JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

I. Other Presentations In Which Either The Date And / Or Sponsoring Organization Is Missing

6. Real Estate Finance/Mortgage Banking/Mortgage Guaranty Insurance

y. "Making the Residential Loan - A Risk Management Process", no date

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Making the Residential Loan--A Risk Management Process

I. Shortly we will compare intermediary lending institutions on the basis of four basic subsystems for management control and institutional differentiation:

   A. Savings pool attraction system--the form of security and its marketing which generate the pool of investment capital (example--selling whole life insurance, providing savings accounts, cooperative thrift programs, pension funds, etc.).

   B. Liquiditdy systems which cushion long term investment positions against short term withdrawals (premium flows, payroll check-off, liquid investments, inter-agency loans).

   C. Loan transaction preference systems (loan patterns established by regulation, history, management styles, market opportunities).

   D. Safety systems to stabilize operating results and solvency in event of natural disaster, economic disaster, or management failure.

II. Assuming a home loan falls within a transaction preference system, the lending opportunity must be analyzed in terms of the following clusters of inter-related factors, generally ranked in order of significance

   A. Analysis of the borrower to determine both his will and his capacity to repay the debt.

   B. The nature and terms of the loan agreement as to its investment and portfolio suitability.

   C. The real estate property characteristics to be pledged as collateral as to its ability to provide a bail-out on the loan.

   D. The maximum potential loss exposure on the final transaction as it relates to the profit center in the deal.

   E. Keep in mind the lender can choose to use a variety of risk management techniques which would include:

      1. Avoidance of certain types of business (through underwriting and marketing).

      2. Combination for purposes of predictability (developing portfolio patterns).

      3. Reduction of frequency of loss (through underwriting and servicing).

      4. Reduction of severity of loss (servicing and property management).

      5. Shifting of losses by means of insurance and guarantys.

6. Limiting maximum liability (underwriting standard and joint loan participation).
7. Standardizing mortgage investment to permit sale to others for liquidity,' better production volume or for risk avoidance.
8. Providing for risk of changing interest rates or devaluation of future money values (short terms, VRM's conditional accelerations, FNMA auction).
9. Loss of seasoned loan business (AMP loans, declining interest loans, closed loans).
10. Exposure to civil suit for usury, truth in lending, redlining, defamation or breach of privacy, minority discrimination.

III. The home loan is initiated by an application from the borrower which provides family data, job history, financial inventory, references, purpose of the loan, proposed property collateral, and desired amount and terms

A. In many cases the application requires a deposit, $35-50 for an appraisal or credit report, partially refundable when the loan is closed. This discourages shopping and reduces the risk of investigation expense which does not lead to an investment.

B. The credit report should reveal past payment records, outstanding judgments or law suits, local as well as some national history of applicant, family, etc.

1. It should reveal motivation to repay in terms of past credit record, family history, employment history, and other indicators of stability.

2. The purpose of the loan is also revealing in terms of purchasing a home, financing a vacation, an illness, or a child's education, etc.

3. Age, family status, savings, insurance programs, and personal conduct will also reveal the self-discipline of the applicant.

C. Employment history is significant as:

1. Revealing income power available for payment of loan.

2. Vulnerability of skills to the economic cycle or technological unemployment.

3. Stability of personality and loyalty to an obligation.

4. Verification of earnings and employment is always sought and decisions made as to quality of partner's income, investment income, and net worth values.

5. Consider pledge of other assets suitable for specific performance or damages.

6. Income power available through savings funds, disability insurance, guaranteed salary plan and life insurance.

IV. The note agreement classifies the loan as to its loan-to-value ratio, term, interest rate, and format of security in terms of home improvement, convential, FHA, VA, PMI, or other endorsement by a third party. An additional assignment of assets may also occur.

A. Certain conditions might have been requested in the application as discussed previously which may reveal motivation.

B. Special conditions may be added to the note to reflect findings of loan analysis.

V. Analysis of the property reveals not only the usefulness of the collateral, but also the motivation of the borrower. In previous times lenders depended largely on the property pledged, but today high ratio loans and cost of foreclosure administrations force lender to put primary dependence on borrower and third party guarantys.

A. However, the threat of foreclosure on a valid equity plus third party guarantys, which contingent on receipt of marketable title as well as old habits, lead to detailed evaluation of the property. Both FHA and PMI have discovered that most losses occur because of faulty credit reporting rather than faulty titles.

B. Control of the property risk begins with correct identification, proper appraisal, protection of priority of claim, inspection of on-going property maintenance, and insurance against casualty loss.

C. Identification requires correct title description, title insurance, survey plan, and blueprints or photographs from a certified appraisal inspection.

D. Appraisal value depends on reliability of the appraiser selected and the adequacy of the required report, typically a form report for $35-50 which are then spot-checked by narrative reports of $100-150.

E. Site analysis is not only concerned with conformity to local codes, but conformity with national flood insurance requirements since federally regulated lenders will no longer be permitted to lend in flood plain areas or communities which have elected not to qualify for federal flood insurance.

F. Priority of claim depends on title status, possible inchoate interests (such as dowry), and identification of potential lien rights to be waived, proper filing and recording of transaction, and provision for contingencies such as death, guardianship, etc.

G. Destruction of the collateral by catastrophe offset by insurance, and special needs for flood, earthquake, or mud slide insurance (example--seiche insurance or Tiboron homes).

H. Continued property inspection and a note covenant is often needed to provide control of property maintenance. (used houses and mobile homes show much higher foreclosure loss in terms of frequency and severity, the latter attributable to inadequate maintenance of waste)

VI. The lender must organize all of the above considerations into either an explicit or implicit matrix of the trade-off between maximum potential loss and profit centers potentially available in the transaction.

A. Loan opportunities typically exceed loan making capacities, so that some device must be designed to rank alternatives as to acceptability or unacceptability.

B. Of those which are accepted risk differentials may justify some difference in terms and the price of credit. The sophistication of these decisions vary drastically.

C. Some lenders set up basic but simple rejection grids, a binary decision process:

   1. Rejecting by type of property (style, construction, age), or location (red-lining).

   2. By borrower status (depositer, member of co-op, length of residency, etc.).

   3. By borrower occupation and age group or marital status.

   4. By note type (no FHA, no 95% loans, no 30 year loans).

D. For any loan which receives a rejection above, either no application is taken, or question of risk is passed on to someone else.

   1. If FHA will accept the deal, the loan is made and then sold to a secondary market.

   2. The onus of rejection may be shifted to the private guarantor which says no in 24 hours.

   3. Marketing process pre-qualifies applicants or property.

E. The FHA attempted to develop a risk-cell classification system which rated the borrower, the property location, loan-to-value ratio, and date of origination in order to forecast loss reserves and balance portfolio risk.

F. Your readings contain several numerical scoring sheets with which to make underwriting decisions. These have reflected factor and regression and other statestical studies of particular lender experience.

   1. The trick is develop a system which rejects both the clearly unacceptable and the potentially troublesome business without rejecting the good loans. Every one of these systems and studies has reached somewhat different conclusions.

   2. The increasing use of computerized records and the research of private guarantors has made possible for the first time statistical studies as a prerequisite of automatic underwriting.

   3. The volume of loan files handled through secondary markets and by the private guarantor is forcing them toward automatic review. Freddie Mack has already developed a computerized review process and MGIC is pushing research and development in this area with great urgency.

NOTE: Articles on numerical rating and S & L step by step construction loan guide.

More on → Residential Finance -

Assorted pages which relate to residential finance

I. Occupancy of any residential unit is the loan of capital

A. The flop house
B. The motel unit
C. The camper pad
D. Apartment by the week - co-op apartments

Real estate finance is narrowly defined as the loan of money secured by fee title and therefore in the vast majority of cases involves the occupant only indirectly. The sensitivity of the lender nevertheless impacts on the occupant for the life of the structure - and in general, American lenders have been insensitive to the occupant. Out-of-sight is out-of-mind and therefore the consumer of ethic institutions is low.

II. What's a Name? - Mortgage titles have a word order much like German prose.

A. Priority position
B. Collateral pledged
C. Form of instrument
D. Pattern of payment
E. Special qualifications may precede or conclude the title

Priority and type of collateral must be considered simultaneously.

A. A second mortgage on a fee is better collateral than first mortgage on the leasehold.
B. You can have first mortgage on a fee, a leasehold, an operating agreement or a group of properties - a blanket loan.
C. A first mortgage on a leasehold isn't any good if the owner of the leasehold doesn't pay the rent to the owner of the fee.

III. Form of Instrument

Trust deed
Mortgage bond
VA or FHA guaranteed loan, etc.

IV. Pattern of Payment

Interest only
Constant principal — followed by term of loan
Constant payment — (i.e., maturity dates)
Balloon

V. Special qualifications might be:

Subordinated firsts, blanket first
FHA, etc. at the beginning or at the end of the descriptor, such things as with indexed interest, closed loan, with income participation, etc.

VI. Thus you could have:

A subordinated first mortgage leasehold loan with 25-year amortization payments ballooning in 10 years - a FHA insured 95% first mortgage with graduated payments and 35-year amortization.

IvV It can be shown that variations in interest rate do not affect purchasing power very greatly at any one time as the full impact is distributed by the compound interest formuoa over a 25 year or longer span. Downpayment and the term of repayment do affect purchasing power.

A. The amount of downpayment required will affect the would-be buyers source for mortgage funds , his use of a guarentee, his interest rate, the total value of the house he can buy, and his will to repay.

B. Downpayment can be reduced by use of
1. the VA Plan LEASED LAND
2. The FHA Plan
3. A collateralized downpayment
4. An MGIC loan
5. Combination of a second mortgage and a first mortgage (state VA plans)
6. Land contracts

C. Since foreclosure will cost 10-20% of the value of the property, even if there has been no decline in value, suchllenders are faced with a loss in the event of foreclsoure. Foreclosure need not take place unless property values have declined.

D. By protracting the repayment period, monthly payments are reduced but so are reductions of the mortgage balance. The property may depreciate at a faster rate than the net worth is increased so that the owner's equity or downpayment will disappear.

E. The will to pay is as important as the ability to pay and the will to pay evaporates as the mortgage becomes greater than the resale value of the property. The borrower and the lender both have an interest in amintaining the property value in the face of the following physical risks:

1. Property distruction due to catastrophe
2. Loss of value due to adverse influences
3. Loss of value due to functional obsolesence
4. Loss of value from curable obsolesence
5. Loss of the intangible values of safety, privacy, and status

F. The ability to pay depends of income or savings capital disregarding savings in excess of an emergency fund or college fund, the principal resource is future income-- income available for the real estate mortgage lender. Thre risks in this regard include

1. Death
2. Disability
3. Unexpected extra expenses of someone else in the family
4. Temporary or final loss of employment
5. Interception of income by other creditors

Inlight of the risks facing the home owner and the lender, let's look at the principal ingredient of the mortgage and then at the position of landlord and tenant.

M. FHA VA documents which includes credit report, verification of employment, flood insurance, etc.

N. Insurance policies for property and liability including mortgagee loss payable clause

O. Loan application--establishes fees and responsibiltiy for paying; real estate brokers often pay closing costs to reduce buyer's cash downpayment.

P. Mortgage or deed of trust document

Q. Properly executed promissory note

R. Borrowers affadavit relative to any current factors such as divorce proceedings, legal judgments, mechanics liens, recent improvements on real estate, etc.

S. Photographs of good quality for secondary market files, etc. and appraisal

T. Survey to correctly idenify property and determine if any encroachments exist

U. Private mortgage insurance documents

V. Title insurance or title abstract must be brought up to date of closing

W. Verification reports of statements made on loan applications, typically for employment, bank deposits, etc.

X. Uniform settlement statement (HUD-1) to establish real estate settlement procedures

Y. Truth and lending statement as to true interest cost

II. For income property loans many of the same forms as above are required but the problem is complicated by the need to validate business organizations and the need to protect the interest and assure all three parties carry out their part of the loan agreement:

1. The construction lender who agrees to finance the construction phase and then sell the mortgage note to the permanent investor upon completion

2. The permanent investor who agrees to buy the loan from the construction lender upon completion

3. The borrower or developer who promises to do nothing to interfere with the transaction.

   a. Because many banks felt they were betrayed by permanent lenders and permanent lenders felt their competition were stealing good laons when construction was completed, many investors require an income loan to be preclosed to make sure builder takes down the permanent loan,

   b. Articles of incorporation, by-laws, and board of directors resolution approving mortgage

   c. Audited financial statements

d. Insurance policies
e. Comfort letters from lawyers or accountants on local legal issues as to usury, zoning, financial condition, etc.
f. Leases including a list of existing leases, letters of intent, subordination agreements, assignments, and approval forms from the permanent investor
g. Partnership agreements
h. personal endorsements
i. Plans and specifications updated for changes
j. Subordination agreements separately arrived at generated later
k. Tax bills
l. Tripartite or buy/sell agreement to establish rights and duties where there was an interceding construction loan lender