) in 1979, and has grown in popularity, particularly among senior citizens ever since then. Very often, those who secure RAM's also drive vehicles with a bumper sticker that says something like "Retired and Busy Spending my Children's Inheritance". In a reverse annuity mortgage, homeowners 62 years old or older can convert the accumulated equity in their homes into cash. Homeowners can receive these funds as a lump sum, in fixed monthly installments, as a line of credit, or in various combinations. This means that the loan increases each period, which is an exact *reversal* of the normal process of amortizing down the debt. If the owners sell the home, their equity will naturally be less, but access to spendable income may be more important than accumulated wealth to retirees, and the RAM can provide an income stream, or lump sum payments. The mortgage does not have to be repaid until the mortgagor moves or dies.

RAM's are available through local banks and savings associations. However, due to the complexity of this loan type, many lenders chose not to offer it in their product portfolio. Loan officers must be specially trained and the originating process can be lengthy and quite tedious. HUD federally insured RAM loans have grown significantly, and has helped expand the number of lenders offering these loans.