Mortgage Loan Brokering and Lending

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Chapter 1

The SAFE Act: MLO licensing

Learning Objectives

After you read this chapter, you will be able to :

- understand the economic history leading up to the registration and licensing of mortgage loan originators (MLOs);
- understand the goals of the Secure and Fair Enforcement Act (SAFE Act); and
- identify conduct which triggers MLO licensing.

Key Terms

consumer mortgage

consumer mortgage application

consumer purpose

Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)

dwelling

mortgage loan originator (MLO)

Nationwide Mortgage Licensing System (NMLS)

Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act)

Regulatory erosion

In the last few decades, the regulation of California **mortgage loan originators (MLOs)** has changed drastically. To understand why, a look at recent mortgage lending history is necessary.

Both the Millennium Boom and the housing bust had roots in the mortgage deregulation of the 1980s. Up until the early '80s, mortgage lending was subject to specific and fine-tuned regulations. These regulations protected society and its institutions from banking failures and economic disruption.

However, the high interest rates and inflation of the early '80s threatened the solvency of lenders — at the time, comprised mainly of savings and loans (S&Ls). To address the potential multi-billion dollar losses and widespread S&L failures, federal regulators and policy makers passed several extensive laws deregulating the S&L market.

These new laws purported to boost S&L profits by allowing money market accounts, increasing deposit insurance, reducing net worth requirements, permitting out-of-state branch operations, removing restrictions on risky lending and — importantly — allowing S&Ls to originate *adjustable rate mortgages (ARMs)*. [See Chapter 20]

Eventually, the S&Ls failed. But the deregulated mortgage market conditions and ARMs remained in the mortgage marketplace.

A big boom

Fast forward to late 2001 when the *Federal Reserve (the Fed)* interrupted the corrective process a normal business recession works on the economy by prematurely lowering interest rates.

The cheap money and low interest rates entered the market and the national appetite for debt — including mortgage debt — exploded. Big banks made a killing as Wall Street investors begin a frenzy of buying and selling *mortgage backed bonds (MBBs)* and other securitized mortgage debt.

To secure their inflow of money, Wall Street and the big banks poured money into congressional lobbying efforts. Successful banks and related companies had a vested interest in keeping the market volume up to ensure their continued profits. Formal regulations were an impediment to innovation (and ever greater profits through deceptive mortgage products).

In April 2004, the big banks won the right to reduce the amount of capital they held in reserve to offset their risks. The result was a dramatic 40% increase in freed-up funds which drove the Wall Street banking operators to snap up ownership in most all mortgage banking operations across the nation.

As the nation's mortgage bankers, they were able to directly acquire more high-yield, risky ARMs at ever greater profit margins without involving Fannie Mae or Freddie Mac as profit-taking intermediaries.

The ARMs they acquired were bundled into investment pools. These pools were then sliced into various levels of vertical priority, called *tranches*. Investors bought into these tranches, which were fractionalized into millions of mortgage-backed bonds (MBBs). From there, the bonds were peddled by the same Wall Street bankers to other banking institutions and individual investors throughout the world.

By the time *demand* for mortgages peaked in mid-2005, Wall Street had perfected its system for originating, buying, bundling and reselling mortgages through the MBB market. Even the credit rating agencies were promoting the virtues of these pools of bonds induced by fees paid by the same Wall Street banks getting the highest ratings.

The result: tons of transaction fees, wide yield spreads and no accountability. Wall Street's millennium battle cry perfectly sums up the prevailing attitude of the time: "I'll be gone, you'll be gone."

ARMs proliferation and the bust

When the real estate market ran out of financially able homebuyers in 2005, the mortgage industry began to entice tenants to become homeowners. Also, property owners of all sorts had to be motivated to refinance. The key to qualifying this growing pool of mortgage applicants was a relic from the 1982 bank and S&L deregulation era: ARMs.

During the 2000s, ARMs allowed buyers to qualify using low initial interest rates, called *teaser rates*, and very low payment schedule options for up to ten years. On top of the already risky ARM structure, lenders lowered their underwriting standards and created a new breed of ARMs which required no verification of income or assets. Credit standards plummeted. By the end of the Millennium Boom, the only underwriting standard left was proof of a pulse.

This combination of deregulation, easy money and ever riskier products catapulted real estate prices to unprecedented highs, the financial accelerator in full bloom. When the crash came in 2007, big banks, individual homeowners and the world's investors all bowed to economic devastation. The Great Recession and the financial crisis had arrived.

> **Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)**
> A 2010 enactment of significant changes to U.S. financial regulation in response to the 2007 financial crisis.

A new era for consumer protection

The real estate and mortgage markets need stability to thrive. In reaction to the financial crisis, Congress passed several major consumer protection laws.

The most sweeping consumer protection law to pass was the omnibus **Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)**, which became law on March 5, 2010. The *Dodd-Frank Act* mandated key changes to mortgage lending regulations.[1] [See Chapters 27 and 29]

The other new consumer protection law resulting from the mortgage meltdown was the **Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act)**. The SAFE Act compels the license and registration of all MLOs.[2]

> **Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act)**
> A federal consumer protection law which created a uniform national licensing and registration scheme for mortgage loan originators (MLOs).

The SAFE Act

The SAFE Act protects consumers by:

- establishing national licensing and educational standards for MLOs; and
- registering all MLOs in a national database, the **Nationwide Mortgage Licensing System (NMLS)**.[3] [See Chapter 1]

> **Nationwide Mortgage Licensing System (NMLS)**
> The national registry of consumer mortgage loan originators (MLOs).

1 12 United States Code §§5301 et seq.

2 12 USC §§5101 et seq.

3 12 USC §5101

Two state regulators

In California, two state entities regulate state-licensed MLOs:

- *the Department of Real Estate (DRE) [Calif. Business and Professions Code §§10166.01 et seq.]; and*
- *the California Department of Financial Protection and Innovation (DFPI). [Calif. Financial Code §§50002, 22100 et seq.]*

*DRE issues an **MLO endorsement**, which attaches to an existing DRE sales agent or broker license. The underlying sales agent or broker license allows the licensee to practice real estate activities in California. The MLO endorsement allows the licensee to originate consumer mortgages as part of those real estate activities. [Bus & P C §10166.02(b)]*

*In contrast, individual MLOs who meet the SAFE Act requirements under the DFPI hold **MLO licenses**. [Fin C §50002(d)]*

Though they have different naming conventions, DRE's endorsement and DFPI's license both meet SAFE Act requirements for state-licensed MLOs. [See Chapter 2]

An MLO with an active DRE license and an active MLO endorsement may originate consumer mortgages for a DFPI lender. However, a DFPI MLO is barred from originating consumer mortgages under a DRE broker unless they also hold an active DRE license and MLO endorsement. [Fin C §§22100(b), 50002.5]

The SAFE Act breaks MLOs into two different categories:

- **federally registered MLOs**, who are employed by federally regulated banks; and
- **state-licensed MLOs**, who are licensed and regulated by state agencies. [See Chapter 2]

The **Consumer Financial Protection Bureau (CFPB)** has authority over the SAFE Act regulations controlling both federally registered and state-licensed MLOs.[4]

In addition, the SAFE Act compelled each state to adopt laws to enact the minimum licensing and educational standards required of state-licensed MLOs.

The California Department of Real Estate (DRE) adopted its version of the SAFE Act in 2009.[5]

Licensing required

The SAFE Act requires a DRE licensee who performs MLO activities to:

- obtain and maintain a four-year real estate license from DRE; and
- obtain and maintain an annual MLO endorsement from DRE.[6]

Failure to hold a proper license and endorsement subjects an individual to a monetary penalty of up to $10,000. The DRE commissioner is able to suspend or revoke licenses for failure to hold the proper license and endorsement.[7] [See Chapter 2]

4 12 Code of Federal Regulations §§1007-1008 et seq.
5 Calif. Business and Professions Code §§10166.01 et seq
6 Bus & P C §10166.02(b)
7 Bus & P C §10166.02(f)-(g)

Activity defining an MLO

An **MLO** is an individual who, for compensation or gain:

- takes an application for, offers or negotiates the terms of a **consumer mortgage**;
- takes an application for, offers or negotiates the terms of a *consumer mortgage modification*;
- advertises they will take a consumer mortgage application, or offer or negotiate the terms of a consumer mortgage; or
- services a consumer mortgage.[8]

mortgage loan originator (MLO)
An individual who receives fees to arrange a consumer mortgage.

A consumer mortgage is:

- used primarily for personal, family or household use, called **consumer purpose**; and
- secured by a trust deed or other security device (land sales contract or lease-option sales agreement) on a **dwelling**, or residential real estate on which a dwelling will be constructed.[9]

consumer mortgage
A debt incurred primarily for personal, family, or household purposes and secured by a parcel of real estate containing one-to-four residential units.

A *dwelling* is a one-to-four unit residential property, a condominium, cooperative, mobilehome or trailer which is used as a residence.[10]

consumer purpose
A primarily personal, family or household use.

Consider a real estate broker who is hired by a buyer to locate a single family residence (SFR) to be used as an investment property. The buyer agrees to pay a separate fee to the broker to negotiate a mortgage to fund the purchase of the investment property. A property and a mortgage lender are located, and the broker is paid for both activities on closing.

dwelling
A building or personal property occupied or designed to be occupied as a residence by one or more families.

Based on this transaction, is the real estate broker required to obtain a MLO license?

No! While the property is considered a dwelling, the buyer as an investor used the proceeds for a business purpose, not a consumer purpose. A consumer mortgage must be both a consumer-purpose mortgage and secured by a dwelling (no occupancy by the buyer required) to be a consumer mortgage covered by the SAFE Act licensing requirements.

Thus, the mortgage in this scenario is not a consumer mortgage and thus does not trigger MLO licensing for the originating broker. [See Chapter 4]

Now consider a DRE real estate agent with an MLO endorsement on their license. Due to a drop in mortgage business, the agent focuses on real estate brokerage, and allows their MLO endorsement to lapse. While their endorsement is lapsed, they continue to hand out business cards to solicit mortgage originations.

Is the real estate agent in this scenario required to have an MLO endorsement on their license?

Yes! The act of advertising mortgage origination services is enough to trigger the MLO endorsement requirement.[11]

8 Bus & P C §10166.01(b)(1), Bus & P C §10131(d)
9 Bus & P C §10166.01(d)
10 Bus & P C §10166.01(d)
11 Bus & PC §10166.01(b)(1)

Taking a mortgage application

> **consumer mortgage application**
> A consumer mortgage application is a request for an offer of consumer mortgage terms.

Taking a **consumer mortgage application** is one of the activities triggering SAFE Act licensing requirements. A *consumer mortgage application* is a request for an offer of consumer mortgage terms in any form, not just the formal written Fannie Mae / Freddie Mac Residential Loan Application form.[12]

Consumer mortgage applications may be taken directly or indirectly. An individual who offers or negotiates a consumer mortgage for compensation or gain is not able to avoid licensing requirements simply by having another person physically receive the application from the prospective buyer or owner.[13]

An individual takes a consumer mortgage application even if they are not responsible for verifying the information in the application. For example, a mortgage broker who interviews an applicant about the applicant's personal and financial situation has taken a consumer mortgage application, even though they later pass the application to a lender for the mortgage decision.[14]

However, a real estate broker or agent who assists an applicant by explaining the general contents of the application is not taking a consumer mortgage application. Generally describing the mortgage application process is not taking a consumer mortgage application, as long as the description does not include a discussion of specific mortgage products.[15]

Offering or negotiating terms

Offering or negotiating terms of a consumer mortgage for compensation or gain also triggers SAFE Act licensing requirements.[16]

An offer has been made if the individual:

- presents the applicant with specific consumer mortgage terms;
- communicates with the applicant to reach a mutual understanding about the terms of the consumer mortgage;
- recommends, refers or steers an applicant to a specific lender or mortgage product based on an incentive from a third-party; and
- receives or expects to receive compensation in connection with any of the above activities related to the consumer mortgage.[17]

To provide the broadest protection to buyers, the SAFE Act deems an offer to have been made even if:

- the offer is verbal;
- further verification of information is necessary;
- the offer is conditional;
- other individuals are also required to complete the mortgage process;

12 Bus & P C §10166.01(b)(1); 12 CFR §1008.103(b)(2)
13 12 CFR §1008.103(c)(1); 12 CFR §1008 Appendix A(a)(1)(i)(A)]
14 12 CFR §1008 Appendix A(a)(1)(i)
15 12 CFR §1008 Appendix A(a)(1)(ii)(B)-(C)
16 Bus & P C §10166.01(b)(1)
17 12 CFR §1008.103(c)(2)

- the individual making the offer lacks authority to negotiate the interest rate or other mortgage terms; or
- the individual making the offer lacks authority to bind the person that is the source of the prospective financing.[18]

Any communications with an applicant to set consumer mortgage terms are considered negotiations. This includes:

- indirect communications (e.g., negotiations through a third party or email);
- sending the applicant a revised mortgage offer in response to the applicant's request for a different rate or different mortgage fees; and
- any communications regarding mortgage terms, even if the applicant does not ultimately accept the terms.[19]

However, offering or negotiating terms of a consumer mortgage does not include:

- providing general explanations in response to inquiries, such as explaining general mortgage terminology or lending policies;
- arranging the mortgage closing or other aspects of the mortgage process, such as an escrow officer does when coordinating a time and place to sign mortgage documents;
- providing an applicant with information unrelated to mortgage terms, such as explaining the best days of the month for scheduling mortgage closings; or
- explaining the steps an applicant needs to take to obtain a mortgage offer, such as providing general guidance about qualifications not specific to the applicant's circumstances.[20]

Lending and origination, differentiated

The activities of origination and lending are related, but distinct. While lenders do also originate mortgages, a person who makes (funds) a consumer mortgage is not automatically considered an MLO in need of an endorsement. Only mortgage origination activities trigger both the license and endorsement requirements.

For instance, a person who personally funds eight or more mortgages secured by one-to-four unit residential real estate in a calendar year needs to hold a DRE broker license if the mortgages are not arranged by a threshold broker.[21] [See Chapter 40]

However, this licensing requirement is distinct from the requirement to hold an MLO endorsement. The MLO endorsement is only required once the licensee charges and collects a separate fee for soliciting the applicant, completing the mortgage application or negotiating the terms of the mortgage (originating).

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18 12 CFR §1008 Appendix A(b)(1)(i)
19 12 CFR §1008 Appendix A(b)(1)(ii)
20 12 CFR §1008 Appendix A(b)(2)
21 Bus & PC §10131.1(b)(1)(C)

Compensation is key

Consider a broker who takes a listing from a seller to locate a buyer for the seller's single family residence. To increase the odds of finding a buyer and to meet the seller's long-term financial goals, the broker counsels the seller to offer seller financing. The broker locates a buyer who will occupy the property as their principal residence, a consumer purpose.

The broker negotiates the terms of the sale, including the seller financing. The deal closes. The broker is paid according to the terms of the listing agreement for the sale of the property. The broker does not collect an additional fee for arranging the seller financing.

Do the broker's activities trigger the MLO endorsement requirement?

No! Here, the broker is compensated for locating a buyer and arranging the sale of the seller's property under the terms of the listing agreement. Recall that in order to fall under the MLO endorsement requirements, the mortgage origination activities must be performed in exchange or in expectation of a fee or other compensation. Since the broker did not charge an additional fee for negotiating the carryback, the broker is not required to hold an MLO endorsement on their license.

Similarly, the source of the compensation also determines whether a broker who negotiates a short sale is required to hold an MLO endorsement.

A short sale is a sale in which the lender accepts the net proceeds at closing in full satisfaction of a greater amount of mortgage debt.

A broker who negotiates a short sale as part of their real estate brokerage services without charging an additional fee for the short sale negotiations is not required to hold an MLO endorsement.

However, if the broker is collecting a fee for negotiating a short sale as part of a consumer mortgage modification service, they are required to hold an MLO endorsement. Here, the broker's underlying service — the consumer mortgage modification service for a fee — is a service which triggers the MLO endorsement.[22]

Referrals

Fees for referring buyers and sellers to a real estate broker or agent are allowable when paid by a real estate broker to an employee or to another real estate broker.[23] [See **RPI** Form 114]

However, this exception does not extend to the broker's receipt of a referral fee for referring a principal in their sales transaction to an MLO service of any type. If a broker is paid a fee for the referral — and the broker's only service is as a transaction agent (TA) acting on behalf of the seller or buyer — the broker is considered an MLO by the very receipt of a fee. Thus, by the acceptance of a kickback referral fee from a lender, they are subject to MLO endorsement and compensation rules.[24] [See Chapter 6]

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22 Bus & P C §10166.01(b)(1)

23 12 CFR §1024.14(g)(1)(v)

24 Bus & PC §10166.01(b)(2)(B); 12 CFR §1026.36(a)(1)(i)(C); Official Interpretation of 12 CFR §1026.36(a)-(1)(iv)

A broker or agent who only performs real estate brokerage activities is not required to hold an MLO endorsement if they refer business to lenders without expectation or receipt of compensation.

Chapter 1 Summary

Both the Millennium Boom and the housing bust had roots in the mortgage deregulation of the 1980s. In reaction to the financial crisis, Congress passed the omnibus Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which mandated key changes to mortgage lending regulations.

The other consumer protection law resulting from the mortgage meltdown was the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act). The SAFE Act compels the license and registration of all mortgage loan originators (MLOs).

An MLO is an individual who, for compensation or gain:

- takes an application for, offers or negotiates the terms of a consumer mortgage;
- takes an application for, offers or negotiates the terms of a consumer mortgage modification;
- advertises they will take a consumer mortgage application, or offer or negotiate the terms of a consumer mortgage; or
- services a consumer mortgage.

Chapter 1 Key Terms

Notes:

Chapter 2

MLO licensing

Learning Objectives

After you read this chapter, you will be able to :

- identify the two different kinds of consumer mortgage brokers created by the Secure and Fair Enforcement Act (SAFE Act);
- understand the difference between a state-licensed broker or sales agent mortgage loan originator (MLO) and a registered bank-employed MLO;
- identify the two MLO licensing schemes in California; and
- understand the requirements to obtain and renew an MLO endorsement.

Key Terms

broker-associate

federally registered mortgage loan originator (MLO)

Nationwide Mortgage Licensing System (NMLS)

Nationwide Mortgage Licensing System (NMLS) identification number (ID)

state-licensed mortgage loan originator (MLO)

DRE or DFPI license

In the aftermath of the 2007 mortgage meltdown and financial crisis, Congress passed the **Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act)**. [See Chapter 1]

The *SAFE Act* requires any individual who solicits consumer mortgage applications or arranges consumer mortgages as an occupation to:

- register as an MLO with the **Nationwide Mortgage Licensing System (NMLS)**; and either

Nationwide Mortgage Licensing System (NMLS)
The national registry of consumer mortgage loan originators (MLOs).

- be employed by a federally regulated bank; or
- hold a state MLO license.[1]

*Editor's note — A **consumer mortgage** is a loan that:*

- *funds a primarily personal, family or household use; and*
- *is secured by a one-to-four unit dwelling, owner-occupied or not.*

Dwellings include individual condominium units, cooperative units, mobile homes and trailers used as a residence.[2]

In contrast, business mortgage originations are not controlled by federal consumer mortgage law. The making or arranging of a mortgage for a business, investment or agricultural purpose secured by any type of real estate, or a consumer-purpose loans secured by other than a one-to-four unit residential property are controlled only by state licensing rules under the Department of Real Estate (DRE) and the Department of Financial Protection and Innovation (DFPI).

federally registered mortgage loan originator (MLO)
A mortgage loan originator (MLO) employed by a federally regulated bank, credit union or financial company.

state-licensed mortgage loan originator (MLO)
A mortgage loan originator (MLO) licensed and regulated by a state agency.

The MLO registration and licensing details are recorded in the *NMLS Consumer Access database*. The NMLS Consumer Access database provides consumers with information about an MLO's employment history and enforcement proceedings.[3]

The federal SAFE Act established two classes of MLOs:

- **federally registered MLOs**, individuals employed by federally chartered banks, credit unions and other federally regulated financial companies; and
- **state-licensed MLOs**, individuals registered with the NMLS and regulated by state agencies.[4]

For the state-licensed MLOs with which this material is concerned, two California state agencies license or endorse MLOs:

- the **Department of Real Estate (DRE),** which issues MLO endorsements to their licensed brokers and sales agents;[5] and
- the **California Department of Financial Protection and Innovation (DFPI),** which issues MLO licenses under the **California Financing Law (CFL)** and the **California Residential Mortgage Lending Act (CRMLA)**.[6]

MLOs may obtain authorization to originate residential mortgages under one or more of these agencies. Why choose one agency over the other?

It depends on many factors, including the type of activities the MLO will engage in and who they are employed by. [See Figure 1]

1 12 Code of Federal Regulations §§1008 et seq.; Calif. Business and Professions Code §10166.01(b)(1); Calif. Financial Code §§22100, 50002
2 Bus & PC §10166.01(d); Fin C §§22012(e), 50003(p)
3 12 United States Code §5102(6)
4 12 USC §5103(a)
5 Bus & P C §10166.02(b)
6 Fin C §§22100(a), 50120

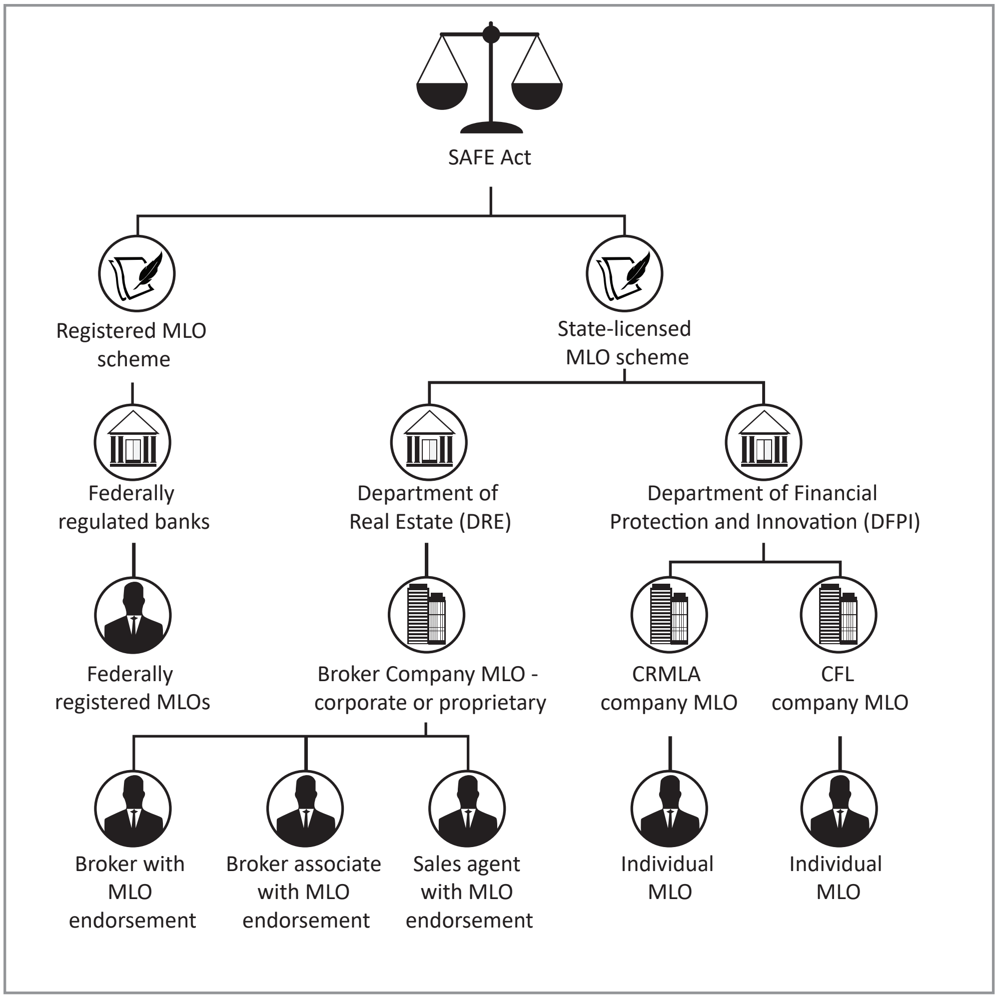

Figure 1

The MLO licensing scheme in California

NMLS requirements, a requisite for all MLOs

All brokers and agents who want to become an MLO, whether as individuals or as employing brokers, submit an application to the NMLS which includes:

- personal residential and employment history;
- fingerprints for a criminal background check by the Federal Bureau of Investigation (FBI);
- an authorization for the NMLS to obtain a credit report; and
- an authorization for the NMLS to obtain information about administrative, civil and criminal proceedings against the licensee.[7]

At a minimum, individual MLOs and responsible individuals for MLO companies need to show they have:

- demonstrated financial responsibility and fitness to operate honestly, fairly and efficiently; and
- not been convicted of, pled guilty or pled no contest to a felony in a domestic, foreign or military court:

7 12 CFR §1026.36(f)(3)(i); Bus & P C §10166.04(a); Fin C §§22105.1, 50140(e)

Figure 2

Mortgage loan originator licensing summary

	Benefits	Practice restrictions	Surety bond	Min. net worth	Statutory education	Fees
Federally registered	No statutory education or testing requirements.	Must work for a federally regulated bank or company.	No	No	No	**Initial** $30 or $60 **Renewal** $30
DRE – Company	Required for DRE corporations and sole proprietorships employing MLOs	Required for corporations and sole proprietorships employing MLOs.	No	No	N/A	**Initial** $330 + fingerprint and credit fees **Renewal** $400 for corporations, $100 for sole proprietor ships
DRE – Individual Broker	In addition to MLO activities, able to perform other real estate activities. Able to make consumer and business loans secured by real estate. Able to service consumer and business loans secured by real estate. Able to also work for a DFPI company without a DFPI MLO license.	Must be associated with a DRE MLO company to originate residential mortgages. Must hold and maintain an active DRE broker license. Individuals or corporations only.	No	No	20 hours licensing, no state-specific material; 8 hours continuing, no state-specific material	**Initial** $330 + fingerprint and credit fees **Renewal** $330
DRE – Individual Sales agent	Able to perform real estate activities. Able to also work for a DFPI company without a DFPI MLO license.	Must work for a DRE broker MLO to originate residential mortgages. Must hold and maintain an active DRE sales agent license. Individuals only.	No	No	20 hours licensing, no state-specific material; 8 hours continuing, no state-specific material	**Initial** $330 + fingerprint and credit fees **Renewal** $330

DFPI – CFL Company	Also able to make secured or unsecured consumer and commercial loans. Any sole proprietorship or business entity may hold this license.	Only able to broker loans to other CFL companies. No warehouse funding. All officers, owners, directors, managers, members to pass background check and financial responsibility requirements.	$25,000 - $200,000, depending on prior year loan volume	$50,000 for brokers; $250,000 for lenders	No	**Initial** $400 + fingerprint and credit fees **Renewal** $100 + $250 minimum assessment based on prior year loan volume
DFPI – CRMLA Company	Able to perform mortgage servicing on behalf of a third party. Licensees do not need a California address. Any sole proprietorship or business entity may hold this license.	All officers, owners, directors, managers, members to pass background check and financial responsibility requirements.	$50,000 - $200,000 depending on prior year loan volume	Audited $250,000	N/A	
DFPI – Individual MLO	Least difficult MLO license to obtain.	Must work for a DFPI company to originate residential mortgages. Individuals only.	Must be covered by employing DFPI company.		20 hours licensing, including 2 hours of California-specific education; 8 hours, including 1 hour of California-specific education.	**Initial** $330 + fingerprint and credit fees **Renewal** $330

Figure 2

Mortgage loan originator licensing summary

cont'd

- for **federally registered MLOs, DRE MLOs** and **individual DFPI MLOs**, during the seven-year period preceding the date of the application or at any time, if the felony involved fraud, dishonesty, a breach of trust or money laundering;[8] and
- for **DFPI MLO companies**, during the ten-year period preceding the date of the application.[9]

In addition to NMLS minimum MLO honesty requirements, the DRE and DFPI each set their own requirements for MLO qualification. [See Figure 2]

Obtaining a federal MLO registration and ID

Nationwide Mortgage Licensing System (NMLS) identification number (ID)
A unique number identifying a consumer mortgage loan originator (MLO) in the Nationwide Mortgage Licensing System (NMLS).

An individual who processes consumer mortgages as an employee of a federally regulated *bank* or credit union is required to obtain an NMLS ID and register as a *federally registered MLO*.[10]

The first step for a federal registration is employment with a federally regulated bank in a residential mortgage position.

If the MLO does not already have an **NMLS identification number (ID)**, the bank will create an NMLS account for them in the NMLS federal registry. The MLO then fills out an application and agrees to credit and background checks. [See NMLS Application Form MU4R]

Fees are involved, payable either by the bank or the MLO at the bank's option. The initial set-up fee for an MU4R filing is $30 if registration occurs between January and June, and $60 if registration occurs between July and December.

A **de minimis exception** to the federal registration requirement exists. An employee of a federally regulated bank is not required to register as an employee who provides the services of an MLO if:

- the employee has never been registered or licensed as a MLO; and
- during the past 12 months, the employee performed MLO services for five or fewer consumer mortgages.[11]

Editor's note — This five-or-fewer exception does not exist for state-licensed MLOs.

Maintaining a federal registration

Federally regulated banks bear the burden of monitoring and confirming the registrations, updates and renewals for the MLOs they employ.[12]

Federally registered MLOs renew their *registrations* annually between November and December. They do not complete continuing education.[13]

Prior to the renewal, the bank will give the MLO a *request to renew* reminder. The MLO confirms and attests the information in their NMLS registration is current.

8 12 CFR §1026.36(f)(3)(ii); Bus & P C §10166.05; Fin C §§22109.1(a)(2), 50141(a)(2)
9 Fin C §§22109(a)(2), 50126(a)(2)
10 12 CFR §1007.103(a)
11 12 USC §5106(c)
12 12 CFR §1007.104
13 12 CFR §1007.103(b)(2)

The renewal fee for a federally registered MLO is $30.

DRE MLO practice

A DRE licensee needs to obtain an MLO endorsement on their real estate license to provide MLO services. For an MLO endorsement to be issued by the DRE, the license needs to be current and the licensee in good standing.[14]

Thus, the first step to being an MLO under the DRE scheme is to obtain a DRE license.

A DRE broker or sales agent license authorizes the licensee to:

- enter into employment/listing agreements;
- negotiate sales;
- negotiate purchase agreements;
- engage in property management and leasing;
- originate mortgages;
- arrange trust deed sales;
- perform escrow activities; and
- engage in other activities which require a DRE license.[15]

The MLO endorsement grants a DRE licensee authority to provide federally regulated consumer mortgage services such as:

- origination;
- brokering;
- servicing; and
- modification negotiations.[16]

Editor's note — The MLO endorsement is only triggered when negotiating a mortgage modification if the licensee is paid a separate fee for negotiating the modification. The endorsement is not triggered by negotiating a mortgage modification as one of the services a seller's broker or their agent performs to earn their fee on a sales transaction.

DRE licensing

DRE issues licenses to individuals and corporations only.

The DRE license comes in two forms:

- the real estate **salesperson license**, also called a **sales agent license**; or
- the real estate **broker license**.[17]

14 Bus & P C §10166.02(b)
15 Bus & PC §§10000 et seq.
16 Bus & P C §10131(d)
17 Bus & P C §10131

DRE sales agent licensing

To obtain a DRE sales agent license, an individual needs to:

- be at least 18;
- complete three college-level licensing courses;
- submit fingerprints for a background check;
- prove legal presence; and
- pass a state examination.[18]

Fees for obtaining a sales agent license include:

- course fees payable to an approved course provider;
- a $60 examination fee;
- a $49 fingerprinting fee plus a fingerprint rolling fee of $20-$40; and
- a $245 license fee.

Once issued, the sales agent license is good for four years.

A DRE sales agent is only able to perform activities requiring a license when employed and paid by a DRE broker.[19]

DRE broker licensing

For an individual to obtain a DRE broker license, they need to:

- be at least 18;
- have at least two years' full-time experience as a real estate sales agent (or equivalent experience) OR a bachelor's degree with a major or minor in real estate;
- complete eight college-level licensing courses (less any courses taken when qualifying as a sales agent);
- prove legal presence;
- provide a place of business in the state; and
- pass a state examination.[20]

Fees for obtaining a broker license include:

- course fees payable to an approved course provider;
- a $95 examination fee;
- a $49 fingerprinting fee plus a fingerprint rolling fee of $20-$40; and
- a $300 license fee.

The broker license is good for **four years**.

Once licensed, a DRE broker is able to operate independently. Alternatively, they may opt to work under another broker as a broker-associate.

18 Bus & P C §10153.4; DRE Regulations §2750
19 Bus & P C §10132
20 Bus & P C §10153.2

DRE license renewal

A DRE broker or sales agent license is renewed with the DRE every four years from the date of issuance. Renewal consists of:

- confirming the DRE license is renewable;
- confirming legal presence; and
- completing 45 hours of continuing education.[21]

Fees for renewing a DRE sales agent license on time are course fees paid to an approved course provider and a $245 renewal fee paid to the DRE.

Fees for renewing a DRE broker license on time are course fees and a $300 renewal fee.

DRE MLO endorsements

The next step after obtaining a DRE license is to obtain the MLO endorsement.

Several DRE MLO endorsements exist:

- the individual sales agent MLO endorsement;
- the individual broker MLO endorsement;
- the sole proprietorship broker MLO endorsement (called a "company" MLO endorsement by the NMLS);
- the corporate broker MLO endorsement; and
- the branch office MLO endorsement.

The type of DRE MLO endorsement obtained depends on the DRE license held, and the licensee's business structure.

To perform MLO services, all brokers and sales agents are required to:

- obtain an individual MLO endorsement on their individual DRE license; and
- be employed by a proprietary or corporate broker with an MLO endorsement.

A DRE sales agent is only able to obtain an individual sales agent MLO endorsement. Further, they are only able to originate mortgages on behalf of an **employing broker** who also holds an MLO endorsement.[22]

For a proprietary broker and corporate broker to obtain an MLO endorsement, the designation of an individual DRE-licensed and MLO-endorsed broker is required.

Thus, an individual DRE broker may:

- obtain an MLO endorsement and arrange consumer mortgages as a broker-associate under an employing broker MLO;
- obtain both an individual broker MLO endorsement and a proprietary broker MLO endorsement and arrange consumer mortgages as a sole proprietor with the option of employing other MLOs; or

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21 Bus & P C §10170.5

22 Calif. Department of Real Estate Regulations §2756

- obtain a DRE corporate license, obtain both an individual broker MLO endorsement and a corporate MLO endorsement and arrange consumer mortgages as an individual employed by their corporate MLO, with the option of employing other MLOs under the corporate broker license and MLO endorsement.

The individual MLO endorsement

Brokers and sales agents apply for an individual MLO endorsement by first registering for an NMLS ID number.

To qualify for the MLO endorsement, they need to:

- complete 20 hours of pre-endorsement education;[23]
- successfully pass a written exam administered by the NMLS on federal and state mortgage lending laws;[24] and
- submit an application for the MLO endorsement through the NMLS.[25]

In addition to meeting the minimum requirements for all MLOs, DRE licensees may not have had an MLO license revoked in any governmental jurisdiction.

DRE doesn't enforce a minimum credit score. Likewise, negative financial events, such as bankruptcies, are not cause for an automatic denial of an MLO endorsement.

Instead, DRE looks for a history of liens, judgments, mishandling of trust funds or financial or personal conditions which indicate a pattern of dishonesty on the part of the applicant. The credit report is used to verify or refute the financial history provided in the application.[26]

DRE licensees with MLO endorsements do not need to post a surety bond, or meet minimum net worth requirements.

Individual endorsements require education, background checks and fingerprinting.

The individual sales agent MLO endorsement

To apply for an MLO endorsement as a DRE sales agent, the licensee completes NMLS Application Form MU4 online at the NMLS website.

Fees for obtaining an individual sales agent DRE MLO endorsement include:

- course fees payable to an approved course provider;
- a $300 DRE endorsement fee;
- a $30 NMLS processing fee;
- a $15 credit report fee; and
- a $36.25 background check fee.

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23 Bus & P C §10166.06(a)
24 Bus & P C §10166.06(d)
25 Bus & P C §10166.04(a)
26 Bus & P C §10166.05(c); DRE Regs. §2758.3

The broker-associate

Broker-associates are brokers who work in the employment of another broker. To originate consumer mortgages as a broker-associate, a DRE broker needs to obtain an individual broker MLO endorsement using NMLS Application Form MU4 online.

broker-associate
A Department of Real Estate (DRE)-licensed broker who works in the employment of another DRE broker.

Fees for obtaining an individual broker MLO endorsement include:

- course fees payable to an approved course provider;
- a $300 DRE endorsement fee;
- a $30 NMLS processing fee;
- a $15 credit report fee; and
- a $36.25 background check fee.

The broker as a sole proprietor

A DRE broker who practices as a **sole proprietor** needs to apply for both:

- an individual broker MLO endorsement, using NMLS Application Form MU4 online; and
- sole proprietorship broker MLO endorsement using the NMLS Application Form MU1 online.

In addition to meeting the requirements for the individual broker MLO endorsement, a broker practicing as a sole proprietor is required to provide on the application to the NMLS:

- any trade names in use;
- a registered agent for service of process;
- the broker designated as the qualifying individual; and
- an explanation of any criminal convictions.

The fee for the sole proprietor application is $100, payable to the DRE through the NMLS website.

The company MLO endorsement requires annual renewal.

Broker as a corporation

A DRE broker who practices under a **corporate license** is required to obtain both:

- an individual broker MLO endorsement using NMLS Application Form MU4 online; and
- a corporate broker MLO endorsement using the NMLS Application Forms MU1 and MU2 online.

In addition to meeting the requirements for the individual broker MLO endorsement, a broker practicing under a corporate MLO endorsement is required to provide on the application to the NMLS:

- any trade names in use;
- a registered agent for service of process;
- the broker designated as the qualifying individual;

- identification of non-licensed officers or stockholders owning 10% or more of the corporation; and
- an explanation of any criminal convictions.

The fee for the corporate DRE broker endorsement application includes:

- a $300 license fee;
- a $100 processing fee; and
- a $15 credit check fee for each of the non-licensed officers and stockholders.

Editor's note — All fees are payable through the NMLS website.

MLO branches

Branch offices require designation of a branch manager. In the application for the branch, the branch manager needs to explain any criminal convictions on their record and pay a $20 NMLS processing fee.

Annual endorsement renewal

All DRE MLO endorsements renew every calendar year between November 1st and December 31st. Renewal consists of:

- confirming the information on the NMLS registry is still current and correct;
- individual MLOs completing eight hours of NMLS-approved continuing education;[27] and
- paying fees to the DRE through the NMLS.

Total fees for renewing a DRE MLO endorsement are:

- $330 for an individual sales agent MLO endorsement;
- $330 for an individual broker MLO endorsement;
- $100 for a sole proprietorship broker endorsement;
- $400 for a corporate broker endorsement; and
- $20 for each branch office endorsement.

Under the DFPI

The other California agency which oversees MLOs is the DFPI. The DFPI oversees MLOs who make residential mortgages under one of two laws:

- the **California Financing Law (CFL)**;[28] and
- the **California Residential Mortgage Lending Act (CRMLA)**.[29]

The DFPI issues company and individual MLO licenses under the CFL and CRMLA. CFL and CRMLA MLO companies are only able to make or broker residential mortgages through licensed individual MLOs. Individual DFPI MLOs are required to work for a DFPI MLO company in order to originate residential mortgages.[30]

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27 Bus & P C §10166.10(a)-(b)

28 Fin C §§22000 et seq.

29 Fin C §§50000 et seq.

30 Fin C §§22100(d), 50002.5(c)

The CFL license

The CFL licenses allow MLOs to make, broker or service residential mortgages, but only to/for other CFL lenders.[31]

Further, a CFL MLO making a loan must lend their own funds. They may not fund a mortgage through a warehouse line of credit.[32]

However, CFL companies and their employees may make both secured and unsecured consumer and commercial loans.

The CRMLA license

In contrast, the CRMLA was created to license mortgage bankers whose main business is making and servicing consumer mortgages. The CRMLA license is the only license which authorizes the licensee to service loans which they did not originate or purchase, i.e., service loans for third parties.

The CRMLA MLO license authorizes a licensee to broker mortgages, but only to other CRMLA lenders, and state and federally chartered institutions.

The CRMLA MLO license does not require the licensee to have a California business address.[33]

Obtaining an MLO license from the DFPI

All entities — corporations, limited liability companies (LLCs), partnerships, trusts and sole proprietorships — are eligible to obtain a CFL or CRMLA MLO license.

The DFPI schemes call for the company to obtain a company MLO license, and its employees to obtain individual MLO licenses. The MLO endorsements available under the DFPI include:

- CFL company license;
- CRMLA company license;
- individual MLO license; and
- CFL or CRMLA branch licenses.

CFL and CRMLA company licenses

As with all MLOs, the first step is to obtain an NMLS ID.

Then, the application for an MLO company license under the DFPI scheme calls for:

- any trade names in use;
- a registered agent for service of process;
- identification of the qualifying individual of record;
- a business plan;
- a certificate of good standing from the California Secretary of State (SOS);
- formation or incorporation documents, if applicable;

31 Fin C §22004
32 10 Calif. Code of Regulations §1460
33 Fin C §§50000 et seq.

- a management chart, including a statement that all members, directors and principals are at least 18 years old;
- an organizational chart;
- fingerprints and background check authorization for the company's controlling members;
- an authorization of disclosure of financial records;
- financial statements showing a minimum net worth of:
  - $50,000 for a CFL license, if the company is only arranging loans;
  - $250,000 for a CFL license, if the company will make as well as arrange loans;[34] or
  - audited financial statements showing a minimum net worth of $250,000 for a CRMLA license;[35]
- surety bond coverage of $25,000 to $200,000 for each company license, depending on the company's residential mortgage volume in the preceding year;[36] and
- payment fees to the DFPI through the NMLS.

CRMLA licenses need to include proof of federal agency approval if they make or service consumer mortgages subject to the approval of any of the following entities:

- the *Federal Housing Administration (FHA)*;
- the *U.S. Department of Veterans Affairs (VA)*;
- the *Farmers Home Administration*;
- the *Government National Mortgage Association (Ginnie Mae)*;
- the *Federal National Mortgage Association (Fannie Mae)*; or
- the *Federal Home Loan Mortgage Corporation (Freddie Mac)*.

Individual DFPI MLO license

To obtain an individual MLO license under the DFPI scheme, an individual needs to:

- obtain an NMLS ID;
- complete 20 hours of pre-endorsement education, including two hours of DFPI-specific mortgage law;[37]
- successfully pass an exam administered by the NMLS on federal and state mortgage lending laws;[38]
- submit an application for the MLO endorsement through the NMLS;
- submit a statement of citizenship to the DFPI;[39] and
- pay fees to the DFPI through the NMLS.

34 Fin C §22104
35 Fin C §50201
36 10 CCR §1437, 10 CCR §1950.205.1
37 Fin C §§22109.2(a), 50142(a)
38 Fin C §§22109.3, 50143
39 Fin C §§22100 et seq., 50000 et seq.

In addition to meeting the minimum requirements for all MLOs, they need to show they have:

- never had an MLO license revoked by any regulatory agency; and
- obtained employment with a CFL or CRMLA MLO company.[40]

Fees for obtaining DFPI licenses are:

- $330 for an individual MLO license, plus a $15 credit report fee and a $36.25 background check fee, all paid through the NMLS;
- $400 for a CFL company MLO license paid through the NMLS, plus $20 per controlling member for LiveScan fingerprint processing paid through the DFPI; and
- $1,100 for a CRMLA company MLO license paid through the NMLS, plus $20 per controlling member for LiveScan fingerprint processing paid through the DFPI.

DFPI renewal

Both company and individual DFPI MLO licenses are good through December 31st of each year if issued prior to November 1st. Endorsements issued on or after November 1st are valid through December 31st of the next year.

The DFPI MLO licenses renew every calendar year between November 1st and December 31st. Renewal consists of confirming the information on the NMLS registry is still current and correct.

DFPI MLO renewal processing fees are:

- $100 for companies;
- $30 for individuals; and
- $20 for branches.

DFPI MLO companies also pay annual assessment fees based on their mortgage volume in the prior year. The minimum annual assessment is:

- $250 for a CFL license; and
- $1,000 for a CRMLA license.

Individual MLOs under the DFPI are required to:

- complete eight hours of NMLS-approved continuing education, including one hour of DFPI-specific mortgage law; and
- pay $330 renewal fees, plus an additional $100 reinstatement fee for late renewals.[41]

All fees are paid through the NMLS.

40 Fin C §§22109.1, 50141
41 Fin C §§22109.5(a), 50145

Chapter 2 Summary

The Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act) requires any individual who solicits consumer mortgage applications or arranges consumer mortgages as an occupation to:

- register as a mortgage loan originator (MLO) with the Nationwide Mortgage Licensing System (NMLS); and either
- be employed by a federally regulated bank; or
- hold a state MLO license.

The federal SAFE Act established two classes of MLOs:

- federally registered MLOs; and
- state-licensed MLOs.

For the state-licensed MLOs with which this material is concerned, two California state agencies license or endorse MLOs:

- the Department of Real Estate (DRE), which issues MLO endorsements to their licensed brokers and sales agents; and
- the California Department of Financial Protection and Innovation (DFPI), which issues MLO licenses under the California Financing Law (CFL) and the California Residential Mortgage Lending Act (CRMLA).

All brokers and agents who want to become an MLO, whether as individuals or as employing brokers, need to:

- submit an application to the NMLS;
- demonstrate financial responsibility and fitness to operate honestly, fairly and efficiently; and
- not have been convicted of, pled guilty or pled no contest to a felony in a domestic, foreign or military court during the timelines set by the SAFE Act.

In addition to NMLS minimum MLO honesty requirements, the DRE and DFPI each set their own requirements for MLO qualification and license retention.

Chapter 2 Key Terms

Chapter 3

Mortgage loan originator transitions

Learning Objectives

After reading this chapter, you will be able to:

- identify the overlapping requirements for obtaining and renewing a mortgage loan originator (MLO) endorsement or license under different licensing agencies;
- understand how to job-transition from one MLO licensing scheme to another; and
- determine the education and testing requirements for holding multiple MLO licenses.

Key Terms

active license

transitional license

Uniform State Test (UST)

MLOs in California

A Department of Real Estate (DRE)-licensed broker or sales agent who solicits or accepts a **consumer mortgage** application or arranges a *consumer mortgage* expecting a fee is classified as a **mortgage loan originator (MLO)**.

MLOs in California may be:

- licensed and regulated by the DRE or the California Department of Financial Protection and Innovation (DFPI); or
- registered with the Nationwide Mortgage Licensing System (NMLS), employed by federally regulated banks and controlled by federal law.

Editor's note — A consumer mortgage is a mortgage that:

- *funds a primarily personal, family or household use; and*

- *is secured by a one-to-four unit dwelling, owner-occupied or not.*[1]

A consumer mortgage is distinguished from a business mortgage. A business mortgage is a mortgage made primarily for business, investment or agricultural purposes.

The regulation of all MLOs is mandated by the federal **Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act)**.

The federal entity charged with regulating and enforcing the SAFE Act is the **Consumer Financial Protection Bureau (CFPB)**. Each state also enforces their adopted version of the SAFE Act for state-licensed MLOs.

Thus, an individual working in California as an MLO needs to be licensed under one or more of three MLO schemes:

- a *state-licensed MLO* holding a **DRE** license with an MLO endorsement;[2]
- a *state-licensed MLO* under the **DFPI**;[3] or
- a **federally registered MLO** working for a federally regulated bank.[4] [See Chapter 2]

Each of the three MLO schemes offers different benefits, depending on the type of employment or self-employment taken on by the MLO. However, an individual MLO's career often sees them transitioning between job opportunities moving from one type of employer to another.

Understanding how to smoothly transition between MLO licensing schemes is part of developing a career advancement plan.

State-licensed MLO guidelines

To understand the mechanics of transitioning from one consumer mortgage origination scheme to another, a general review of MLO licensing requirements is necessary.

To become a **state-licensed MLO**, individuals need to:

- complete pre-licensing coursework;
- pass exams on state and federal mortgage law;
- meet minimum financial and employment history requirements, as verified by credit and background checks; and
- register with the NMLS and receive an ID number.

In addition, each of the two California state licensing agencies impose their separate requirements.

The DRE, for example, requires an individual to hold a DRE real estate license before they may obtain an MLO endorsement. The DFPI, in contrast, issues MLO licenses directly to individuals and companies.[5]

1 Calif. Business and Professions Code §10166.01(d); Calif. Financial Code §§22012(e), 50003(p)
2 Bus & P C §10166.02(b)
3 Fin C §§22100(f), 50002.5(a)
4 12 United States Code §5103(a)
5 Bus & P C §10166.02(b)

Further, state-licensed MLOs need to renew their state MLO licenses or endorsement every year. The renewal process involves the completion of eight hours of continuing education (CE) approved by the NMLS, online renewal and the payment of renewal fees. State-mandated renewal requirements include a DFPI-specific course for DFPI MLOs, background checks and/or minimum financial requirements.

A bank's federally registered MLO employees

In contrast, employees of a federally regulated bank need only be **federally registered MLOs**. These bank-employed MLOs meet minimum financial and employment history requirements verified by credit and background checks. They do not need to pass state or federal exams or take pre-licensing education.

A bank-employed MLO may perform the services of an MLO only while they are employed by a federally regulated bank.

A federally registered MLO may also be employed by a DFPI-licensed MLO company without holding a DFPI MLO license, due to a DFPI exemption. No such exemption exists under the DRE scheme. A DRE MLO broker may only employ an MLO who holds a DRE license with an MLO endorsement.[6]

Federally registered MLOs are required to update their registration information in the NMLS registry within 30 days of:

- a change in the MLO's name;
- the MLO leaving the federally regulated bank's employment; or
- a change in the disciplinary history or legal actions taken against the MLO.[7]

The federally regulated bank is also required to report to the NMLS within 30 days of a change in a federally registered MLO's employment.[8]

Federally registered MLOs are not subject to NMLS CE requirements, but still renew their registration each year.

Common transitions between employers and basic requirements for making those transitions follow.

Note that the NMLS unique identification number (NMLS ID) used to identify each MLO follows the MLO throughout their career in consumer mortgage origination work — across different employers, MLO license types and states. The purpose of the NMLS ID is to allow consumers to see the MLO's employment and disciplinary history, regardless of which type of MLO they are.

6 Fin C§§22100(g), 50002(e); Bus & P C §10137

7 12 Code of Federal Regulations §1007.103(b)(1)

8 12 CFR §1007.103(e)(2)(ii)

From registered MLO to state-licensed MLO

Consider an individual who works for several years as a registered MLO with ABC Bank, a federally regulated bank. ABC Bank closes its consumer mortgage department. The MLO decides to go into business for themselves and open their own, non-federally regulated mortgage company.

May the MLO use their federally registered MLO status, without other licensing, to originate loans for their own non-federally regulated mortgage company?

No! A federally registered MLO is exempt from state MLO licensing only so long as the MLO is an employee of a federally regulated bank.

When not employed by a bank, the federally registered MLO is merely an unlicensed individual with an NMLS ID — unauthorized to work in consumer mortgage originations until individually licensed by the state or employed by a bank.

To continue their MLO activities after their bank employment terminates, the NMLS registrant needs to:

- acquire a state DFPI MLO license or a DRE license and MLO endorsement, then work for a DFPI MLO licensed employer or a DRE proprietary or corporate MLO broker; or
- find employment with another federally regulated bank.

Thus, if the federally registered MLO was not previously a DFPI-licensed or DRE-licensed MLO, they need to complete the required pre-licensing education and testing and meet DRE or DFPI standards to be qualified to work other than for a bank.

The CFPB does not provide for a transitional grace period after the MLO loses their bank employment until they become a state-licensed MLO.[9]

When a bank-employed MLO was previously state-licensed, they do not need to repeat the NMLS pre-licensing courses or exams they previously completed. However, they do need to fulfill any new state-licensed MLO requirements put in place after they completed the state requirements.

For example, consider an MLO who completes pre-licensing education, testing and background checks and becomes a state-licensed DFPI MLO. Later, they find employment with a federally regulated bank as a federally registered MLO. They let their DFPI MLO license lapse.

In 2015, the MLO leaves the employment of the federally regulated bank to form their own DFPI MLO mortgage company.

However, in the meantime, the DFPI began requiring two hours of California-specific mortgage law as part of its pre-licensing education requirements.

9 Consumer Financial Protection Bureau Bulletin from April 19, 2013

Since the MLO did not originally complete these two hours of California-specific mortgage law when they became a licensed DFPI MLO years earlier, they are now required to do so before they are eligible to reacquire a DFPI MLO license.

From state-licensed MLO to registered MLO

Now consider an individual who holds a DRE broker license and MLO endorsement. After originating consumer mortgages for a few years as an MLO broker, the broker decides to make a career change. They obtain a position with a federally regulated bank as a consumer mortgage loan officer. This change requires them to update their federally registered MLO status.

An MLO transitioning from acting as a state-licensed MLO (here, DRE) to employment as a federally registered MLO with a bank meets the federal registration requirements by:

- updating their principal place of business and business contact information in the NMLS registry;
- updating their ten-year financial services-related employment history;
- submitting new fingerprints to the NMLS for the background check;
- re-authorizing a background check;
- attesting to the correctness of the updated information; and
- re-authorizing the NMLS to publish their name, new principal place of business and any adverse disciplinary history to NMLS registry.[10]

Fingerprints on file with the NMLS are sufficient for the fingerprinting requirement if they are less than three years old.[11]

The federally regulated bank employing the registered MLO is then tasked with:

- bringing its information on file with the NMLS current; and
- confirming with the NMLS the employment of the transitioning MLO.[12]

Editor's note — These same steps are also taken when a federally registered MLO changes employment from one federally regulated bank to another.

Further, the DRE requires notification whenever an MLO begins or ceases consumer mortgage activity under their DRE MLO endorsement.[13] [See Chapter 8]

Intrastate: DRE to DFPI

Moving between state-licensed employers, one operating as a DFPI licensee and the other as an MLO-endorsed DRE licensee, also requires transitional steps.

10 12 CFR §1007.103(a)(4)
11 12 CFR §1007.103(a)(4)(i)(B)
12 12 CFR §1007.103(a)(4)(i)(C)
13 Bus & P C §10166.01

active license
A license status which allows an individual Department of Real Estate (DRE) licensee to perform mortgage loan originator (MLO) services as an employee of a Department of Financial Protection and Innovation (DFPI) MLO.

Individual DRE brokers and sales agents holding an **active license** with a **current MLO endorsement** are able to perform consumer mortgage activities as an employee of a DFPI MLO company without acquiring an additional license as a DFPI MLO. This employment need not be reported to the NMLS. Thus the NMLS registry does not reflect a DRE licensee's employment under a DFPI MLO company.[14]

For MLO transitions, the definition of an **active license** changes depending on whether the licensee is an employing broker, broker-associate or sales agent.

Active DRE brokers

A **DRE broker** has an *active DRE license and MLO endorsement* when:

- their DRE broker license is current and in good standing; and
- they are either:
    - a DRE broker holding both a current individual and a proprietary or corporate MLO endorsement; or
    - a broker-associate employed by a DRE broker who holds both their individual and a proprietary or corporate MLO endorsement.

Accordingly, a DRE broker who works alone (or employs other DRE licensees) needs both an individual MLO endorsement to their license and a separate sole proprietorship or corporate broker license with an MLO endorsement.

However, an MLO broker with only an individual MLO endorsement — i.e., not licensed and endorsed as a sole proprietorship or corporate MLO broker — who is not employed by an active DRE broker is inactive and may not act alone to arrange consumer mortgage.

To begin work employed by a DFPI MLO company, the unemployed broker-associate with only an individual endorsement needs to either:

- obtain an individual DFPI MLO license; or
- apply for a DRE proprietary or corporate broker license and MLO endorsement.

The second option provides the DRE broker the latitude to work for themselves as a DRE MLO under their corporate broker license and work for a DFPI MLO employer at the same time.

Active DRE sales agents

A **DRE sales agent** has an active license and MLO endorsement if:

- their DRE license is current and in good standing; and
- they are employed by a DRE broker who holds both an individual MLO endorsement and either a proprietary or corporate broker license with an MLO endorsement.

14 Fin C §§22100(b), 50002.5(a)

Once a DRE sales agent is no longer employed by an MLO-endorsed DRE broker, they are inactive. When they transition to a DFPI MLO employer, they need to acquire a DFPI MLO license to perform MLO services for the DFPI MLO company.

Education, testing and fingerprints

A transitioning DRE-licensed MLO is able to apply previously completed pre-licensing education towards their DFPI MLO license requirements. Since so much of the coursework involves federal mortgage law, this transferability of courses is common for all intrastate MLO transitions.[15]

However, any state agency-specific pre-licensing MLO education requirements need to be completed before the transitioning MLO is eligible for the new license.

To this end, California's DFPI requires two hours of DFPI-specific pre-licensing education. Thus, a DRE MLO transitioning to a DFPI MLO license needs to complete this pre-licensing requirement before they are eligible to obtain a DFPI MLO license.[16]

The federal and California-specific MLO exam requirements are the same for DRE and DFPI MLOs. However, when it has been five years or longer since the MLO held an active MLO endorsement or license, they are required to retake both exams to re-qualify. Time spent employed by a bank as a federally registered MLO is not counted towards the five-year period.[17]

Fingerprints, credit and background reports are also resubmitted to the NMLS.

If negative financial, criminal, civil or administrative history and explanations were previously filed with the MLO's DRE MLO application, the MLO may submit an affidavit to the DFPI in lieu of re-submitting this information. The affidavit gives the DFPI the authority to review the MLO's history and contact DRE for additional details.

A DRE MLO-endorsed proprietary or corporate MLO broker looking to transition to a DFPI MLO status and hire other MLOs is also required to meet net worth and surety bond requirements.

For renewal of a DFPI license, CE requirements have shifted from a generic one-hour elective each year to a DFPI-specific one-hour elective as part of the annual eight hours of CE.[18]

Intrastate: DFPI to DRE

The DRE MLO requirements are the strictest in the state. A DFPI MLO transitioning to a DRE MLO has no licensing or endorsement exemption to avoid DRE requirements. In order to work for a DRE MLO-endorsed corporate or proprietary broker, they must first obtain a DRE license and MLO endorsement.

15 Bus & P C §10166.06(c); Fin C §§22109.2(e), 50142(e)
16 Fin C §§22109.2(a)(4), 50142(a)(4)
17 Bus & P C §10166.06(j); Fin C §§22109.3(g), 50143(d)(4)
18 Fin C §§22109.5(a), 50145

Further, a DRE sales agent license and MLO endorsement allows the MLO agent to provide consumer mortgage services only under the employment of a DRE broker who holds an individual and a proprietary or corporate license, with MLO endorsements on both licenses.

DRE does not impose any DRE-specific pre-licensing or exam requirements for the MLO endorsement. Thus, the NMLS pre-licensing education and exams taken by a DFPI MLO meets DRE MLO endorsement requirements.

However, an MLO transitioning from DFPI to DRE needs to resubmit fingerprints, credit and background to the NMLS, with a full financial, criminal, civil or administrative history, and explanations of any negative history.

Interstate transitions

Any MLOs leaving California for employment also transition from one regulatory scheme to another.

Bank-employed federally registered MLOs moving out of state to be employed by a federally regulated bank and arrange consumer mortgages are required to update their MLO registration, but have no additional filings to make.

For DFPI- and DRE-licensed MLOs, other states' MLO licensing agencies have authority to agree to reciprocity agreements with agencies in other states. State agencies may take into consideration or rely on findings made by another state agency when evaluating an MLO applicant's eligibility.[19]

California does not have reciprocity agreements with other states. Thus, to move to California and perform MLO services, an individual needs an MLO license or endorsement under one of the three licensing and registration schemes: DRE, DFPI or solely federal registration.

transitional license
A provisional mortgage loan originator (MLO) license which allows an MLO moving to another state to perform MLO services for a short period of time while they fulfill requirements to obtain an MLO license in the new state.

California MLOs looking to move out of state need to check with their destination state's MLO licensing agency to see if it recognizes a **transitional license**. A *transitional license* allows the MLO to perform MLO services for a short period of time while they fulfill requirements to obtain a full state MLO license.

Before a transitional license can be issued, a state-licensed MLO is required to:

- meet the net worth or surety bond requirements of the new state; or
- pay into the new state's state fund.[20]

Neither DRE nor DFPI recognize a transitional license.

19 76 Federal Register 38464, 38482
20 CFPB Bulletin 2012-05

Multiple licenses

An alternative to transitioning from one scheme to another is to be licensed (or endorsed by DRE) under multiple schemes at once.

Of course, holding multiple licenses is less common for transitioning MLOs than for MLOs who actively provide MLO services in multiple states. For smaller MLO companies and individual MLOs, the time and money it takes to obtain and maintain multiple state licenses is to be weighed against the amount of business expected in the additional state.

For example, in some regions of the state, such as in the Lake Tahoe basin, holding multiple licenses is a logical business step to take to serve the basin's inhabitants.

Editor's note — The location of the financed dwelling determines the state agency from which the MLO is required to obtain the MLO license.

For instance, when the property securing the consumer mortgage is located in California, the MLO needs to hold either a DRE or DFPI *license. A Nevada MLO may not negotiate consumer mortgages for California properties by telephone from their Nevada location. This is an unlawful circumvention of California and federal SAFE Acts.*[21]

A common strategy for most MLOs is to expand to other regions. As of mid-2018, the average number of licenses held by a state-licensed MLO nationwide was 3.52, a figure that has increased steadily since the SAFE Act's inception.

Holding multiple MLO licenses commits an MLO to:

- fulfilling the individual state agency requirements to obtain each license; and
- renewing each state license, each year.

Licensing and renewal fees for each state are paid separately. For example, an individual MLO licensed as a DRE sales agent MLO and a DFPI MLO pays:

- $330 for the DRE MLO annual renewal; and
- $330 for the DFPI MLO annual renewal.

Uniform testing

Individuals seeking MLO licenses in multiple states need to meet each state agency's MLO exam requirement. The NMLS provides a **Uniform State Test (UST)** to make this easier.

MLO candidates who take the UST satisfy the NMLS testing requirements for licensure in any state which adopts the UST. The UST is integrated into the national MLO exam.

The DRE and DFPI adopted the UST on January 1, 2016.

Uniform State Test (UST)
A standardized test fulfilling both national and state components of the mortgage loan originator (MLO) exam.

21 HUD Commentary on Model State Law, Section E

Thus, an MLO whose first state license is with DRE or DFPI and who seeks MLO licensure in other states needs to determine whether they took the UST to fulfill their NMLS exam requirements.

When the DRE MLO took the UST within five years prior to seeking an MLO license in a state which has adopted the UST, they are not required to retake NMLS exams.

Renewal and continuing education

CE requirements vary from agency to agency, with a minimum of eight hours required for renewal.

The core requirements comprise seven of the eight hours:

- three hours of federal mortgage law;
- two hours of consumer protection and fraud;
- two hours of nontraditional mortgage products; and
- at least one hour of elective material.

An MLO with multiple MLO licenses needs to take the core requirements only once per year. Credit for the core requirements are applied to all state MLO licenses the MLO holds.

DFPI imposes an agency-specific elective hour; DRE accepts any elective hour approved by the NMLS.

Other conditions

In addition to education and fee considerations, state agencies may require state-specific conditions, such as:

- annual background checks;
- surety bond requirements;
- net worth requirements; and
- residency requirements.

Chapter 3 Summary

An individual working in California as a mortgage loan originator (MLO) needs to be licensed and endorsed under the Department of Real Estate (DRE), licensed by the California Department of Financial Protection and Innovation (DFPI)) or a federally registered MLO working for a federally regulated bank.

Understanding how to smoothly transition between MLO licensing schemes is part of developing a career advancement plan.

A federally registered MLO may work for a DFPI-licensed MLO company without holding a DFPI MLO license. However, the federal MLO registration alone will not permit employment by a DRE MLO proprietary or corporate broker.

A state-licensed MLO transitioning to a federally registered MLO with a bank meets the federal registration requirements by updating their information in their Nationwide Mortgage Licensing System (NMLS) account and resubmitting information for a new background check.

Individual DRE brokers and sales agents holding an active license with a current MLO endorsement are able to perform consumer mortgage activities as an employee of a DFPI MLO company without acquiring an additional license as a DFPI MLO. The definition of an active license changes depending on whether the licensee is an employing broker, broker-associate or sales agent.

A DFPI MLO transitioning to a DRE MLO must first obtain a DRE license and MLO endorsement.

California MLOs looking to move out of state need to check with their destination state's MLO licensing agency to see if it recognizes a transitional license. A transitional license allows the MLO to perform MLO services for a short period of time while they fulfill requirements to obtain a full state MLO license.

An alternative to transitioning from one scheme to another is to be licensed (or endorsed by DRE) under multiple schemes at once.

Chapter 3 Key Terms

Notes:

Chapter 4

Exclusions from MLO endorsement requirements

Learning Objectives

After reading this chapter, you will be able to:

- identify activities which do not trigger the need for a mortgage loan originator (MLO) endorsement to your Department of Real Estate (DRE) license; and
- determine the activities an unlicensed employee of an MLO broker may perform in connection with a consumer mortgage origination.

Key Terms

consumer mortgage
carryback mortgage
business mortgage

Exclusions by definition

Real estate licensees are permitted, as a service they may offer to members of the public for compensation, to take an application to make or arrange the terms of a consumer mortgage. However, to provide consumer mortgage services they need to hold a **mortgage loan originator (MLO) endorsement** issued by the Department of Real Estate (DRE), a requirement of California's **Secure and Fair Enforcement Act (SAFE Act)**.[1]

A **consumer mortgage** is a mortgage made by anyone to a buyer or owner:

- primarily to fund a personal, household or family use, called a consumer-purpose mortgage; and
- secured by a one-to-four unit residential property.[2]

consumer mortgage
A debt incurred primarily for personal, family, or household purposes and secured by a parcel of real estate containing one-to-four residential units.

1 Calif. Business and Professions Code §10166.01(b)
2 Bus & P C §10166.01(d); 12 Code of Federal Regulations §1026.43(a)

business mortgage
A debt incurred primarily for other than personal, family or household purposes, whether secured or unsecured.

Conversely, when a DRE licensee makes or arranges a mortgage for a non-consumer purpose — such as investment, agricultural or business mortgages, called **business mortgages** — they are not required to hold an MLO endorsement to receive a fee for this service. [See Chapter 2]

Further, a mortgage which funds a consumer purpose but is secured by any property other than a one-to-four unit residential property does not trigger the need for an MLO endorsement. Similarly, a business-purpose mortgage secured by a one-to-four unit residential property, whether or not it is owner occupied, does not trigger the need for an MLO endorsement.

Mortgage origination by other schemes

An MLO who engages in consumer mortgage activities as a Department of Financial Protection and Innovation (DFPI) licensee or solely under Nationwide Mortgage Licensing System (NMLS) registration rules (bank employee) are not required to hold a DRE license and MLO endorsement.[3]

Real estate activities

Licensees who only perform real estate sales, leasing or business mortgage activities do not need an MLO endorsement.

Thus, a sales agent or broker in the regular course of their sales activities and without expectation of an extra fee may advise their clients about mortgage features offered by lenders and assist them to shop several lenders for the purchase-assist mortgage needed to close escrow, all without holding an MLO endorsement. [See **RPI** Form 312]

However, when the broker (or their agent), receives any fees or other compensation from a lender or MLO, both the broker and the agent involved are required to first obtain an MLO endorsement.[4]

Consider a real estate broker employed by a seller to locate a buyer for the seller's single family residence. The seller owes more on their mortgage than the property is currently worth, called negative equity.

The broker locates a buyer willing to purchase the property for its current fair market value. As part of the broker's representation of the seller, the broker contacts the lender and negotiates a short payoff in the amount of the buyer's purchase price.

The lender accepts the short payoff, and escrow closes. The broker collects a fee from the seller for the broker's real estate sales transaction representation.

Is the broker in this scenario required to obtain an MLO endorsement on their license?

No! Although the broker is negotiating with a lender on behalf of the seller, the broker is performing the negotiations as part of their licensed real estate activities unrelated to the origination of a consumer mortgage.

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3 Bus & P C §10166.01(b)(2)(E)

4 Bus & P C §10166.01(b)(2)(B)

Funding vs. origination

A person who, in a calendar year, uses their own funds to make eight or more mortgages secured by one-to-four unit residential real estate, and which are not arranged by a threshold broker, is required to hold a California Department of Real Estate (DRE) broker license. [Calif. Business and Professions Code §10131.1(b)(1)(C)]

However, this exclusion rule to licensing for persons who make mortgages does not also exempt individuals who originate consumer mortgages from mortgage loan originator (MLO) endorsement requirements (and thus DRE licensing).

When a person collects compensation for arranging a consumer mortgage they also fund, the person is required to hold a DRE license with an MLO endorsement. This holds true even if the consumer mortgage is the very first mortgage the individual funds during the calendar year. [Bus & P C §10166.02(b)]

*In other words, the funding of eight or more mortgages triggers the DRE broker license; the origination (or arranging) of **just one** consumer mortgage triggers the need for a DRE license and MLO endorsement.*

Further and importantly, the broker does not receive a separate fee for negotiating the short payoff with the lender. The short sale negotiations were part of the broker's transaction agent activities representing a seller engaged in a short sale.[5]

Now consider a broker who advertises mortgage modification services for negative equity homeowners. They enter into an employment agreement with a homeowner to negotiate a short payoff with the homeowner's lender in exchange for a fee.

The broker negotiates a short payoff — a discount — and arranges a refinance for the homeowner. The broker is paid a fee from the homeowner upon close of the loan escrow.

Here, the broker is required to hold an MLO endorsement to their license. Their advertisement of mortgage modification services and their collection of a separate fee for the negotiation of the short payoff and refinance trigger the need for an MLO endorsement.[6]

Clerical exclusions for processors and underwriters

Individuals who provide administrative or clerical staff to perform "back-room" functions for MLOs are exempt from MLO endorsement.[7]

An MLO broker's unlicensed administrative or clerical employees may:

- prepare and design mortgage advertisements for the broker's review prior to use — writers and graphics;
- distribute preprinted advertisements or fact sheets about mortgages the broker is able to offer or negotiate — solicitations;
- make appointments for service providers, such as appraisers, to enter the real estate securing a mortgage; and

5 Calif. Department of Real Estate SAFE ACT – FAQ "Do the MLO License Endorsement Requirements Apply to Me?

6 DRE FAQ "Do the new MLO License Endorsement requirements apply to me?"

7 Bus & P C §10166.01(b)(2)

- make appointments for the buyer/owner or lender to meet with the broker or service provider — secretarial functions.

Others included under the clerical exemption are back-room employees such as loan processors and underwriters employed by the MLO broker to:

- *receive, collect or distribute information* required to process or underwrite a consumer mortgage; or
- *communicate with an applicant* to obtain information required to process or underwrite a consumer mortgage.[8] [See Chapter 9]

These back-room activities include:

- discussing the general terms of a mortgage based on information prepared or approved in writing by their employing broker;
- notifying a buyer or owner of any additional information required to complete a mortgage application;
- entering information provided by the buyer or owner in a pre-printed application form or computer database;
- accepting and providing a receipt on behalf of the broker for appraisal or credit fees;
- preparing requests for verification of employment, verification of deposits, credit reports or appraisal reports;
- assembling documents to be submitted to the lender with the mortgage application, with the broker's approval;
- obtaining signatures from the buyer/owner or service providers;
- contacting the lender to determine the status of a mortgage application;
- responding to an inquiry from the buyer or owner on the status of a mortgage application; and
- preparing documents related to the mortgage under the review or written approval of the broker.[9]

Materials distributed by the unlicensed assistant, loan processor or underwriter on the broker's behalf may not include the unlicensed employee's name or contact information.

Additionally, an unlicensed employee may not counsel or offer advice to the buyer or owner when performing any of the unlicensed activities listed above. Communications with a buyer or owner are to be based on the terms and features of the consumer mortgage approved by the broker and being processed under the homeowner's application.[10]

Loan processors and underwriters are required to hold an MLO endorsement when they:

- perform MLO activities, such as negotiating the terms of a consumer mortgage with the applicant;

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8 Bus & P C §10166.01(b)(2)
9 Calif. Department of Real Estate Regulations §2841
10 DRE Regs §2841

- advertise or present themselves to the public as an MLO; or
- perform loan processor or underwriter activities as an independent contractor, hired but not in the employ of the broker.[11]

Thus, independent underwriters and contract underwriting companies (such as private mortgage insurers) are required to comply with the SAFE Act licensing requirements.

The attorney exemption

When an attorney originates or arranges consumer mortgages for compensation, they are required to hold a DRE license and MLO endorsement. In this respect, they are just like any other licensee, apart from their status as an attorney.

However, a small exception exists for attorneys who negotiate, arrange or otherwise originate consumer mortgages as part of their representation of a client when acting solely in their capacity as an attorney.

An attorney is NOT required to be licensed under the SAFE Act — DRE licensed and MLO endorsed — when their consumer mortgage origination activities are:

- considered to be an authorized practice of law within the state;
- carried out within an attorney-client relationship; and
- accomplished within the applicable laws.[12]

Thus, attorneys are afforded an exemption when they perform MLO activities as an ancillary matter to their representation of a client and do not hold themselves out as consumer mortgage arrangers or originators.

Seller carrybacks

Consider the owner of a single family residence. The owner sells their home to a buyer without the assistance of a sales transaction agent. The buyer or their family members will occupy the property as their residence. The terms for payment of the price include a seller carryback note and trust deed, called a **carryback mortgage** or installment sale. Thus, the financing — credit — extended to the buyer to fund the purchase price is for a consumer purpose.

carryback mortgage
A note and trust deed executed by a buyer of real estate in favor of the seller for the unpaid portion of the sales price on closing, also known as an installment sale, credit sale or seller financing.

The owner does not collect a fee for negotiating the credit in the form of the installment sale financing available to the buyer. Is the owner required to hold a DRE license and MLO endorsement since they are originating a consumer mortgage?

No! The carryback seller does not collect a fee for agreeing to make a consumer mortgage — the origination of a carryback note and trust deed. Thus, they are not required to hold a DREDRE license and MLO endorsement.

11 Bus & P C §10166.03

12 12 CFR §1008 Appendix D

Now consider the seller of a single family residence who is represented by a real estate broker. The real estate broker or their agent holds himself out to be a carryback expert who has arranged numerous installment sales in the past for sellers and buyers of homes.

The real estate broker negotiates the carryback financing arrangement with a buyer who will occupy the dwelling. The real estate broker collects a brokerage fee for his real estate sale activities as a transaction agent. Further and critically, the broker does not charge or collect a separate fee from the seller or buyer for negotiating the sale on terms including a carryback installment mortgage.

Is the broker required to be licensed as an MLO?

No! The broker in this scenario is merely performing a real estate sales activity for a fee, a transaction which does not trigger the need for an MLO endorsement.

However, had the broker charged and collected a separate fee from the seller or buyer for negotiating the carryback note and trust deed – the consumer mortgage aspect of the single family residence sales transactions – they would have needed to hold an MLO endorsement on their DRE license.[13]

13 DRE FAQ "Do the new MLO License Endorsement requirements apply to me?"

Chapter 4 Summary

A real estate licensee is required to hold a mortgage loan originator (MLO) endorsement when they take an application for, offer or negotiate the terms of a consumer mortgage in exchange for compensation.

An MLO who engages in MLO activities as a licensee of under the Department of Financial Protection and Innovation (DFPI)) or under the Nationwide Mortgage Licensing System (NMLS) federal registration rules are not required to hold a Department of Real Estate (DRE) license and NMLS endorsement.

Further, licensees who only perform real estate brokerage activities are exempt from MLO endorsement, as are individuals who provide administrative or clerical staff to MLOs are exempt from MLO endorsement. Included under the clerical exemption are loan processors and underwriters who are employed by the MLO or the MLO's broker.

A small licensing exception exists for attorneys who negotiate, arrange or otherwise originate loans as part of their representation of a client in their capacity as an attorney.

Lastly, a broker who arranges a carryback mortgage, but does not charge a separate fee for negotiating the carryback mortgage does not trigger the MLO endorsement requirement.

Chapter 4 Key Terms

business mortgage .... pg. 40
carryback mortgage .... pg. 43
consumer mortgage .... pg. 39

Notes:

Chapter 5

The Nationwide Mortgage Licensing System and Registry

Learning Objectives

After you read this chapter, you will be able to :

- locate public information about mortgage loan originators (MLOs) on the Nationwide Mortgage Licensing System (NMLS) website; and
- keep current with MLO statistics.

Key Terms

mortgage loan originator (MLO)

Nationwide Mortgage Licensing System (NMLS)

NMLS consumer access

Each state is compelled to adopt and enforce a minimum standard for **mortgage loan originator (MLO)** licensing under the federal *Secure and Fair Enforcement for Mortgage Licensing Act* (*SAFE Act*). California adopted its version of the SAFE Act in 2010. To implement the SAFE Act, the California Department of Real Estate (DRE) and the **Nationwide Mortgage Licensing System (NMLS)** work together.

mortgage loan originator (MLO)
An individual who receives fees to arrange a consumer mortgage.

Editor's note — The NMLS is also sometimes called the Nationwide Multistate Licensing System.

Nationwide Mortgage Licensing System (NMLS)
The national registry of consumer mortgage loan originators (MLOs).

The minimum standards for DRE licensees who arrange consumer mortgages for a fee as MLO endorsees are set by the DRE.[1]

On the other hand, the NMLS, a federal agency:

- processes MLO applications;
- assigns unique NMLS ID numbers; and
- administers the national MLO registry.

1 Calif. Business & Professions Code §10166.01 et seq.

Recall that one of the goals of the SAFE Act is to provide mortgage consumers with a national database of public information about mortgage loan originators. The NMLS Consumer Access website meets this goal. The NMLS Consumer Access website gives mortgage consumers access to their MLOs' licensing and employment records.

The fully-searchable list is updated nightly and features information on MLOs such as:

- whether an individual acting as an MLO is federally registered;
- the MLO's unique identifier (NMLS ID);
- the MLO's phone number;
- whether an MLO is licensed, and in what states;
- the company or companies the MLO is currently working for and has worked for in the past;
- whether an MLO is engaged in other lines of business;
- the MLO's aliases, if any;
- the MLO's criminal record, if any; and
- any disciplinary actions taken against the MLO.

Common misconceptions MLOs have about the Consumer Access site include:

- "NMLS exam scores are available on the Consumer Access site." In fact, NMLS exam scores are not available on the site. Consumers cannot see how MLOs have done on their federal or state exams. Consumers also cannot see how many times MLOs have taken either exam.
- "My credit scores/reports are available on the site." In fact, personal financial information is not available on the Consumer Access site. The credit report and any scores obtained as part of the MLO application are protected by federal privacy rules, including the SAFE Act.[2]

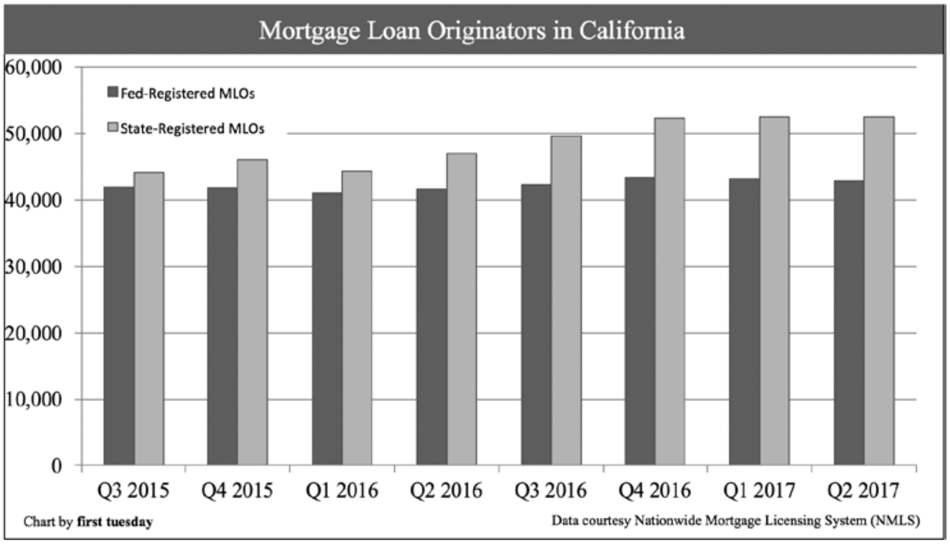
Current MLO trends

For California, 41,717 MLOs were registered at the federal level in the second quarter (Q4) of 2018. This was level with a year earlier. These MLOs are employees of banks.

State-licensed MLOs in California totaled 55,360 in Q2 2018, up 5% from a year earlier. These MLOs are licensed by the **California Department of Financial Protection and Innovation (DFPI)** or the **DRE**.

California accounts for 35% of the nation's state-licensed MLO population (we are 12% of the nation's population). This indicates mortgage bankers are relying on broker-packaged originations for business. However, stagnant mortgage originations will dampen the growth in state licensed MLOs in the coming year.

2 12 United States Code §5111



This chart displays the number of federally registered MLOs and state-licensed MLOs in California.

Figure 1

Mortgage Loan Originators in California

MLOs on the rise

Federally registered MLOs are employed by federally regulated entities. In other words, these MLOs work for *big banks* like Chase, Wells Fargo or Bank of America, etc.

State licensed MLOs are mortgage brokers and mortgage bankers. In California, state licensed MLOs are regulated by either:

- the **DRE;** or
- the **DFPI**.

The DFPI had the lion's share of California's MLO applications and MLO licenses issued in Q2 2018, as:

- DRE received 485 new applications for individual licenses and approved 248 individuals (including pending applications from the prior quarter); while
- the DFPI received 2,098 new applications and approved 2,569 individuals (including pending applications).

The general trend for state-licensed MLOs is up, while federally registered MLOs remain about even. Further, California accounts for one-third of the nation's MLO population licensed by state entities.

Future MLO trends

The number of state-licensed MLOs increases throughout the year, and takes a dip in the first quarter of every year. All MLO licenses expire at the end of the calendar year. The January drop-off is due to licensees choosing not to renew at the end of the prior year.

Thus, expect to see a small dip in state-licensed MLOs through mid-year, to be regained and exceeded over the rest of the year. [See Figure 1]

Chapter 5 Summary

California adopted its version of the Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act) in 2010. To implement the SAFE Act, the Department of Real Estate (DRE) and the Nationwide Mortgage Licensing System (NMLS) work together.

Federally registered MLOs are employed by federally regulated entities. In other words, these MLOs work for big banks. State licensed MLOs are mortgage brokers and mortgage bankers. In California, state licensed MLOs are regulated by either the DRE or the Department of Financial Protection and Innovation (DFPI).

The general trend for state-licensed MLOs is up, while federally registered MLOs remain about even. Further, California accounts for one-third of the nation's MLO population licensed by state entities.

Chapter 5 Key Terms

Chapter 6

Mortgage loan originator compensation rules

Learning Objectives

After reading this chapter, you will be able to:

- identify the circumstances and activities which establish a person as a mortgage loan originator (MLO) under the Truth in Lending Act (TILA);
- differentiate between allowable and non-allowable MLO compensation on a consumer mortgage transaction; and
- identify MLO-prohibited activities under steering prohibitions.

Key Terms

advance fee

discount point

individual mortgage loan originator (MLO)

mortgage loan originator (MLO) broker

mortgage steering

upcharging

Who is subject to the MLO compensation rules?

In response to **mortgage loan originator (MLO**) abuses during the mortgage and housing boom, Regulation Z (Reg Z) was amended to prohibit any person from compensating an individual MLO or MLO broker based on the terms or conditions of a consumer mortgage.

An MLO is an individual or corporation licensed and endorsed by the Department of Real Estate (DRE) or licensed by the California Department of Financial Protection and Innovation (DFPI) who, for compensation or other gain, negotiates or arranges a **consumer mortgage** for another individual, typically a homebuyer.[1]

1 12 Code of Federal Regulations §1026.36(a)(1)(i)

MLO status includes:

- mortgage brokers and their employees who perform MLO services;
- a mortgage lender's employees who perform MLO services;
- warehouse lenders, sometimes called mortgage bankers; and
- any lender who makes mortgages using funds which it does not own, e.g., deposits.[2]

To distinguish, a *mortgage broker* is an MLO who is not an employee of a lender. MLO status includes DRE-licensed and MLO-endorsed brokers who engage in the practice of originating consumer mortgages, and any employees of those brokers who engage in the practice of originating consumer mortgages such as licensed agents and broker-associates who hold MLO endorsements.[3]

individual mortgage loan originator (MLO)
A natural person who meets the definition of a mortgage loan originator (MLO).

Further, MLOs are either:

- **individual MLOs**, defined as natural persons who meet the definition of an MLO such as agents and brokers individually licensed and MLO-endorsed by the DRE;[4] or
- **MLO brokers**, defined as MLOs other than natural persons such as corporate brokers licensed and MLO-endorsed by the DRE.[5]

mortgage loan originator (MLO) broker
A mortgage loan originator (MLO) who is other than a natural person, such as a corporate broker.

Individual MLOs do *not* include:

- individuals who performs purely *administrative or clerical tasks* on behalf of an MLO broker or agent;
- the employee of a *manufactured home retailer* who does not take an application or advise consumers on credit terms;
- an individual or entity who only performs real estate brokerage activities as a transaction agent on the sale of a home, unless they are also compensated by an MLO or mortgage lender; and
- mortgage servicers or their employees, as long as they do not offer or negotiate a transaction that constitutes a refinance.[6] [See Chapter 1]

In California, a **carryback seller** of a home to a buyer who will occupy the property is not an MLO unless they bargain for or receive additional compensation beyond the sales price and interest for agreeing to carryback a mortgage.[7]

Prohibited compensation

When an MLO originates a consumer mortgage, no part of the compensation paid by any person and received by an MLO may be based on:

- the terms or conditions of a mortgage transaction;
- the terms of multiple mortgage transactions by the MLO; or
- the terms of multiple mortgage transactions by multiple individual MLOs.[8]

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2 12 CFR §1026.36(a)(1)
3 12 CFR §1026.36(a)(2); Official Interpretation of 12 CFR §1026.36(a)-2
4 12 CFR §1026.36(a)(1)(ii)
5 12 CFR §1026.36(a)(1)(iii)
6 12 CFR §1026.36(a)(1)(i)
7 Calif. Business and Professions Code §1066.01(b)(1)
8 12 CFR §1026.36(d)(1)

The rule prohibits compensation of a corporate or individual MLO based on the terms of the mortgage, which include:

- the interest rate of the mortgage originated;
- whether the mortgage contains a prepayment penalty;
- the annual percentage rate (APR);
- the loan-to-value ratio (LTV); or
- whether the homebuyer's title insurance was purchased from an affiliate of the broker.[9]

The terms of a consumer mortgage do not include the principal amount of the mortgage. Thus, MLO compensation may be based on the amount of the mortgage or mortgages the MLO originates. While the MLO's compensation may be a percentage of the mortgage amount, the percentage may not vary from one mortgage to the next based on the differing mortgage amounts.[10]

For example, a lender or MLO broker who offers an MLO 1% of the mortgage amount on **all mortgages** arranged by the MLO conforms to regulations. However, a lender who offers an MLO 1% of the loan amount for mortgages of $300,000 or more and 2% of the loan amount for mortgages less than $300,000 violates the prohibitions.[11]

Allowable compensation

MLO compensation includes salaries, fees, commissions or annual or periodic bonuses, awards of merchandise, services, trips, i.e., any compensation collected which the MLO retains. The name given a fee is irrelevant for determining whether it is compensation.[12]

Costs collected by an MLO from the homebuyer to pay third-party charges such as for an appraisal or title insurance are not compensation. They are trust funds held by the MLO but belonging to the homebuyer.

However, when the MLO marks-up the price of third-party services and pockets the difference, a practice called **upcharging**, the difference is MLO compensation. When an MLO estimates a third-party service charge within a reasonable range and the third-party service charge turns out to be less than the estimate, the difference between the two charges while being trust funds is not considered compensation if taken as additional compensation.[13]

upcharging
The practice of marking up the price of a third-party service and keeping the difference.

Other examples of allowable bases for a lender to compensate an MLO broker include:

- the MLO broker's overall dollar volume delivered to the lender;
- the long-term performance of a an MLO's mortgages;
- hourly pay for the actual number of hours worked for the lender;
- pay dependent on whether the homebuyer is a new or existing customer;

9 12 CFR §1026.36(d); Official Interpretation of 12 CFR §1026.36(d)(1); 12 CFR §1026.36(d)(1)
10 12 CFR §1026.36(d)(1)(ii)
11 Official Interpretation of 12 CFR §1026.36(d)(1)-9
12 Official Interpretation of 12 CFR §1026.36(a)-5(ii)
13 Official Interpretation of 12 CFR §1026.36(a)-5(v)

- a payment fixed in advance for the volume of mortgages originated with the lender (e.g., $1,000 for the first 100 mortgages originated, and $1,500 for all mortgages above the 100-mortgage threshold);
- the percentage of closed mortgages to mortgage applications submitted to the lender; and
- the accuracy and completeness of the submitted mortgage files.[14]

These MLO compensation rules also apply to an MLO or MLO broker who pays individual MLOs, such as MLOs they employ.

For example, an MLO broker may not pay another MLO, such as an MLO employee, more for generating a mortgage with a 7% interest rate than they would pay for a mortgage of the same amount with a 6% interest rate. Thus, an MLO may not be paid by the lender or their MLO broker based on the yield spread premium, a type of kickback commonly paid to MLOs before the Great Recession.[15]

Occasionally, a homebuyer pays a fee to the MLO. However, when an MLO receives any compensation for their mortgage services from the homebuyer, the MLO may not receive compensation for mortgage services from anyone else in the same mortgage transaction.

An MLO broker may not base fees paid to their MLO employees on the terms of the mortgage, other than a percentage of the mortgage amount.[16]

Again, MLOs need to be federally registered and state licensed and DRE endorsed (unless a DFPI licensee) to practice. However, non-licensed employees of an MLO broker also need to:

- meet standards similar to those given in the **Secure and Fair Enforcement for Mortgage Licensing (SAFE) Act**, especially as it applies to criminal background checks; and
- receive professional training appropriate to their duties.[17]

Steering prohibitions

MLOs may not direct or "steer" a homebuyer to a consumer mortgage product with terms or conditions which will generate greater compensation for the MLO — unless the mortgage is in the homebuyer's interest.

mortgage steering
A mortgage loan originator (MLO) practice of directing a homebuyer to a consumer mortgage with less favorable terms in order to obtain greater compensation.

To avoid **mortgage steering**, an MLO will present the homebuyer with mortgage options for all types of mortgages the homebuyer expresses an interest in, including:

- a fixed rate mortgage (FRM);
- an adjustable rate mortgage (ARM); and
- reverse mortgages.[18]

14 Official Interpretation of 12 CFR §1026.36(d)(1)-2(i)
15 Official Interpretation of 12 CFR §1026.36(d)
16 12 CFR §1026.36(d)(2)
17 12 CFR §1026.36(d)(3)(i)
18 12 CFR §1026.36(e)(2)

The MLO broker needs to make available mortgage products from at least three lenders the MLO does business with regularly, and needs to present to the homebuyer themselves or through their MLO agents:

- the mortgage with the lowest interest rate;
- the mortgage with the lowest interest rate without:
  - negative amortization;
  - a prepayment penalty;
  - a balloon payment within the initial seven years of the mortgage;
  - a demand feature; or
  - shared equity or appreciation; and
- the mortgage with the lowest total dollar amount for origination points and/or **discount points**.[19]

discount point
The amount of money the borrower or seller must pay the lender to get a mortgage at a stated interest rate.

Editor's note — A discount point is the amount of money the homebuyer or seller needs to pay the lender to get a mortgage at a stated interest rate. A point equals one percent of the mortgage.

The mortgages an MLO presents to a homebuyer need to be based on the homebuyer's **ability to repay** to comply with anti-steering rules.[20] [See Chapter 10]

Additionally, an MLO is charged with conducting negotiations and arrangements with homebuyers not to:

- steer a homebuyer into a mortgage with terms the homebuyer is not reasonably able to pay back;
- steer a homebuyer into a mortgage with predatory terms such as excessive fees or rates;
- steer a homebuyer away from *qualified mortgages* to *non-qualified mortgages*, as defined by the Truth in Lending Act (TILA);
- discriminate against homebuyers based on race, ethnicity, gender or age;
- misrepresent the credit history of a homebuyer;
- misrepresent the availability of a residential mortgage to a homebuyer;
- misrepresent the appraised value of a property; or
- discourage homebuyers from seeking less expensive mortgages from competing MLOs.[21]

To satisfy these requirements against steering, the MLO need not actually receive an offer from the lender to fund the mortgage disclosed to the homebuyer. The MLO may independently determine what their lender will accept in terms and conditions based on a reasonable review of the homebuyer's creditworthiness and available lender requirements.[22]

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19 Official Interpretation of 12 CFR §1026.36(e)(3)-1; 12 CFR §1026.36(e)(3)

20 12 CFR §1026.36(e)(4)

21 15 United States Code §1639b(c)(3)

22 Official Interpretation of 12 CFR §1026.36(e)(1)-2

Home equity lines of credit (HELOCs) are exempt from these requirements, as are mortgages on timeshare plans.[23]

Advance fees prohibited

advance fee
A fee paid in advance of any services rendered.

An **advance fee** is a fee an MLO receives before the service is fully completed.[24]

In California, advance fees are trust funds when received. Also, before an MLO collects an advance fee they must first submit form agreements and receive approval from the DRE. The MLO seeking to collect an advance fee needs to submit all materials used to obtain an advance fee agreement at least ten calendar days before use. DRE has ten days from the date of receipt to determine whether the materials are misleading.[25]

An MLO who collects an advance fee needs to deposit the full amount in a trust account with a bank. These funds are only to be withdrawn for benefit of the agent after the advance-fee services have been completed and an itemized billing presented to the homebuyer. Until that time, the funds remain the property of the person paying the fee.[26]

However, an MLO negotiating, attempting to negotiate or arranging the modification or forbearance of a consumer mortgage is barred from collecting any advance fees.[27]

MLO compensation: paid by other than the homebuyer

Any party, such as the lender, who is aware the homebuyer is compensating the MLO may not pay any compensation to the MLO broker for mortgage services.[28]

Direct payments received by an MLO from the homebuyer include payments made out of the mortgage proceeds via the home sale escrow, title insurer or otherwise. However, when the homebuyer pays points to the lender who funds the mortgage, the lender's payment of compensation to the MLO is not a direct payment by the homebuyer.

Here, the lender is deemed to have paid the MLO. However, when the lender pays the MLO broker, the MLO is prohibited from receiving any payment from the homebuyer.[29]

Further, when an MLO broker receives compensation directly from the homebuyer, neither the MLO broker nor any employees of the MLO broker may receive any type of compensation from the lender in connection with the same mortgage transaction.[30]

23 12 CFR §1026.36(b)
24 Calif. Bus & P C §10026
25 Calif. Bus & P C §10085
26 Calif. Bus & P C §10146
27 Calif. Bus & P C §10085.6
28 12 CFR §1026.36(d)(2)(i)(A)
29 12 CFR §1026.36(d)(2)(i)-2
30 Official Interpretation of 12 CFR §1026.36(d)(2)(i)-1

On receiving compensation from the homebuyer, an MLO broker may split the compensation with an individual MLO in their employ. This allows an MLO broker to pay its employed MLOs.[31]

In a consumer mortgage transaction, *MLO brokers* may collect a separate fee for performing other sales transaction services not included as part of mortgage origination services. However, an MLO broker may not base payment of compensation to its employed MLOs or other employees involved in their mortgage origination activities on whether the homebuyer uses other services provided by the MLO broker. For example, an MLO broker cannot charge homebuyers 1% of the mortgage amount as their MLO fee when they use escrow services provided by the MLO broker, but a 2% MLO fee when the homebuyer escrows with a third-party escrow service provider.[32]

Recordkeeping rules

For mortgage applications, lenders and MLO brokers are to keep records on compensation an MLO broker receives from lenders. MLO brokers are to keep records on their payments to individual MLOs for three years after the date of payment.[33]

Records include documentation of compensation agreements existing between an MLO broker and their individual MLOs.[34]

Guidance on 401k and retirement plan payments

An individual MLO may receive compensation in the form of 401Ks, stock plans or tax-deferred retirement plans. However, the employing MLO broker's contributions may not be based on transaction terms generated by the individual MLO.[35]

Further, an individual MLO employed by an MLO broker may receive a non-deferred bonus based on the MLO broker's profits attributable to the individual MLO's origination activities, but only when one of the following criteria is met:

- the bonus does not exceed 10% of the individual MLO's total compensation paid by the MLO broker for the time period used to determine the bonus-based profits; or
- the individual MLO has originated ten or fewer mortgage transaction during the preceding 12-month period.[36]

Miscellaneous additions

The mortgage compensation rules also prohibit:

- mandatory *arbitration*; and
- financing credit insurance.

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31 12 CFR §1026.36(d)(2)(i)(C)
32 Official Interpretation of 12 CFR §1026.36(a)-5(iv)
33 12 CFR §1026.25(c)(2)(i)
34 12 CFR §1026.25(c)(2)(ii)
35 12 CFR §1026.36(d)(1)(iii)
36 12 CFR §1026.36(d)(1)(iv)(B)

A homebuyer and lender may arbitrate to settle a dispute on the transaction. However, the terms of the mortgage may not require arbitration or any other non-judicial action for settling claims, and may not bar the homebuyer from bringing an action to court for:

- closed-end consumer mortgages; and
- HELOCs secured by a principal residence.[37]

A lender is prohibited from financing directly or indirectly premiums or fees for credit insurance in connection with a consumer mortgage transaction, including a HELOC.[38]

37 12 CFR §1026.36(h)
38 12 CFR §1026.36(i)

Chapter 6 Summary

A mortgage loan originator (MLO) is an individual or corporation licensed and endorsed by the Department of Real Estate (DRE) or licensed by the California Department of Financial Protection and Innovation (DFPI) who, for compensation or other gain, negotiates or arranges a consumer mortgage for another individual, typically a homebuyer.

When an MLO originates a consumer mortgage, no part of the compensation paid by any person and received by an MLO may be based on:

- the terms or conditions of a mortgage transaction;
- the terms of multiple mortgage transactions by the MLO; or
- the terms of multiple mortgage transactions by multiple individual MLOs.

MLOs may not direct or "steer" a homebuyer to a consumer mortgage product with terms or conditions which will generate greater compensation for the MLO — unless the mortgage is in the homebuyer's interest.

Any party, such as the lender, who is aware the homebuyer is compensating the MLO may not pay any compensation to the MLO broker for mortgage services.

For mortgage applications, lenders and MLO brokers are to keep records on compensation an MLO broker receives from lenders.

The mortgage compensation rules also prohibit:

- mandatory arbitration; and
- financing credit insurance.

Chapter 6 Key Terms

Notes:

Chapter 7

Office management for mortgage brokers

Learning Objectives

After reading this chapter, you will be able to:

- understand the process of creating a well-thought-out business plan for a brokerage firm conducive to the type of services offered; and
- identify the need for supervision and licensing compliance standards within the brokerage firm.

Key Terms

Articles of Incorporation

errors and omissions (E&O) insurance

sole proprietor

The employing broker's management

A mortgage brokerage firm needs a detailed business plan. The well-thought-out plan for a firm's mortgage operations includes specifics about:

- business legal structure;
- DBA ("doing business as") brand recognition;
- services offered;
- operating structure;
- licensing compliance;
- employee supervision;
- employee compensation; and
- regulatory reporting.

Sole proprietorship vs. corporation

Real estate brokers rendering services to the public, independent of a broker-associate relationship with another broker, choose one of two business structures to operate their brokerage:

- a California corporation; or
- a sole proprietorship.

Corporate brokerage

Brokers who form a corporation for conducting their brokerage operations do so to limit personal liability exposure due to the conduct of employees.

Operating as a corporation, the individual broker serves as the entity's **designated broker-officer** for licensing purposes. The broker will be the corporation's corporate officer responsible to the public and the California Department of Real Estate (DRE) for the operations of the business and supervision of its employees, including all licensees employed by the corporation.

A broker who wants to establish a corporation needs to:

Articles of Incorporation
An instrument setting forth the basic rules and purposes under which a private corporation is formed.

- file **Articles of Incorporation** with the California Secretary of State (SOS) establishing the corporation;
- register a **Fictitious Business Name Statement** with the county clerk of the county of the corporation's principal place of business when a name different from the corporation's is used to conduct business; and
- submit a **Corporation License Application** to the DRE completed by the *designated broker-officer* applicant and each broker-officer who acts for and on behalf of the corporation. [See RE 201]

A DRE corporate broker-officer license may be obtained by an individual:

- currently licensed as a DRE broker; or
- who is qualified to obtain a broker license by having passing the DRE state licensing examination within the 12-month period prior to applying for the broker-officer license.

The corporate officer license is needed to qualify the corporation for a license. The officer license is separate from an individual broker license. However, the individual need not be licensed as a DRE broker to be licensed as a broker-officer.

Further, the licensed officer qualifying the corporation will only be allowed to conduct licensed activities directly with members of the public on behalf of the corporation. Thus, they cannot conduct any licensed activities outside of the corporation unless they obtain and maintain an individual DRE broker license.

In addition to the primary broker-officer designated to qualify the corporation for its broker license, the DRE will issue any number of broker-officer licenses sought. Additional broker-officer licenses may be obtained by other brokers holding an officer title in the corporation who conduct activities on behalf of the corporation requiring a broker license.

The corporate liability shield

A broker who, as a licensed officer, operates a corporation is afforded a personal liability defense as a shield against:

- acts of others employed by the corporation; and
- debts and obligations entered into solely by the corporation.

Here, the corporation provides protection to the broker-officer by preventing corporate creditors from going after the personal assets of the individual who is the broker-officer to satisfy a corporate business monetary obligation.

However, the liability shield is not available to bar a creditor from pursuing recovery for personal obligations of the broker-officer arising out of their conduct in the operations of the corporation's brokerage business.

Conceptually, the use of a corporation to conduct a brokerage separates business assets from personal assets. Each individual owner of the corporation is legally distinguishable from the corporation they own. The corporation and the individuals have separate obligations, liabilities and assets.

Thus, when the corporation is sued or files for bankruptcy, the "owner's" personal assets will not be at risk — unless they manage their personal expenses under the corporate umbrella, the alter-ego situation.

However, the separate liability provided by a corporation for its business operations does not protect the broker-officer from liability for their individual professional activities acting as a real estate agent on behalf of the corporation. Here, the corporate shield against a money judgment award due to the broker-officer's personal conduct does not protect them when they are an active participant in the transaction which becomes the subject of litigation.

The sole proprietor

Alternatively, a broker who conducts business as an individual and does not operate through a licensed corporate entity is a sole proprietorship by default. Thus, the individual broker operating as a **sole proprietor** is the business.

sole proprietor
A broker who conducts business as an individual rather than through a licensed corporate entity.

An individual broker operating independently of an employing broker and conducting their real estate services business as a *sole proprietor* takes on exposure to liability for the actions of their employees.

Many small business owners, including real estate brokers, establish their businesses as *sole proprietorships*. Typically, the individual broker seeking to be independent — who is not employed by another broker and does not employ other licensees — recognizes they are always responsible for their own actions whether acting alone as a sole proprietorship or under a corporate umbrella. Thus, they may choose not to incorporate and save the initial and annual costs of maintaining a corporation.

A broker as a sole proprietor is responsible for all the legal and financial liabilities of their brokerage business. These liabilities include the:

- business debts;

- operating losses; and
- actions of their employees.

When a brokerage business operates as a sole proprietorship and incurs debts or other legal liabilities, the broker is directly responsible for payment of these obligations from their own income and assets. This might eventually result in personal bankruptcy to settle excessive debts and liabilities of the brokerage business.

When a broker acting as a sole proprietorship is sued, personal assets in addition to their business assets are at risk of seizure to satisfy any settlement or judgment.

errors and omissions (E&O) insurance
An insurance policy protecting brokers and agents from negligent conduct when acting as a licensee.

Errors and omissions (E&O) insurance covers negligent conduct when acting as a licensee. E&O insurance does not cover business operating liabilities or promotional expenses — or intentional misbehavior of the broker or their employees.

Similarly, when the broker acting as a sole proprietor is personally sued for any occurrence outside of business activities, such as in the case of a car accident or another's personal injury at their home (both the subject of other insurance coverage), the broker's business assets in addition to their personal assets are at risk to satisfy any judgment not covered by insurance.

Conversely, a broker who incorporates their brokerage business shields their corporate assets in the event of a personal lawsuit.

Company identity

The name a broker uses attracts clientele and agents. The attraction may be due to the words used in the name, or the words may have no common meaning but one developed by the broker — usually by branding — about the expected services the firm offers. Thus, the company's name selection is part of its business plan to create goodwill, and may be:

- generic;
- descriptive;
- personal;
- that of a franchise; or
- a secondary meaning.

To use a fictitious name to render real estate services, the individual broker or corporate DRE license needs to bear the fictitious name.

Conversely, a real estate agent may not use a fictitious business name other than one licensed to their employing corporate or proprietary broker by the DRE. When an agent intends to use a fictitious business name of their own, such as a "team" name, they need to first obtain the authorization and approval from their employing broker before filing the fictitious name with the DRE on behalf of their broker.[1]

1 Calif. Business and Professions Code §10159.5; Calif. Department of Real Estate Regulations §2731

DBA for services offered

The brokerage's DBA generally reflects the types of services being offered. A broker need not limit their services to just one aspect of real estate practice. For example, words often included in DBAs reflect the types of services offered by a licensed real estate practice and may describe one or several services, such as:

- realty services;
- sales and escrow services;
- mortgage brokers;
- homes and mortgages;
- property management;
- trust deed loan broker services; and
- commercial sales and leasing.

Agent recruitment and supervision

Brokers have several business operating models to choose from based on their purpose for hiring agents. Some brokers hire as many agents as they can squeeze into the cubicles in their offices. In contrast, others may recruit only agents and brokers with track records of proven success in capturing clientele for the services offered. Regardless of the broker's business model, recruiting and hiring agents routinely include:

- a **recruiting goal**;
- a **plan of action**; and
- **minimum standards.**

Setting a *recruiting goal* will determine how many agents will be hired, their level of expertise and plans for locating and soliciting them. Prospective recruits may include:

- pre-license prospects;
- newly licensed agents; or
- experienced agents and broker-associates.

Once the recruiting goal is set, the *plan of action* is prepared. This plan determines:

- who is in charge of soliciting potential agents;
- the source of the prospects;
- the media used to solicit agents and broker-associates (e.g., direct mail, e-mail, telephone calls); and
- the scripts used to solicit, set the appointments and interview the prospects.

Minimum standards are then set to create expectations and guidelines for the agents to follow. This enables them to:

- set realistic and attainable goals; and
- create an accountability program with the broker or office manager based on the broker's minimum standards.

Unlicensed employees

Brokerage firms hire unlicensed staff members to perform administrative and back office activities which support the services licensed employees provide to clients. The activities of unlicensed employees are limited in their contacts with clients and members of the public.

When assisting an employing broker who engages in the origination of consumer mortgages, an unlicensed assistant performs administrative duties, such as information gathering, loan processing and delivery of documents — activities of functionaries which do not require a real estate license or **mortgage loan originator (MLO)** license endorsement.[2]

Thus, brokers may assign tasks to their unlicensed employees, such as:

- handling documents;
- performing residential tenant-related negotiations;
- canvassing for prospective clients;
- opening a property to third-party service providers; and
- communicating with parties to a transaction. [See **RPI** Form 507]

However, all unlicensed personnel performing on the broker's behalf need to do so with the broker's permission and their activities continuously supervised.[3]

Agent duties

To insure agents diligently comply with the duties the broker owes to clientele and others, their employing broker establishes office policies, procedures, rules and systems relating to:

- *soliciting*, *negotiating* and *originating* mortgages;
- the *documentation* arising out of licensed activities, such as agreements, disclosures, reports and authorizations prepared or received by the agent, which may affect the rights and obligations of clientele and others;
- *filing, maintaining and storing* all documents affecting the rights of clientele and others;
- the *handling* and *safekeeping* of **trust funds** received by the agent for deposit, retention or transmission to others;
- **advertisements**, such as flyers, brochures, press releases, etc.;
- compliance by their agents with all federal and state laws relating to **unlawful discrimination**; and
- the *receipt* of regular **periodic reports** from agents on their performance of activities within the course and scope of their employment.[4]

Rules and procedures are established by the broker to comply with their responsibility to manage and oversee the conduct of their agents in dealings with clientele and other members of the public. These rules and procedures need to be agreed to in writing with the agents they employ.

2 Bus & P C §10137

3 Calif. Department of Real Estate Real Estate Bulletin, Winter 1993

4 DRE Regs. §2725

A written **employment contract** sets forth the duties of the agent and the agent's need to comply with an office manual which contains the broker's policies, rules, procedures and other conduct the broker deems necessary to control the fulfillment of their responsibility for supervision. [See **RPI** Form 505 and 506]

Also, the written employment agreement spells out **compensation** the agent is to receive for representing the broker in soliciting and negotiating mortgage originations.[5]

The administration of agents employed by a broker also requires record keeping of expiration and renewals of their licenses and MLO endorsements, and notice to the DRE of hiring and terminating agents. [See **RPI** Form 508]

Agent supervision

An employing broker's supervision begins with the development and adoption of a **business model** delineating the operating structure for their mortgage broker firm. In an operating plan for a mortgage business, the broker lays out how clients are to be solicited, mortgage applications negotiated, originations processed and servicing procedures to be followed by their employees — licensed or administrative. Categories of administrative and licensed activities outlined and described in an operating plan include:

- **administrative rules**, covering a description of the office operations of the mortgage service, such as office routines, phone management, budgetary allocations (advertising, farming), agent interviews, goal setting and daily work schedules;
- **achievement guidelines**, comprising the means, methods and procedures to be used by agents to obtain and report measurable results (applications, closings, etc.);
- **substantive conduct**, focusing on the documentation needed when taking applications, negotiating mortgage terms and fulfilling the duties owed by the broker to clientele and others;
- **compliance checks**, consisting of periodic (weekly) and event-driven reports (an origination submitted to underwriting) to be prepared by the agent, and the review of files and performance schedules by the broker, office manager and assistants; and
- **supervisory oversight**, an ongoing and continuous process of updating agents and managing their activities which fall within the course and scope of their employment.

The deceptive "independent contractor" title

Brokers typically negotiate fee sharing arrangements which call for the use of an **independent contractor (IC)** agreement to document their employment and compensation of agents. Alternatively, brokers may choose other pay and tax withholding arrangements documented using an **employee agreement** form. Either way, they have a signed written

5 DRE Regs. §2726

employment agreement and are DRE compliant. In contrast to an employee agreement form, an employing broker uses an IC agreement to avoid income tax withholding and employer contributions. [See **RPI** Form 505 and 506]

Despite the labels given to these agent/broker-associate employment forms, an agent or broker-associate acting on behalf of an employing broker is always an employee of the broker under California's labor law. Thus, the broker is always liable as an employer for their agent's wrongful conduct.

An agent may not permissibly advertise or act independently of the broker just because they enter into an *IC agreement*. More particularly, the broker employing agents using an IC agreement still owes a duty of supervision (as well as a mandated worker's compensation policy). [See **RPI** Form 506]

Both types of employment agreements include a provision calling for the agent to deliver to the broker a *binder* for *liability insurance* on the car the agent is using for business naming the broker as an insured party. Employment agreements also require all documents and funds received on transactions to be entered into and taken in the name of the broker. Thus, all advertising and business cards identify the agent or broker-associate as acting for the broker as an *associate licensee*.

Mandated workers' compensation insurance coverage

As with any other business, employing brokers are required to provide workers' compensation to all employees, including their licensed agents.

Even though agents and broker-associates are considered independent contractors for income tax and unemployment purposes, they are employees under workers' compensation and labor laws. Thus, they are required to be covered by workers' compensation insurance.[6]

A broker's employees include:

- their agents;
- broker-associates working under the broker's license; and
- any non-licensed administrative staff.

Some arrangements exclude the broker from needing to provide workers' compensation insurance.

When the broker and their spouse (or child or parent) are the **sole owners** of the brokerage, workers' compensation insurance coverage is voluntary for the sole owners. Sole means the only owners of the company are the broker and their relatives. The broker's spouse or relative needs to be clearly defined as part owner, either as a general partner of a proprietorship or as an officer of the corporation.[7]

Otherwise, any licensed and unlicensed family members (a spouse, child or parent) *employed* under the broker's license are required to be covered, just like any other agent or employee working for the broker. This includes a

6 Calif. Labor Code §2750.5

7 Lab C §4150

spouse who is a licensee employed and acting under the supervision of the broker, whether or not any other persons are employed. In most cases, family members are required to be covered by workers' compensation insurance since they are acting with members of the public in the capacity of an agent of the brokerage operation.[8]

Officers and directors of a corporation are not required to have workers' compensation coverage for themselves when they are paid only as owners of the corporation. However, an officer (or director) who is also employed and paid to render services as an agent of the corporation (e.g., taking a loan application) is required to be covered by workers' compensation insurance — unless the corporation is owned solely by its officers and directors.

When a corporation is co-owned by non-officer owners, an officer rendering real estate services is required to be covered by workers' compensation insurance.[9]

Failing to provide workers' compensation coverage is a criminal offense. A broker not in compliance may face:

- a stop order from the Department of Industrial Relation's Division of Labor Standards Enforcement (DLSE), preventing them from conducting business until proof of insurance is provided;
- civil penalties and fines up to $100,000; and
- reimbursement claims from current and former agents for premiums they paid.[10]

Mitigating risk

As a buffer against liability, a broker purchases negligence insurance, called **E&O insurance**.

With the payment of a premium, *E&O insurance* protects brokers from the full cost of defending against a **negligence claim** made by a client or others. E&O insurance is commonly obtained when a broker conducts real estate sales transactions as part of the scope of their operation.

Further, as required by the IC and employment agreements, the broker requires their agents to name the brokerage as additionally insured by endorsement to their *auto insurance* policies. This covers broker liabilities resulting from the agent's use of their own vehicle to conduct activities within the scope of the brokerage activities authorized by the broker for the agent to undertake.

Through both forms of insurance, the liability exposure for professional negligence and the cost of defense are shifted to corporate insurers willing to take on the financial burden of those uncertainties.

Even with insurance, a broker hiring agents needs to determine what level of risk is acceptable for them in their chosen brokerage activity.

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8 Lab C §3700

9 Lab C §3351(c)

10 DRE Real Estate Bulletin, Fall 2004, Page 10

For example, risks in providing information to mortgage applicants and lenders might only result in minimal liability exposure for claims. These are *absorbable risks* the broker and their agents can take which are either uninsured or within the range of the deductible not paid by the insurer. When brokers authorize absorbable-risk conduct, an agent needs to agree to contribute a pro-rata based contribution to any settlement paid out by the broker on claims generated by the agent's conduct.

However, some conduct in the performance of agency duties are **pure risks** which need to be avoided since they lead to *absolute liability* as entirely unacceptable acts. *Pure risks* include:

- deceit;
- withholding known or unknown but readily available information; or
- misstating or permitting the misstatement of facts or consequences of facts which cause the person relying on the statements to suffer a financial loss.

Substandard activity, sometimes called a **classified risk**, needs to be given special emphasis. This activity is typically due to a lack of proper performance.

Occasionally it is the activity itself which is considered improper and automatically imposes liability for any losses it may cause.

Each broker hiring agents will have a different level of acceptable risk they are comfortable with. Whatever that level may be, policy measures need to be adopted to provide guidelines and instructions on just what steps agents may take when conducting a brokerage activity chosen by the broker as an acceptable risk.

For example, trust funds need to be explained so the agent can identify them. Then there is the handling of an agent's receipt, recording, safekeeping and delivery of trust funds to the intended recipients and the agent's timely performance and journal entries at each step. Trust fund procedures need to be laid out in clear, concise language for agents to understand if risks from mishandling are to be avoided. DRE audits may be the biggest risk of all.

The management by the agent of a loan application, deposit, disclosures and the preparation of documents needs to be detailed so the expectation of the agent about their conduct is well understood.

Mortgage activity reporting

When originating or servicing one or more mortgages in a calendar year that are secured by one-to-four unit residential property, DRE licensees are required to submit periodic reports about their mortgage activity and financial condition to both the **DRE** and the **Nationwide Mortgage Licensing System (NMLS)**.[11]

These loan activity reports are:

- the **mortgage loan activity notification** (**DRE Form RE866**), reportable to the DRE;[12]

11 Bus & P C §§10166.07-08; 12 United States Code §5104(e)

12 Bus & P C §10166.02

- the **business activity report**, reportable to the DRE;[13]
- the **residential mortgage loan report** (DRE Form RE857), reportable to the DRE;[14] and
- the **mortgage call report**, reportable to the NMLS.[15] [See Chapter 8]

Further, DRE brokers are required to file additional reports when they collect trust funds or engage in multi-lender transactions (fractionalized trust deeds). [See Chapter 47]

13 Bus & P C §10166.07

14 Calif. Health and Safety Code §§35815-35816

15 12 USC §5104(e)

Chapter 7 Summary

A mortgage brokerage firm needs a detailed business plan. As part of the plan, real estate brokers rendering services to the public, independent of a broker-associate relationship with another broker, choose one of two business structures to operate their brokerage:

- a California corporation; or
- a sole proprietorship.

Brokers who form a corporation for conducting their brokerage operations do so to limit personal liability. Operating as a corporation, the individual broker serves as the company's licensed designated broker-officer. A broker who incorporates their brokerage is protected from personal liability for the activities and conduct of their agents and employees.

Alternatively, a broker who conducts business as an individual and does not operate through a licensed corporate entity is a sole proprietorship by default. An individual broker operating independently of an employing broker and conducting their real estate services business as a sole proprietor takes on exposure to liability for the actions of their employees.

The name a broker uses attracts clientele and agents. The attraction may be due to the words used in the name, or the words may have no common meaning but one developed by the broker about the expected services the firm offers.

To use a fictitious name to render real estate services, the individual broker or corporate Department of Real Estate (DRE) license needs to bear the fictitious name. The brokerage's DBA ("doing business as") generally reflects the types of services offered.

Brokers have several business operating models to choose from based on their purpose for hiring agents. Some brokers hire as many agents as they can, while others may recruit only agents and brokers with track records of proven success in capturing clientele for the services offered.

Brokerage firms hire unlicensed staff members to perform administrative and back office activities which support the services licensed employees provide to clients.

To insure agents diligently comply with the duties the broker owes to clientele and others, their employing broker establishes office policies, procedures, rules and systems. Rules and procedures are established by the broker to comply with their responsibility to manage and oversee the conduct of their agents in dealings with clientele and other members of the public.

An employing broker's supervision begins with the development and adoption of a business model delineating the operating structure for their mortgage broker firm.

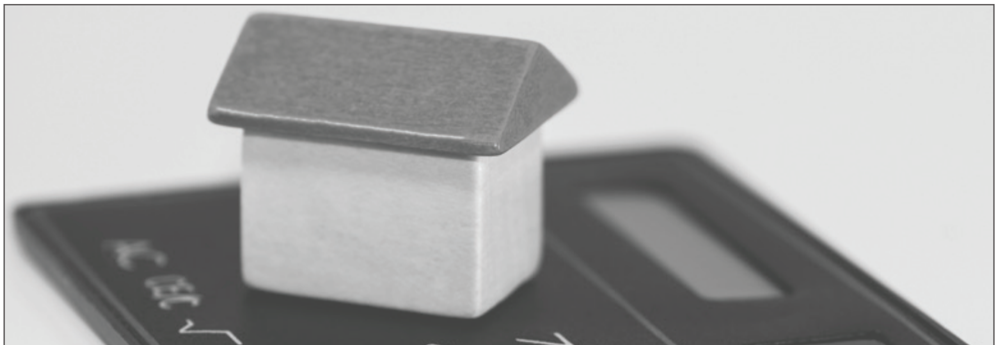
Brokers typically negotiate fee sharing arrangements which call for the use of an independent contractor (IC) agreement to document their employment of agents. Despite the labels given to these agent employment forms, an agent is always an employee under California's labor law.

As with any other business, employing brokers are required to provide workers' compensation to all employees, including their licensed agents.

As a buffer against liability, a broker purchases negligence insurance, called errors and omissions (E&O) insurance. Further, the broker requires their agents to name the brokerage as additionally insured by endorsement in their auto insurance policies.

When originating or servicing one or more mortgages in a calendar year that are secured by one-to-four unit residential property, DRE licensees are also required to submit periodic reports about their mortgage activity and financial condition to both the DRE and the Nationwide Mortgage Licensing System (NMLS).

Chapter 7 Key Terms



Chapter 8

Mortgage activity reporting

Learning Objectives

After reading this chapter, you will be able to:

- understand the proper timeline and procedures for filing mortgage activity reports with the Department of Real Estate (DRE) and the Nationwide Mortgage Licensing System (NMLS);
- identify the criteria triggering the need to file each report; and
- determine the data included in each report.

Key Terms

business activity report
mortgage call report
mortgage loan activity notification
residential mortgage loan report

Mortgage activity reports

Department of Real Estate (DRE) licensees are required to submit periodic reports about their mortgage activity and financial condition to both the DRE and the **Nationwide Mortgage Licensing System (NMLS)**.[1]

These mortgage activity reports are:

- the **mortgage loan activity notification** (**DRE Form RE 866**), reportable to the DRE;[2]
- the **business activity report**, reportable to the DRE;[3]

1 Calif. Business and Professions Code §§10166.07-08; 12 United States Code §5104(e)
2 Bus & P C §10166.02
3 Bus & PC §10166.07

- the **residential mortgage loan report** (**DRE Form RE 857**), reportable to the DRE;[4] and
- the **mortgage call report**, reportable to the NMLS.[5]

None of these reports requires a filing fee.

Editor's note — DRE brokers and agents are required to file additional reports if they collect trust funds or engage in multi-lender transactions (fractionalized trust deeds).[6] [See Chapter 40]

The broker's consumer mortgage activity notice (RE 866)

mortgage loan activity notification
A report notifying the Department of Real Estate (DRE) when a licensee commences offering mortgage loan originator (MLO) services.

A DRE licensee who makes, arranges or services consumer mortgages for a fee under their DRE license is required to file a **mortgage loan activity notification** with the DRE.

Editor's note — A consumer mortgage is a debt incurred primarily for personal, family, or household purposes and secured by a parcel of real estate containing one-to-four residential units, whether or not the owner occupies the property.[7]

The activities triggering the filing requirement are not exclusive to consumer mortgage loan originator (*MLO)-endorsed licensees*. While arranging a consumer mortgage for a fee requires a DRE licensee to obtain and maintain a MLO endorsement, the funding or servicing of a consumer mortgage does not. Thus, both MLOs and non-MLO licensees who perform these services relating to consumer mortgages are required to make this filing.[8]

Online filing

The mortgage loan activity notification is filed by each DRE licensee within 30 days of commencing the consumer mortgage activity triggering the report. Sales agents are responsible for their personal filings. Brokers who perform consumer mortgage services using both their personal and designated officer broker license file twice:

- once for their personal broker license; and
- once on behalf of the corporation.[9]

Filing is completed online at *https://secure.dre.ca.gov/elicensing/nmls.asp*.

Content of the filing

Information provided by the licensee in the mortgage loan activity notification filing includes:

- the licensee's business telephone number;
- the licensee's email address;
- the licensee's Nationwide Mortgage Licensing System (NMLS) ID number associated with their MLO endorsement, if applicable;

4 Calif. Health and Safety Code §§35815-35816
5 12 USC §5104(e)
6 Bus & P C §10238
7 Bus & P C §10131.1(b)
8 Bus & P C §10166.01
9 Bus & P C §10166.02(a)

- the type of consumer mortgage activity (fund, broker, buy, sell, exchange or service) the licensee will engage in;
- the type of consumer mortgage origination activity (solicit or negotiate) the licensee will engage in; and
- an indication of whether the licensee also performs mortgage loan activity on non-consumer mortgages.

Updating, cancelling and reinstatement

DRE does not mandate a specific update schedule for the mortgage loan activity notification. However, it does require DRE licensees to keep the filing up-to-date. Any change in a licensee's consumer mortgage activities imposes a duty on the licensee to update the information in the filing.

Additionally, a DRE licensee needs to cancel the filing if they no longer perform consumer mortgage activities under their DRE license.

Cancellation of the filing does not cancel the DRE license or any associated MLO endorsements. It simply notifies the DRE the licensee is no longer actively engaging in consumer mortgage activity.

Consider a DRE sales agent with an MLO endorsement on their license. They work under a DRE MLO broker, originating consumer mortgages for two years. Then, they obtain employment as a senior loan officer with a federally regulated bank. In their new position, they originate loans as a federally registered MLO. Since they are no longer using their DRE MLO endorsement to originate loans, they are required to cancel their mortgage loan activity filing with the DRE.

Licensees with cancelled filings are still required to renew their DRE license every four years to continue to perform real estate activities. Likewise, they need to renew their MLO endorsement if they plan on resuming consumer mortgage activity under their DRE license endorsement at a later date, and want to avoid the NMLS reapplication process.

To resume any activities which initially triggered the filing, the licensee simply files a new mortgage loan activity notification.

Penalties for failure to timely file

A licensee who fails to timely file the mortgage loan activity notification is subject to a fine of:

- \$50 per day for the first 30 days after the filing becomes overdue; and
- \$100 per day after the first 30 days, up to a maximum total penalty of \$10,000.[10]

Failure to pay any of the above penalties may result in DRE license suspension or revocation.[11]

10 Bus & P C §10166.02(f)
11 Bus & P C §10166.02(g)

The business activity report

business activity report
A report notifying the Department of Real Estate DRE) of an employing broker's mortgage activities during the fiscal year.

The **business activity report** provides to the DRE details about mortgage activity undertaken by an employing broker and any sales agents and broker-associates working under the broker's license. The report is filed by brokers providing mortgage services:

- under their individual broker license, as a **sole proprietorship**; or
- under a **corporation broker** license.

Sales agents and broker-associates do not file this report. Instead, *employing brokers* provide data on their individual mortgage activity and the mortgage activity of licensees in their employ.

The business activity report provides the DRE with data about employing broker's mortgage activities during the fiscal year, in two parts:

- *Part A* collects data about residential consumer and business mortgage activity;[12] and
- *Part B* collects data from threshold brokers and multi-lender brokers.[13]

Employing brokers file this report online with the DRE within 90 days of the end of the broker's fiscal year.[14]

Part A reporting is triggered when a DRE broker *makes*, *arranges* or *services* one or more consumer or business mortgages secured by residential property for a fee, under their DRE license.[15]

Part B reporting is required of:

- *threshold brokers*, who deal in *hard money transactions*, or *private lender transactions*;[16] and
- brokers engaging in *multi-lender transactions* (fractionalized trust deed originations and sales).[17] [See Chapter 40]

Filing is completed online at *https://bars.dre.ca.gov/*. Failure to report mortgage business activity exposes the broker to a DRE audit, and disciplinary action.[18]

Part A: Residential mortgage activity

Part A collects information about:

- the agents and broker-associates employed by the employing broker;[19]
- the employing broker's real estate activities;[20]
- advertisements used by the employing broker, including the media type used;[21]
- the employing broker's lender and mortgage activity;

12 Bus & P C §10166.07
13 Bus & P C §10232.2
14 Bus & P C §10166.07(a)
15 Bus & P C §10166.07(a)(1)
16 Bus & P C §10232.2(a)
17 Bus & P C §10238(k)(3)
18 Bus & P C §10166.07(c)
19 Bus & P C §10166.07(a)(1)
20 Bus & P C §10166.07(a)(2)
21 Bus & P C §10166.07(a)(3)

- foreclosure activity initiated and completed by the employing broker;[22]
- the employing broker's compensation for brokered mortgages;[23] and
- bilingual Mortgage Loan Disclosure Statements (MLDSes) provided by the employing broker to buyers and owners.[24] [See Chapter 34; see **RPI** Form 204 and 204-1]

Real estate activities reported include:

- arranging (brokering) mortgages;
- making (funding) mortgages;
- servicing mortgages;
- buying, selling or exchanging trust deed notes or land sales contracts (real property sales agreements);
- listing or selling real estate;
- fee-based property management services;
- making or servicing mortgages under a Department of Financial Protection and Innovation (DFPI) *California Residential Mortgage Lending Act (CRMLA)* license;
- making or arranging mortgages under a DFPI *Consumer Financing Law (CFL)* license; and
- performing broker escrows.[25]

Lender and mortgage information provided by the employing broker includes:

- identification of the institutional lenders with which the broker does business, and the type of mortgage (fixed, adjustable, other) associated with each institutional lender;[26]
- for mortgages serviced, the amount of funds advanced to protect the security described in the trust deed;[27] and
- the broker's mortgage activity for:
    - fixed rate mortgages (FRMs);
    - adjustable rate mortgages (ARMs);
    - mortgages with prepayment penalties;
    - mortgages with a conforming loan amount, with rates 8% or more over the rate for a Treasury security with a comparable maturity, or with 6% or more in points and fees, called *covered loans*;[28] and
    - mortgages which allow the buyer or owner to defer principal or interest, called **non**-*traditional loans* (excluding reverse mortgages or home equity lines of credit (HELOCs).

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22 Bus & P C §10166.07(a)(4)-(5)
23 Bus & P C §10166.07(a)(8)
24 Bus & P C §10166.07(a)(9)
25 Bus & P C §10166.07(a)(2)
26 Bus & P C §10166.7(a)(4)(A), (a)(5)(A
27 Bus & P C §10166.7(a)(10)
28 Calif. Financial Code §4970(b)

Part B: Threshold and multi-lender brokers

Part B collects detailed information about:

- mortgages the employing broker originated as an agent of another;
- mortgages funded by the employing broker for resale;
- costs and expenses paid by owners and buyers to the employing broker;
- mortgages made for the employing broker's benefit;[29]
- the sales of notes as an agent, or as a principal;[30]
- the sales of real property sales contracts as an agent or principal;[31] and
- note and real property sales contract servicing.[32]

Collecting data throughout the year

Brokers are required to keep documents relating to transactions for a total of *three years*. Some documents, such as the documents used to determine investor suitability for funding hard money loans, are to be kept for *four years*.[33]

However, collection of data is not enough. As any broker who has filed this report knows, the data reporting is a detailed, harrowing process if proper records were not maintained in an organized fashion during the year.

Proper pipeline management is completed on a deal-by-deal basis. As files are completed, data is harvested and stored for forthcoming end-of-year reporting. Since this report covers both the broker's individual deals and deals of all licensees in their employ, the broker is responsible for developing and enforcing a thorough process for data collection compliance.

Brokers often use software to manage mortgage applications, and keep track of their mortgage pipeline. Compiling information required for this, and other reports, is a matter of:

- confirming mortgage files are up-to-date and in the correct statuses in their origination software; and
- running reports to pull the necessary data.

Offices with less formal procedures still need to update information at least every month to ensure the data to be reported is readily available.

At a minimum, brokers need to set up a basic spreadsheet keeping track of this data as mortgages or deals close.

The residential mortgage loan report

The **residential mortgage loan report (DRE Form RE 857)** is a report filed by mortgage brokers who act as **direct lenders**.

Brokers acting as direct lenders use this filing to report their annual **residential mortgage** activity to the DRE. Data on both applications and closed *residential mortgages* are reported.

29 Bus & P C §10231.2
30 Bus & P C §§10131(e), 10131.1
31 Bus & P C §§10131(e), 10131.1
32 Bus & P C §10232.2(c)
33 Bus & P C §§10148, 10232.45

A residential mortgage for this report includes both consumer mortgages and business mortgages secured by one-to-four unit residential property which fund either the purchase or improvement of the secured property. This includes cash-out refinancing which funds some improvement to the property.[34]

residential mortgage loan report
A report filed by Department of Real Estate (DRE)-licensed mortgage brokers who act as direct lenders.

A residential mortgage does not include:

- a mortgage secured by unimproved land;
- a rate and term refinance by modification;
- a mortgage which funds a purpose other than the purchase or improvement of the secured one-to-four unit residential property, such as a vacation, education or business/investment/agriculture activity;
- a mortgage secured by other than a one-to-four unit residential property;
- a mortgage applied for outside of California;
- a mortgage made in California, but secured by property outside of California;[35] or
- a mortgage made by the lender when a real estate broker arranges the mortgage acting as an MLO or an mortgage loan broker (MLB).[36]

Direct lenders are to report

Residential mortgage activities of direct lenders exempt from the federal Home Mortgage Disclosure Act (HMDA) reporting are *monitored* by the California State Transportation Agency and the California Business, Consumer Services and Housing Agency (BCSH).

The purpose of the oversight is to determine whether direct lenders of residential mortgages are fulfilling their obligation to provide lending to all qualified applicants in their respective communities. Like HMDA, the report data is reviewed to identify potentially discriminatory lending patterns based on the demographics of a community.[37] [See Chapter 34]

To comply with state reporting, lenders exempt from federal HMDA rules file a residential mortgage loan report with the state agency governing their licensure:

- real estate brokers making mortgages secured by one-to-four residential units as direct lenders report to the DRE;
- broker-dealers, credit unions, industrial loan companies, finance lenders and residential mortgage lenders report to the California DFPI;
- mortgage insurers report to the Department of Insurance; and
- all other mortgage lenders report to the BCSH.[38]

34 21 Calif. Code of Regulations §7117(d), 7118(b)-(c)
35 21 CCR §7118(c)
36 21 CCR §7121(b)
37 Health & S C §35816
38 21 CCR §7117(b)

The residential mortgage loan report DRE-licensed direct lenders file with DRE is the California equivalent of the federal HMDA disclosure required of larger, federally regulated direct lenders. [See Chapter 33]

Meeting the threshold for reporting

DRE-licensed direct lenders who report under the federal HMDA are exempt from having to file this DRE report.[39]

A DRE-licensed broker making mortgages as a direct lender who is exempt from HMDA reporting files the California residential mortgage loan report with the DRE if, during the calendar year:

- they make residential mortgages exceeding 10% of the total dollar amount of all mortgages they make;[40]
- they make 12 or more residential mortgages during the calendar year with a total mortgage amount of $500,000; and
- they have assets no greater than $10 million. [See Form RE 857A]

Reporting forms and timeline

For DRE-licensed brokers who make mortgages as direct lenders, loan data is compiled and filed with DRE on the residential mortgage loan report — DRE Form RE 857. A separate residential mortgage loan report is completed for each metropolitan statistical area (MSA) in which the broker has a branch. MSAs are regions defined by the U.S. Office of Management and Budget (OMB) and used by government agencies for statistical purposes. MSAs represent regions of high population density.[41]

A DRE-licensed direct lender files the residential mortgage loan report in duplicate every March 31. The report provides data on the prior calendar year's mortgage activity.[42]

A direct lender's residential mortgage loan report is available to the public for *five years*. This is accomplished by having the report available in every branch, and providing it upon request.

The five-year period commences from the filing due date. For example, a report due by March 31, 2015 needs to be available to the public until March 31, 2020.[43]

Data collected

In the top portion of the residential mortgage loan report, the DRE-licensed direct lender provides:

- their name;
- their DRE license number;
- their address and phone number;
- the enforcement agency (pre-filled with "Department of Real Estate");

39 Health & S C §35816(b)
40 21 CCR §7121(a)
41 21 CCR §7118(b)
42 21 CCR §7119(b)
43 21 CCR §7119(a)

- the address of the enforcement agency (pre-filled with DRE's address);
- the census map on which the MSA is based (pre-filled with 2010 data, the latest census data available);
- the year of the data being reported; and
- the MSA covered in the report.

Section 1 contains information about originations and applications, sorted by census tract. The census tract is also pulled by reviewing the census maps linked above.[44]

For each census tract within the MSA, the report provides:

- the total number of applications taken;
- the total number of mortgages made; and
- the total dollar amount of mortgages made, shown in terms of thousands;

for each of the following situations:

- the total of Federal Housing Administration (FHA)-insured mortgages, Farmers Home Administration (FmHA) mortgages and U.S. Department of Veterans Affairs (VA)-guaranteed mortgages used to purchase a property occupied by the buyer;
- conventional mortgages used to purchase a property occupied by the buyer;
- home improvement mortgages on one-to-four unit residential properties occupied by the owner; and
- all home improvement loans on one-to-four unit residential properties not occupied by the owner.[45]

In Section 2, the broker provides the same totals for mortgages secured by one-to-four residential properties located outside of the MSA for their branch. The data is not broken down by census tracts for financed properties in MSAs other than where the broker has a branch.[46]

The mortgage call report

The **mortgage call report** is administered by the NMLS. Data collected by the mortgage call reports are used to track origination activity and enhance regulatory oversight.

mortgage call report
A quarterly report on consumer mortgage data provided to the Nationwide Mortgage Licensing System (NMLS), used to enhance regulatory oversight.

For example, when the mortgage call report shows reverse mortgage originations are rising, regulators know to focus consumer protection efforts on reverse mortgages.

The mortgage call report is generated quarterly. It is filed with the NMLS by any DRE-licensed broker MLO who has a company MLO endorsement as a:

- sole proprietorship; or
- corporation.

44 21 CCR §7118(b)
45 21 CCR §7118(b)(2)
46 21 CCR §7118(b)(1)(B)

Like the business activity report, sales agents and broker associate MLOs do not file this report. Instead, the broker of record for the MLO company provides data on their individual mortgage activity and the mortgage activity of licensees they employ.

Contents of the mortgage call report

Two types of mortgage call reports exist:

- the **standard mortgage call report**; and
- the **expanded mortgage call report.**

The *expanded mortgage call report* is required for reporting DRE brokers who:

- sell mortgages to Fannie Mae or Freddie Mac;
- service mortgages for Fannie Mae or Freddie Mac; or
- issue mortgages on behalf of Ginnie Mae.

All other reporting DRE brokers complete the *standard mortgage call report*.

Both mortgage call reports contain:

- a **residential mortgage loan activity (RMLA) report**; and
- a **financial condition (FC) report**.

The residential mortgage loan activity report

The RMLA for a standard mortgage call report contains:

- a *company-level report;* and
- a *state-level report*.

The company-level report provides information about the broker's MLO company's nationwide mortgage activity, including:

- identification of providers of lines of credit available to the broker's MLO company, the total credit limit and current amount available at the end of the reporting period;
- total nationwide servicing activity by total dollar amount, mortgage count and average mortgage size; and
- delinquency data on serviced mortgages.

The state-level report is completed for each state in which the MLO conducts business. For each state, mortgage activity reported includes the dollar amount, count and average dollar amount of:

- mortgage applications;
- closed mortgages, by channel (brokered, retail or wholesale), organized by:
    - mortgage type (conventional, FHA-insured, etc.);
    - property type;
    - mortgage purpose; and

  - lien position;
- the amount of fees collected;
- reverse mortgages;
- qualified versus non-qualified mortgages;
- mortgage repurchase information;
- the total revenue from MLO operations;
- servicing data; and
- mortgages originated by each MLO employed, including the name and NMLS ID of each MLO employed.

The state-level report in an expanded mortgage call report additionally includes reporting of the dollar amount, count and average dollar amount of mortgages by features such as:

- whether the mortgage has a fixed or adjustable interest rate;
- whether the mortgage is classified as a jumbo or non-jumbo;
- the buyer or owner's FICO score;
- the loan-to-value ratio (LTV);
- the warehouse period; and
- additional servicing detail.

The financial condition report

The *financial condition report* contains information about the MLO company's:

- assets;
- liabilities and equity;
- income;
- cash flow; and
- non-interest expenses and net income.

The expanded financial condition report requires a much greater amount of detail for each of categories above.

Filing the mortgage call report

Both parts of the mortgage call report are filed online through the MLO's NMLS account. Data are compiled during the year using mortgage origination software.

For brokers filing the standard mortgage call report:

- the RMLA is filed within 45 days of the end of each calendar quarter; and
- the financial condition report is filed within 90 days of the end of the broker's fiscal year.

For brokers filing the expanded mortgage call report, both the RMLA and the financial condition report are filed within 45 days of the end of each calendar quarter.

A employing broker files both parts of the mortgage call report even if their MLO company has no mortgage activity to report. On the RMLA, the employing broker simply checks the "No Activity to Report" button. A full financial condition report is still required.

Company-specific data, such as financial data, is not made available to the public. Aggregate mortgage call report data is available on the NMLS website: *http://mortgage.nationwidelicensingsystem.org/about/Pages/Reports.aspx*.

Failure to file

When a employing broker fails to file a mortgage call report within the designated timeline, a deficiency notation is placed on their MLO endorsement. This can result in state regulatory action preventing license or endorsement renewal.

Chapter 8 Summary

California Department of Real Estate (DRE) licensees are required to submit periodic reports about their mortgage activity and financial condition to both the DRE and the Nationwide Mortgage Licensing System (NMLS).

These mortgage activity reports are:

- the mortgage loan activity notification (DRE Form RE 866), reportable to the DRE;
- the business activity report, reportable to the DRE;
- the residential mortgage loan report (DRE Form RE 857), reportable to the DRE; and
- the mortgage call report, reportable to the NMLS.

A DRE licensee who makes, arranges or services consumer mortgages for a fee under their DRE license is required to file a mortgage loan activity notification with the DRE.

The business activity report provides to the DRE details about mortgage activity undertaken by an employing broker and any sales agents and broker-associates working under the broker's license. The report is filed by brokers providing mortgage services:

- under their individual broker license, as a sole proprietorship; or
- under a corporation broker license.

The residential mortgage loan report (DRE Form RE 857) is a report filed by mortgage brokers who act as direct lenders. The report data is reviewed to identify potentially discriminatory lending patterns based on the demographics of a community.

The mortgage call report is administered by the NMLS. Data collected by the mortgage call reports are used to track and enhance regulatory oversight.

Chapter 8 Key Terms

Notes:

Chapter 9

Processing and underwriting

Learning Objectives

After reading this chapter, you will be able to:

- identify the role and duties of a mortgage processor to document the information in a mortgage application;
- discuss the analytical role and duties of an underwriter on review of the processor's file and appraisal; and
- understand the analysis undertaken by an underwriter to assess risk and set the maximum mortgage rate for a buyer or owner.

Key Terms

back-end DTI
compensating factors
debt-to-income ratio (DTI)
Desktop Underwriter (DU)
front-end DTI
lender overlays
Loan Prospector (LP)
loan-to-value ratio (LTV)
mortgage processing
principal, interest, taxes and insurance (PITI)
reserve requirement
risk layering
stacking order
three Cs of underwriting
underwriting

Preparing the file for submission to underwriting

Mortgage processing is the receipt of a mortgage application and the organization, preparation and confirmation of supporting documentation by the lender's mortgage processor for submission to the lender's *underwriter*. A mortgage processor is the mortgage loan originator (MLO)'s equivalent to the *transaction coordinator (TC)* employed by real estate brokers and agents to obtain, review and clear all documents in a real estate sales transaction.

mortgage processing
The receipt of a mortgage application and the organization, preparation and confirmation of supporting documentation by the lender's mortgage processor for submission to the lender.

The mortgage processor is commonly the employee of a broker licensed and endorsed by the Department of Real Estate (DRE) as an MLO who arranges or makes consumer mortgages. Often, one mortgage processor will support several MLO agents also employed by the MLO broker. Department of Financial Protection and Innovation (DFPI) MLOs also hire mortgage processors when originating consumer mortgages.

Rather than an employee, the mortgage processor may be an independent contractor who processes mortgage for several different brokerages.

In smaller proprietary or corporate MLO brokerages, the broker may choose to process their own mortgage applications. However, hiring a processor to handle the mortgage documentation allows the MLO to focus on finding the mortgage best suited for their client, fielding issues with their mortgage lenders and soliciting new mortgage applicants.

A processor's duties

Unlike an MLO agent, the processor does not negotiate the terms of the mortgage. Only a DRE broker holding an MLO endorsement, or their licensed and endorsed sales agent (or a DFPI licensee), may undertake negotiations regarding the terms, pricing or features of a mortgage.[1]

Instead, a mortgage processor's responsibilities and duties include:

- applying the lending programs and guidelines set by the lender and federal and state mortgage law;
- gathering the mortgage application documentation to submit to a lender's underwriter, including:
    - a completed mortgage application [See **RPI** Form 202 (FNMA 1003); see Chapter 15];
    - the buyer's or owner's credit report [See Chapter 11];
    - documentation verifying the buyer's or owner's financial information and assets; and
    - other application-specific supporting documentation [See Chapter 51];
- coordinating the gathering of documents with the MLO, buyer or owner and lender;
- comparing the income data and debt ratios in the application against the financial documentation requested and reviewed by the processor;
- organizing the mortgage application in the appropriate order requested by the lender, called the **stacking order**; and
- submitting all required documentation to the lender. [See **RPI** Form 233]

stacking order
The order of mortgage application documents requested by a lender.

A processor anticipates the conditions the lender's underwriter will place on the file. The more organized and complete a submitted file is, the more smoothly and quickly the mortgage will proceed through underwriting and funding.

1 Calif. Business & Professions Code §10166.01(b)(2)(A)

For example, a processor who reviews a mortgage applicant's bank statements and finds a recent large deposit will request an explanation letter from the buyer or owner as to the source of the funds. The letter becomes part of the mortgage application package submitted to the lender by the processor. [See **RPI** Form 217-1]

Licensing of processors

Consumer mortgage processors employed and under the direction supervision of an MLO broker are not required to obtain a DRE license or NMLS endorsement. Thus, an unlicensed processor may not negotiate a consumer mortgage or advertise they are authorized to negotiate the terms of a sale or consumer mortgage.[2]

However, when an MLO company hires an independent contractor to process consumer mortgages, the independent contractor needs to be both DRE-licensed and endorsed as an MLO.[3]

Underwriting for assessing risk

On the flipside of the mortgage process is the lender's underwriter. **Underwriting** is the analysis of the risk of default posed by the information in a complete mortgage application and documentation acquired by the processor. To properly arrange mortgages for a homebuyer, an MLO agent needs to understand the lender's mortgage underwriting activities.

underwriting
The analysis of the risk of default posed by the information in a complete mortgage application and documentation.

While processing is an administrative task of gathering and confirming information, the separate task of underwriting involves decision-making and discretion.

The underwriter is an employee (or a third-party contractor) of the lender hired to:

- review a mortgage application for adherence to the lender's consumer mortgage guidelines;
- verify and confirm information provided in a mortgage application on behalf of the lender acting independent of the processor's analysis [See **RPI** Forms 202-230]; and
- make a decision on whether to approve or deny a mortgage application based on whether the application poses an acceptable risk to the lender and investors.

Further, the underwriter sets:

- the maximum mortgage amount the buyer or owner is approved to borrow;
- the maximum interest rate available to the buyer or owner; and
- any conditions to be met before loan approval or funding. [See **RPI** Form 209 and 209-1]

2 Bus & P C §10166.03(a)-(b)
3 Bus & P C §10166.03(c)

According to guidelines

An underwriter's decision is based on guidelines set by:

- *government regulations* restricting the terms of a consumer mortgage;
- the *private mortgage insurer*, when private mortgage insurance (PMI) is required [See Chapter 17];
- the *secondary mortgage market investor* who will purchase the mortgage; and
- the *lender*.

Government regulations restricting consumer mortgage terms include:

- the federal ability-to-repay (ATR) rules [See Chapter 10];
- the U.S. Housing and Urban Development (HUD)'s guidelines for consumer mortgages insured by the Federal Housing Administration (FHA) [See Chapter 21]; and
- the U.S. Department of Veterans Affairs (VA)'s guidelines for consumer mortgages guaranteed by the VA.

loan-to-value ratio (LTV)
A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property's fair market value (FMV).

For consumer mortgages with **loan-to-value ratio (LTVs)** over 80% and not FHA-insured or VA-guaranteed, PMI is required. *Private mortgage insurers* impose additional restrictions on the types of properties acceptable as security and the mortgages they will insure.

Further, few lenders who originate consumer mortgages will hold them in their mortgage portfolios. Instead, consumer mortgages are sold into the secondary market to avoid devaluation of the lender's portfolio and free up funds for future lending.

Most consumer mortgages made by lenders are sold to either the **Federal Home Loan Mortgage Corporation (Freddie Mac)** or the **Federal National Mortgage Association (Fannie Mae),** collectively known as **government sponsored enterprises (GSEs).** *Freddie Mac* and *Fannie Mae* set minimum standards for consumer mortgages they will purchase.

lender overlays
Lender-imposed standards on consumer mortgages to be met by applicants in addition to standards set by mortgage insurers and investors.

Finally, on top of licensing, regulations, default insurance and GSE standards, lenders may impose additional minimum requirements for consumer mortgages, called **lender overlays**.

For example, HUD sets the minimum credit score requirement for an FHA-insured mortgage at 500. Most lenders, however, require a buyer or owner seeking an FHA-insured mortgage to have a credit score of 620 or higher. Other overlays may involve more restrictive maximum LTVs, or greater cash reserves.

Lender overlays exist to offset a lender's risk aversion to some types of mortgages. The risk aversion stems from risk management analysis revealing more buyback requests from Fannie Mae on these types of mortgages. Or, the lender retaining the mortgage as a portfolio investment may simply prefer to make less risky mortgages as a matter of policy.

The three Cs of underwriting

To assist the lender in their decisions, the underwriter uses guidelines to review three major components of a mortgage application, called the **three Cs of underwriting**:

- **credit**;
- **capacity**; and
- **collateral**.

three Cs of underwriting
The three major components of a mortgage applicant reviewed by an underwriter: credit, capacity and collateral.

The underwriter may deny the mortgage application when one component of the consumer mortgage application indicates the applicant presents an unacceptably high risk of default. More commonly, many smaller aspects of a mortgage application indicate whether the applicant presents a cumulative high risk of default, called **risk layering**.

Creditworthiness as propensity to repay

risk layering
The increased risk of default posed by cumulative smaller risks.

The underwriter's review of *credit* issues presented by a consumer mortgage applicant involves:

- reviewing the credit report of the consumer mortgage applicant against the financial information they gave in their mortgage application;
- requesting explanations for delinquencies, foreclosures, bankruptcies or other negative credit events revealed in the credit report;
- reviewing the age and standing of credit available to the applicant;
- requesting alternative credit information when the mortgage applicant's credit file is insufficient [See Chapter 13]; and
- determining the credit score to be used in making the decision to fund. [See Chapter 11]

The credit score, once set, is used to qualify the consumer mortgage applicant for mortgage programs. For instance, an applicant with a high credit score may qualify for a consumer mortgage with lower down payment requirements or a lower interest rate. These factors, in turn, impact the total amount the applicant is qualified to borrow.

Capacity as ability to pay

The underwriter's analysis of the *capacity* component consists of reviewing and verifying the documentation provided by the processor regarding the consumer mortgage applicant's:

- employment history and the likelihood of continued employment [See **RPI** Form 202, 210 and 210-1];
- gross monthly income and the stability of the income sources [See **RPI** Form 209-2, 209-3, 215 and 215-1];
- liabilities, such as credit card debt, existing mortgage debt, student loans and payments for child support or alimony [See **RPI** Form 212-1 and 213];
- source of funds for paying mortgage closing costs [See **RPI** Form 211]; and

- assets, such as **cash reserves** in a savings account, or other valuable property. [See **RPI** Form 211]

The underwriter verifies employment independent of the processor's documentation. Further review of income, asset and liability is based on tax returns, bank statements and paystubs.

debt-to-income ratio (DTI)
The percentage of monthly gross income that goes towards paying debt.

The analysis of income and debt is completed by calculating the **debt-to-income ratio (DTI)**. Two DTIs exist:

front-end debt-to-income ratio (DTI)
The percentage of monthly gross income that goes towards paying mortgage debt.

principal, interest, taxes and insurance (PITI)
The four components of monthly mortgage debt.

back-end debt-to-income ratio (DTI)
The percentage of monthly gross income that goes towards paying non-mortgage debt.

- the **front-end DTI**, which is a ratio of the proposed monthly mortgage **principal, interest, taxes and insurance (PITI)** as a percentage of the applicant's monthly gross income; and
- the **back-end DTI**, which is a ratio of all recurring monthly debt payments including the proposed PITI as a percentage of the applicant's monthly gross income. [See **RPI** Form 202 and 233]

For example, consider a mortgage applicant with a $3,000 monthly gross income. Monthly PITI for the consumer mortgage they seek will be around $850. Other recurring debt payments they have amount to $200 a month.

Here, the front-end DTI is 28% ($850 PITI divided by their $3,000 monthly gross income).

The back-end DTI is 35% ($850 PITI plus $200 other recurring monthly debt payments, divided by $3,000 monthly gross income).

Both *front-end DTI* and *back-end* DTI are subject to ceilings set by the lender, federal mortgage law and the investors.

For conventional (non-government-insured) mortgages sold to Fannie Mae or Freddie Mac, the general guideline is a 28% front-end DTI, and a 36% back-end DTI.[4] [See Chapter 19]

For FHA-insured mortgages, the general guideline is a 31% front-end DTI, and a 43% back-end DTI.[5] [See Chapter 21]

compensating factors
Positive factors which compensate for a high debt load.

The lender at their discretion may exceed these general guidelines when the consumer mortgage applicant possesses positive factors, such as extensive assets, which compensate for a high debt load. The analysis of these **compensating factors** is part of the underwriter's review of risk layering.

reserve requirement
A requirement to hold cash in reserve as a buffer against default in case of a life-changing event.

Finally, a review of capacity takes into account how much reserve cash the consumer mortgage applicant has. The **reserve requirement** exists as a buffer against a default in the event of a change in employment, an illness, a divorce or other life-changing event. A general guideline is three to six months of PITI payments on the mortgage. [See **RPI** Form 211]

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4 Fannie Mae Single Family Selling Guide Chapter B3-6-02 to B3-6-03; Freddie Mac Single Family Seller/Servicer Guide Chapter 5401.1-5401.2

5 HUD Handbook 4000.1(II)(A)(5)(d)

Collateral as security for repayment

The underwriter also reviews the appraisal report the lender has acquired and a title report to determine whether the property is sufficient security for the consumer mortgage amount. [See Chapter 14]

This review looks for factors such as:

- the proper valuation of the one-to-four unit residential property contained in the appraisal report;
- property improvement conditions at issue;
- undisclosed liens on the one-to-four unit residential property;
- clouds on title; and
- the need for additional insurance due to the location of the property, necessary when a property is located in a floodplain or a wild fire-prone location.

Once the lender's underwriter approves the value of the one-to-four unit residential property, the ratio of mortgage amount to the property value sets the LTV.

With a purchase-assist consumer mortgage, the difference between the mortgage amount requested and the value of the one-to-four unit residential property is the down payment required of the mortgage applicant.

For example, a mortgage amount of $400,000 and a property value of $500,000 results in an LTV of 80%. The down payment is equal to 20% of the property value, or $100,000.

A significant down payment — 20% — gives the lender a buffer against suffering a loss when home values decrease, as occur during most recessions.

Without a significant down payment buffer, only a minimal decrease in home value may occur before the homeowner owes more on their mortgage than their property is worth, called *negative equity*. Negative equity is a position which often leads to default and foreclosure.

Automated underwriting

Today, most consumer mortgages are submitted into an automated underwriting (AU) system as part of the underwriting process. An AU system assists, if not supplants, the underwriter in determining whether a mortgage application presents an acceptable level of risk.

The AU system recommendation indicates whether the mortgage meets investor guidelines for purchase after the mortgage closes. It is not an automatic mortgage approval for the consumer mortgage applicant.

The two main AU systems are:

- Fannie Mae's **Desktop Underwriter (DU)**; and
- Freddie Mac's **Loan Prospector (LP)**.

Desktop Underwriter (DU)
Fannie Mae's automated underwriting (AU) system.

Loan Prospector (LP)
Freddie Mac's automated underwriting (AU) system.

The **FHA Total Scorecard** system is used in tandem with one of the AU systems to deliver recommendations on consumer mortgage applications for FHA-insured mortgages.

For MLO brokers who arrange consumer mortgages, the AU systems also come equipped to handle submissions from an MLO (or their mortgage processor). Fannie Mae has a separate **Desktop Originator (DO)** application which functions as a portal for submissions from MLOs.

After the mortgage application is received by the lender, the underwriter begins their initial review of the file to verify the information in the mortgage application is in line with the documentation provided.

Then, the verified information is input into the AU system. The AU system provides the MLO or underwriter with general status of:

- approved and eligible for purchase;
- approved but ineligible for purchase; or
- ineligible for an automated underwriting decision.

In some cases, the recommendation will give the mortgage application credit approval, but indicate additional scrutiny needs to be given to discrepancies found by the AU system.

For example, consider a limited cash-out refinance consumer mortgage application submitted into an AU system. The mortgage applicant's credit score and DTI are acceptable under the AU guidelines. However, the amount of cash-out sought exceeds the AU system guidelines.

In this case, the AU system would return an indication of approval, with a note the mortgage is ineligible for purchase by Fannie Mae. It is then the underwriter's job to review the file to confirm the information entered is correct, and issue either a denial or a counter-offer for the mortgage applicant to lower the cash-out amount — a lower mortgage amount.

An AU system may return a recommendation that results in the file being underwritten manually. This is usually triggered by insufficient traditional credit, or a DTI which exceeds the standard guidelines. Not all lenders (and thus, not all underwriters) will complete manual underwriting, as out-of-guideline files are subject to more scrutiny by investors.

Manual underwriting is more common on government-insured mortgages than on conventional mortgages.

Underwriter qualifications

Similar to mortgage processors, consumer mortgage underwriters who are employees of an MLO broker making mortgages are not required to hold a DRE license or NMLS endorsement. Consumer mortgage underwriters who are independent contractors do need to hold both a DRE license and an MLO endorsement.[6]

6 Bus & P C §10166.03(a)-(b)

Further, only underwriters with a **direct endorsement (DE)** are qualified to review FHA-insured mortgages as underwriters.

A lender authorized to make FHA-insured mortgages may elect a non-DE underwriter with sufficient experience to become a DE underwriter and register in HUD's DE underwriter registry. The MLO broker is responsible for ensuring any underwriter they elect for the DE designation meets HUD standards for DE underwriter designation.[7]

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7 HUD Handbook 4155.2 Chapter 2.A.3

Chapter 9 Summary

Mortgage processing is the receipt of a mortgage application and the organization, preparation and confirmation of supporting documentation by the lender's mortgage processor for submission to the lender's underwriter.

A mortgage processor's responsibilities and duties include:

- gathering the mortgage application documentation to submit to a lender's underwriter;
- coordinating the gathering of documents with the mortgage loan originator (MLO), buyer or owner and lender;
- comparing the income data and debt ratios in the application against the financial documentation requested and reviewed by the processor;
- organizing the mortgage application in the appropriate order requested by the lender, called the stacking order; and
- submitting all required documentation to the lender.

On the flipside of the mortgage process is the lender's underwriter. Underwriting is the analysis of the risk of default posed by the information in a complete mortgage application and documentation acquired by the processor.

The underwriter uses guidelines to review three major components of a mortgage application, called the three Cs of underwriting:

- credit;
- capacity; and
- collateral.

Today, most consumer mortgages are submitted into an automated underwriting (AU) system as part of the underwriting process. The AU system recommendation indicates whether the mortgage meets investor guidelines for purchase after the mortgage closes.

Chapter 9 Key Terms

Chapter 10

Ability-to-repay and qualified mortgage rules

Learning Objectives

After reading this chapter, you will be able to:

- identify the parameters for assessing a buyer's or owner's ability to repay a consumer mortgage;
- differentiate between the ability-to-repay (ATR) rules and the qualified mortgage rules; and
- distinguish between the four kinds of qualified mortgages.

Key Terms

ability-to-repay (ATR) rules
balloon payment
balloon-payment qualified mortgage
business mortgage
consumer mortgage
general qualified mortgage
prepayment penalty
small lender
small lender qualified mortgage
temporary qualified mortgage

Federal consumer protection policy

In the wake of the Great Recession, the *Consumer Financial Protection Bureau (CFPB)* was created and placed in charge of implementing and regulating all federal consumer protection laws, including consumer mortgage originations under:

- the Truth in Lending Act (TILA)'s Regulation Z (Reg Z);
- the Real Estate Settlement Procedures Act (RESPA)'s Regulation X (Reg X); and
- the appraisal rules in the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), which other agencies regulate with guidance from the CFPB.[1]

1 12 Code of Federal Regulations §§1026.1 et seq.; 12 CFR §§1024.1 et seq.

Numerous new mortgage regulations were also created, the most critical being minimum lending standards for **consumer mortgages** under Reg Z **ability-to-repay (ATR) rules**.

Consumer mortgages, not business mortgages

ability-to-repay (ATR) rules
A federal standard for determining an applicant's ability to repay a consumer mortgage.

A *consumer mortgage* is a mortgage secured by a one-to-four unit residential property, owner occupied or not, made primarily for funding a:

- personal;
- household; or
- family use.

A mortgage funding a consumer purpose but secured by property other than a one-to-four unit residential property is not a federally controlled consumer mortgage.

In contrast to consumer mortgages, **business mortgages** are made for **other** than personal, household or family use, and may be secured by any type of real estate including one-to-four unit residential property. *Business mortgages* are not regulated by federal law except for enforcement of the adhesive due-on clause.[2]

The Reg Z ATR rules

Individuals or companies that make consumer mortgages, called **lenders**, are subject to Reg Z ATR rules when they make more than five consumer mortgages in any calendar year. This threshold applies to both private and institutional lenders.[3]

Exceptions to the ATR rules

The ATR rules do not apply to consumer mortgages which are:

- home equity lines of credit;
- mortgages secured by a timeshare;
- reverse mortgages;
- temporary or bridge loans with terms of 12 months or less;
- a construction phase of 12 months or less, on a construction-to-permanent loan; and
- mortgages made by government housing finance agencies and nonprofits.[4]

Additionally, an existing consumer mortgage to be paid off by refinancing may have one of the following characteristics:

- an adjustable rate mortgage (ARM) with an introductory fixed interest rate for a period of one year or longer;
- an interest-only mortgage; or
- a mortgage with a negative amortization feature.[5]

consumer mortgage
A debt incurred primarily for personal, family, or household purposes and secured by a parcel of real estate containing one-to-four residential units.

business mortgage
A debt incurred primarily for other than personal, family or household purposes, whether secured or unsecured.

2 12 United States Code §1701j-3(e)
3 12 CFR §1026.43(c)(1)
4 12 CFR §1026.43(a)
5 12 CFR §1026.43(d)(1)(i)

When the existing mortgage has one of these features, the mortgage to be originated as refinancing to fund the payoff is restricted to:

- a payment schedule that does not include a balloon payment or allow for negative amortization;
- points and fees no more than 3% (for amounts of $100,000 or greater);
- a term not to exceed 40 years;
- an interest rate fixed for at least five years; and
- is used to pay off a non-standard mortgage and closing and settlement charges.[6]

Further, the mortgage funding the payoff of the existing mortgage is not subject to ATR rules when:

- the lender refinancing the existing mortgage is the same lender who holds or services the existing mortgage;
- the monthly payment for the new mortgage is materially lower than the monthly payment for the existing mortgage;
- the lender receives the owner's refinance application within two months after their existing mortgage recasts;
- the owner has not had more than one payment late 30 days or more on the existing mortgage during the 12 months immediately preceding the refinance application;
- the owner has not had any payment late 30 days or more on the existing mortgage in six months immediately preceding the refinance application; and
- the lender has considered whether the refinance will prevent a default.[7]

A mortgage broker's role

Mortgage brokers arranging consumer mortgages also need to understand the *ATR* rules to fulfill their duty to find the best mortgage product for their client's needs. An assessment of each consumer mortgage product offered by a lender for compliance with the ATR rules protects the buyer or owner against default, and the mortgage broker and lender against later claims the consumer mortgage was improperly originated.

Additionally, a mortgage broker who brokers mortgages to private individual investors needs to confirm whether the private lender's consumer mortgage lending volume subjects the lender to the Reg Z ATR rules.

This analysis sets the parameters for the consumer mortgage the mortgage broker arranges on behalf of the buyer or owner. If the private lender's consumer mortgage origination volume does not trigger the ATR rules, the mortgage broker may arrange the mortgage to meet both the buyer/owner's and private lender's needs, without regard to Reg Z restrictions on consumer mortgage terms.

6 12 CFR §1026.43(d)(1)(ii)
7 12 CFR §1026.43(d)(2)-(3)

However, if the mortgage broker is brokering consumer mortgage to a private lender who is subject to the ATR rules, the mortgage origination is necessarily bound by the lender's adherence to the ATR rules.

Two ways to comply

A consumer mortgage meets the requirements of the Reg Z ATR rules in one of two ways:

- by conforming to the **ATR rules**; or
- by conforming to one of the four **qualified mortgage** definitions.[8]

Whether a lender structures a mortgage under the ATR rules or one of the *qualified mortgage* definitions depends on their mortgage activity, investment goals and risk tolerance.

The Reg Z ATR rules

The *ability-to-repay rules* give a lender the most flexibility. Unlike consumer mortgages made under the alternative qualified mortgage rules, consumer mortgages made under the ATR rules aren't restricted in their features, terms or points and fees which may be charged.

Beyond the few hard rules set below, a consumer mortgage lender acting under the ATR rules is able to set their own acceptable level of **risk tolerance** for defining the buyer/owner's repayment capacity.

In exchange for this flexibility, consumer mortgages made under the ATR rules do not provide the lender with any *liability exposure protection* for failing to comply with the ATR rules. They provide the lender neither a safe harbor nor a rebuttable presumption of compliance with the ATR rules.

Additionally, the holder of a consumer mortgage originated under the ATR rules loses the ability to:

- sell the consumer mortgage to Fannie Mae or Freddie Mac (collectively, the *government-sponsored enterprises (GSEs*); or
- receive a government guarantee for the consumer mortgage.

Thus, consumer mortgages which are made under the *ATR rules* are either retained in the mortgage holder's portfolio or sold to private-sector investors.

ATR assessment

A lender funding a consumer mortgage under the ATR rules is required to assess and determine the buyer/owner's ability to repay the consumer mortgage.

The assessment includes the request and review of third-party documents to verify eight items:

1. The buyer/owner's current and expected income or assets, other than the value of the property to be mortgaged. Income and assets are verified through a review of:
    - federal or state tax returns;
    - W-2s;

8 12 CFR §1026.43(c)-(f)

- payroll receipts;
- bank statements; and
- any other third-party documents verifying income.[9]

2. If employment income is used, the buyer/owner's current employment status. [See **RPI** Form 210 and 210-1]
3. The buyer/owner's monthly payment on the consumer mortgage sought.
4. The buyer/owner's monthly payment on other consumer mortgages that are or will be secured by the property.
5. The buyer/owner's monthly payment for mortgage-related obligations, such as property taxes, mortgage insurance, improvement district assessments or homeowners' association (HOA) assessments, in connection with the mortgage sought.[10]
6. The buyer/owner's current debt, alimony and child support obligations.
7. The buyer/owner's monthly debt-to-income ratio (DTI) or residual income.
8. The buyer/owner's credit history.[11]

Substantially equal monthly payment schedule

When calculating whether the buyer/owner is able to repay the mortgage, a mortgage loan originator (MLO) uses a monthly payment schedule which fully amortizes the consumer mortgage through **substantially equal** payments.

What are *substantially equal* payments? For fixed rate consumer mortgages (FRMs), the measurement is straightforward.

Consider a $200,000 30-year FRM. At a 7% interest rate, the MLO will use a monthly payment of $1,331 to determine the buyer's or owner's ability to repay the debt.

For ARMs, consider a $200,000 30-year consumer mortgage with a 6% initial interest rate. [See Chapter 20]

After five years, the interest rate will adjust annually based on a specified index plus a margin of 3%, subject to a 2% annual periodic interest rate adjustment cap. The index figure on origination is 4.5%. Thus, the fully indexed rate is 7.5% (4.5% plus 3%).

Even though the scheduled monthly payment required for the first five years is $1,199, the lender is required to use the substantially equal monthly payment which will fully amortize payment of the $200,000 over 30 years, using the fully indexed rate of 7.5%. Thus, the lender will use a monthly payment of $1,398 to determine the buyer/owner's ability to repay the consumer mortgage.[12]

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9 12 CFR §1026.43(c)(4)

10 12 CFR §1026.43(b)(8)

11 12 CFR §1026.43(c)(2)

12 Official Interpretation of 12 CFR §1026.43(c)(5)(i)-5

Further ATR rules

The ability-to-repay rules allow mortgage originations with provisions for:

- a final/balloon payment;
- interest-only payments; and
- negative amortization.

For consumer mortgages with a final/balloon feature, the monthly payment used to determine the buyer/owner's ability-to-repay is the largest payment scheduled during the first five years of the mortgage. A different threshold applies if the mortgage is a **Section 35 mortgage**.[13] [See Chapter 26]

For consumer mortgages with an **interest-only** or negative amortization feature, to determine a buyer/owner's ability to repay, a monthly payment schedule which will fully amortize principal by its maturity date — the due date for the final/balloon payment of principal — is used.[14]

Prepayment penalties on an early payoff of the mortgage may not be charged on consumer mortgages under the ATR rules.[15]

The definition of a qualified mortgage

The alternative way for a lender to meet the Reg Z ATR requirements is to make a *qualified mortgage*.

A mortgage holder who originates a qualified mortgage in **good faith** is deemed to have met the Reg Z ATR requirements.

The benefits the lender receives for consumer mortgage originations meeting the more restrictive qualified mortgage rules include:

- the ability to sell the consumer mortgages meeting the qualified mortgage criteria to the GSEs;
- access to government insurance or guarantees for consumer mortgages it originates; and
- safe harbor protection from liability exposure for failing to comply with the ATR requirements (different treatment applies to Section 35 mortgages).[16]

Types of qualified mortgages

To permit some flexibility for small lenders, four types of qualified mortgages have been established entitled:

- the **general qualified mortgage;**[17]
- the **temporary qualified mortgage;**[18]
- the **small lender qualified mortgage;**[19] and

13 12 CFR §1026.43(c)(5)(ii)
14 12 CFR §1026.43(c)(5)(ii)(B); 12 CFR §1026.43(c)(5)(ii)(C)
15 12 CFR §1026.43(g)
16 12 CFR §1026.43(e)-(f)
17 12 CFR §1026.43(e)(2)
18 12 CFR §1026.43(e)(4)
19 12 CFR §1026.43(e)(5)

- the **balloon-payment qualified mortgage**, with both temporary and permanent definitions.[20]

Qualified mortgages of the general and temporary types may be originated as consumer mortgages by all lenders. Balloon-payment and small lender qualified mortgages may only be originated by small lenders.

The general qualified mortgage

general qualified mortgage
A consumer mortgage conforming to safe harbor status under the federal ability-to-repay (ATR) rules.

To be a general qualified mortgage, the consumer mortgage meets six criteria:

1. Regular periodic payments. No interest only, negative amortization or final/balloon payment features are allowed.[21]
2. A mortgage term of 30 years or less.[22]
3. Maximum points and fees of no more than 3% of the principal amount for mortgages of $107,747 or more in 2019, adjusted annually for inflation.[23]
4. Monthly payments used to determine repayment ability are to be based on a full amortization schedule, using the maximum interest rate that applies during the first five years.[24]
5. Assets, debts and two years' income are to be verified and documented. Income used needs to be verified, stable and expected to continue. The lender is responsible for verifying the most recent two years' employment.[25]
6. The maximum total DTI, also known as the **back-end DTI,** is 43%.[26]

The temporary qualified mortgage

temporary qualified mortgage
A transitional qualified mortgage for lenders originating mortgages insured or guaranteed by the federal government or sold to Fannie Mae or Freddie Mac.

A *temporary qualified mortgage* allows the GSEs and government agencies time to adjust their criteria to meet the qualified mortgage definition.

For mortgages **sold** to the GSEs, the temporary qualified mortgage definition will exist until the earlier of exiting their federal conservatorship, or January 10, 2021.

For mortgages **guaranteed or insured** by the federal government, the temporary qualified mortgage definition applies until the earlier of the government agency's creation of its own definition of a qualified mortgage, or January 10, 2021.

A temporary qualified mortgage is to meet the general qualified mortgage requirements for regular periodic payments, maximum mortgage terms, and total points and fees restrictions.

In addition, temporary qualified mortgages are required to be eligible for purchase by a GSE, or insurance or guarantee by the:

- Department of Housing and Urban Development's (HUD's) Federal Housing Administration (FHA);

20 12 CFR §1026.43(f); 12 CFR §1026.43(e)(6)
21 12 CFR §1026.43(e)(2)(i)
22 12 CFR §1026.43(e)(2)(ii)
23 12 CFR §1026.43(e)(3)
24 12 CFR §1026.43(e)(2)(iv)
25 12 CFR §1026 Appendix Q Parts A-B
26 12 CFR §1026.43(e)(2)(vi)

What are included in points and fees?

Points and fees include charges paid directly or indirectly by the buyer/owner which are required by the lender. [12 Code of Federal Regulations §1026.43(e)(3)(i); 12 CFR §1026.32(b)(1); 12 CFR §1026.4(a)]

Lender charges include those points and fees paid before, at or after the mortgage closes (amounts rolled into the mortgage).

Six general rules govern whether lender charges and fees are considered in the points-and-fees threshold:

1. ***Finance charge***

   The finance charge is the cost of the mortgage as a dollar amount. For calculating the finance charge to compare to the points and fees threshold, the following amounts are not included:

   - *interest;*
   - *mortgage insurance premiums;*
   - *third-party fees not kept by the lender or mortgage loan originator (MLO) [12 CFR §1026.32(b)(1)(i)(D)]; and*
   - *bona fide discount points. [12 CFR §§1026.32(b)(1)(i)(E)-(F), 12 CFR §1026.32(b)(3)]*

   Bona fide discount points are paid by the buyer/owner to lower the interest rate on their mortgage.

   The discount amount excluded from the finance charge is limited to two points when the pre-discounted interest rate is no more than one percentage point higher than the average prime offer rate (APOR) for a comparable mortgage.

   Only one point is excluded if the interest rate before the discount is between one and two percentage points higher than the APOR for a comparable mortgage.

2. ***Mortgage loan originator (MLO) compensation***

   Fees paid directly or indirectly by a buyer/owner or lender for services of a mortgage loan originator (MLO) are included.

   Salaries and other types of compensation which are not based on the origination of any one specific mortgage are excluded. [12 CFR §1026.32(b)(1)(ii)]

- the U.S. Department of Veterans Affairs (VA);
- the Department of Agriculture (USDA); or
- the Rural Housing Service (RHS).[27]

The temporary qualified mortgage does not restrict the total back-end DTI ratio to 43%. Instead, it temporarily defers to the GSEs and the government agencies for underwriting procedures. However, lenders, government agencies and the GSEs may place more restrictive requirements on consumer mortgages they make, insure, guarantee or purchase.

The GSEs do not purchase consumer mortgages which are not qualified mortgages.

HUD's qualified mortgage definition follows the general qualified mortgage definition, with limited exceptions to the 3% up-front points and fees rule, to facilitate smaller mortgages.

27 12 CFR §1026.43(e)(4)(ii)

3. ***Real estate-related fees***

   Included in this category are fees for title reports, escrow charges, notary and credit report fees, appraisal fees and home inspection fees. [12 CFR §1026.32(b)(1)(iii)]

   These amounts are excluded, but only if:

   - *the charge is reasonable;*
   - *the lender receives no direct or indirect compensation in connection with the charge; and*
   - *the charge is not paid to an affiliate of the lender.*

4. ***Premiums for credit insurance; credit property insurance; other life, accident, health or loss-of-income insurance where the lender is the beneficiary; or debt cancellation or suspension coverage payments***

   These charges are included, unless they are paid after the mortgage closes, e.g., by making monthly premium payments. [12 CFR §1026.32(b)(1)(iv)]

5. ***Maximum prepayment penalty***

   When allowed by Reg Z rules, the prepayment penalty is included in this calculation. [12 CFR §1026.32(b)(1)(v)]

6. ***Prepayment penalties paid in a refinance***

   Prepayment penalties charged by the lender of an existing mortgage when refinanced by a new mortgage are included if the new lender (or an affiliate) currently holds or services the existing mortgage. [12 CFR §1026.32(b)(1)(vi)]

What are included in points and fees?

cont'd

The appraisal and a consumer mortgage

The *small lender qualified mortgage* allows small lenders to originate consumer mortgages with more flexible standards for being qualified mortgages.

In 2018, a **small lender** is a lender with assets of $2.112 billion or less which made 2,000 or fewer first-lien consumer mortgages in the preceding calendar year (two years, if the mortgage application is received before April 1). The asset threshold is adjusted for inflation each year.

small lender
In 2018, a lender with assets of $2.112 billion or less which made 2,000 or fewer first-lien consumer mortgages in the preceding calendar year (two years, for applications received before April 1).

To meet the requirements of a small lender qualified mortgage, the consumer mortgage may not:

- allow for negative amortization;
- have a term longer than 30 years; and
- have total points and fees more than 3% of the mortgage amount.

The buyer/owner's ability to repay is determined by calculating monthly payments based on a full amortization schedule, using the maximum interest rate that may apply during the first five years. DTI caps are not imposed, but DTI is to be considered in the underwriting analysis.[28]

small lender qualified mortgage
A type of qualified mortgage which allows small lenders to include features otherwise prohibited in consumer mortgages.

For a small lender qualified mortgage to retain its status when funded as part of a *warehouse line of credit* (or other agreement entered into prior to the funding of the mortgage to sell the mortgage, known as a *forward commitment*) the mortgage may only be sold to another small lender.

28 12 CFR §1026.43(e)(5)

If a small lender qualified mortgage isn't subject to a forward commitment, the mortgage is to be retained in the small lender's portfolio for at least three years. It may be sold after three years, but only to another small lender.[29]

The balloon-payment qualified mortgage

Consumer mortgages with final/balloon payments to be classified as qualified mortgages, called **balloon-payment qualified mortgages**, may only be originated by small lenders.

balloon-payment qualified mortgage
A type of qualified mortgage which allows small lenders to include a balloon feature.

A **balloon payment** is any final payment on a note which is greater than twice the amount of any regularly scheduled payments.[30] [See **RPI** Form 418-3 and 419]

balloon payment
Any final payment on a note which is greater than twice the amount of any regularly scheduled payments.

A small lender may only make a balloon-payment qualified mortgage when it originated at least one first-lien consumer mortgage secured by a property in a rural or underserved area in the prior calendar year (two years if the mortgage application is received before April 1).

Like a general qualified mortgage, a final/balloon payment qualified mortgage:

- may not allow for negative amortization;
- may not have a consumer mortgage term in excess of 30 years;
- may not have total points and fees in excess of 3% of the mortgage amount; and
- requires the lender to verify buyer/owners' income, assets and debt according to the general qualified mortgage rule.[31]

Additionally, a final/balloon payment qualified mortgage:

- needs to have a fixed interest rate and periodic payments based on an amortization schedule of no more than 30 years;
- needs to have a term of at least five years before it is due;[32] and
- may not be sold after origination to an entity other than another small lender eligible to make balloon-payment qualified mortgages.[33]

No maximum DTI requirements are imposed.

Prepayment penalties

Charging a prepayment penalty on any consumer mortgage is restricted.

A *prepayment penalty* is levy charged by a mortgage holder to a property owner who pays off the outstanding principal balance on a mortgage prior to its maturity. [See **RPI** Form 418-2]

29 12 CFR §1026.43(e)(5)(ii)(A)-(B)
30 12 CFR §1026.18(s)(5)(i)
31 12 CFR §1026.43(f)(1)(i)
32 12 CFR §1026.43(f)(1)(iv)
33 12 CFR §1026.43(f)(1)(v)

prepayment penalty
A levy charged by a mortgage holder to a borrower who pays off the outstanding principal balance on a mortgage prior to its maturity.

Prepayment penalties are only permissible on qualified mortgages, not consumer mortgages which are not qualified mortgages. When permitted, the restrictions include:

- the penalty period is limited to three years after origination; and
- the amount of the penalties may not exceed:
  - 2% of the outstanding balance during the first two years; and
  - 1% of the outstanding balance during the 3rd year.[34]

This restriction also applies to carryback sellers, regardless of the number of consumer mortgages they have carried back on sales of homes to buyer-occupants.

A lender (not a carryback seller) offering a buyer/owner a mortgage with a prepayment penalty is also required to offer the option of a mortgage without a prepayment penalty.[35]

Civil liability for violations

A buyer/owner may bring an action against a lender who fails to meet the ATR rules by:

- filing an action against the lender within three years of the violation;[36] or
- using the violation as a defense against a lender's foreclosure action.[37]

A lender who violates the ATR rules is subject to:

- actual money losses incurred, called damages;
- special statutory monetary sums equal to all finance changes and fees paid by the buyer/owner;
- other TILA statutory monetary sums; and
- court costs and attorney fees.[38]

A lender who is found to have violated the ATR rules under a defense against foreclosure recoupment action is subject to no more than three years of finance charges and fees paid, plus costs and attorney fees.[39]

Civil penalties available against lenders who violate Reg Z are also extended to MLOs who violate their responsibilities under Reg Z.[40]

As with other consumer protection laws, a lender is exempt from liability when a buyer/owner obtains a consumer mortgage through fraud.[41]

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34 12 CFR §1026.43(g)
35 15 USC §1639c(c)(4)
36 15 USC §1640(e)
37 15 USC §1640(k)
38 15 USC §1640(a)(4)
39 15 USC §1640(k)(2)(B)
40 15 USC §1639b(d)
41 15 USC §1640(l)

Chapter 10 Summary

Individuals or companies that make consumer mortgages, called lenders, are subject to Regulation Z (Reg Z) ability-to-repay (ATR) rules when they make more than five consumer mortgages in any calendar year.

A consumer mortgage meets the requirements of the Reg Z ATR rules in one of two ways:

- by conforming to the ATR rules; or
- by conforming to one of the four qualified mortgage definitions.

The ATR rules give a lender the most flexibility. Unlike consumer mortgages made under the alternative qualified mortgage rules, consumer mortgages made under the ATR rules aren't restricted in their features, terms or points and fees which may be charged. In exchange for this flexibility, consumer mortgages made under the ATR rules do not provide the lender with any liability exposure protection for failing to comply with the ATR rules.

In contrast, the benefits the lender receives for consumer mortgage originations meeting the more restrictive qualified mortgage rules include:

- the ability to sell the consumer mortgages meeting the qualified mortgage criteria to the government sponsored enterprises (GSEs);
- access to government insurance or guarantees for consumer mortgages it originates; and
- safe harbor protection from liability exposure for failing to comply with the ATR requirements.

Four types of qualified mortgages have been established entitled:

- the general qualified mortgage;
- the temporary qualified mortgage;
- the small lender qualified mortgage; and
- the balloon-payment qualified mortgage, with both temporary and permanent definitions.

Chapter 10 Key Terms

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balloon payment .... **pg. 106**
balloon-payment qualified mortgage .... **pg. 106**
business mortgage .... **pg. 98**
consumer mortgage .... **pg. 98**
general qualified mortgage .... **pg. 103**
prepayment penalty .... **pg. 107**
small lender .... **pg. 105**
small lender qualified mortgage .... **pg. 105**
temporary qualified mortgage .... **pg. 103**

Chapter
11

Credit matters

Learning Objectives

After reading this chapter, you will be able to:

- understand the use of credit to qualify for a mortgage;
- identify the factors which generate the most referenced credit score, the FICO score; and
- differentiate between FICO scoring and other credit scoring.

Key Terms

credit report
credit score
creditworthiness

The credit score

A mortgage loan originator (MLO)'s role extends beyond simply negotiating the terms of a mortgage, a service called *arranging*. They have a duty to the buyer to inform them about the terms of available mortgages and the requirements to be met to qualify for a mortgage.

Lenders rely heavily on **credit scores** to make their lending decisions, be it on a mortgage, a credit card or a car loan. Most buyers know they have a credit score, and its general use, but few consider the nuts and bolts behind the score — that is, until they apply for a mortgage and are denied or offered unfavorable terms. Thus, understanding credit and credit scores is intrinsic to an individual's understanding about the availability of mortgages.

credit score
A numerical representation of a borrower's creditworthiness, based on credit information obtained by a credit bureau.

What makes up a credit report

A compilation of a buyer's collected credit history is called a **credit report**. The factors that build a credit report include:

- the number of credit accounts a buyer holds;
- the length of time credit accounts have been held;

credit report
A compilation of a buyer's collected credit history.

- the amount of debt owed;
- the buyer's payment history; and
- other financial history such as judgments or bankruptcies.

Various sources such as banks and credit card companies voluntarily provide a buyer's financial activity to the three main national credit reporting agencies (or credit bureaus): Equifax, TransUnion and Experian. Each of the credit bureaus independently compiles the information to create a buyer's credit report. Thus, three different reports (one from each bureau) report on each buyer.

Each bureau's credit report on a buyer may be pulled either directly from the bureaus or from third-party vendors that pull information from all three sources at once, called a **tri-merge credit report**.

Credit report elements

Each vendor's presentation of the credit report is slightly different. However, credit reports typically contain:

- information identifying the buyer, such as name, date of birth, Social Security number and address;
- file alerts, such as fraud alerts or notifications of active military duty; and
- credit history, including:
    - public records, such as bankruptcies and judgment liens;
    - collections;
    - trade accounts, such as credit cards and mortgages; and
    - inquiries.

For each trade account, information is provided regarding:

- the date and duration of credit reporting;
- the account type (revolving or installment);
- the date the account was opened;
- whether the account is open or closed;
- the date the account was last used, for revolving debt;
- the term of the account, for installment debt;
- the credit limit;
- the highest balance in the history of the account, for revolving debt;
- the current balance on the account;
- the minimum monthly payment on the account;
- the payment status (e.g., current, paid as agreed, not paid as agreed, etc.);
- a payment history;
- any past due balance; and
- the length and number of delinquencies.

Most tri-merge credit reports also contain summary information about a buyer's credit history, such as the total number of open accounts, the total balance of outstanding debt and the total number of payments late by 30 days or more.

The FICO score

Based on these credit reports, unrelated companies have developed their proprietary algorithms to analyze the credit performance of buyers. These algorithms using credit report information calculate a buyer's credit score. Credit scores allow lenders to outsource the responsibility of a standardized credit review and avoid the expense of maintaining their own staff to make an internal evaluation of a buyer's credit history.

Simplified, the algorithm is an equation which mathematically weighs selected components of a buyer's credit history and present financial circumstances to arrive at a number — the score — which gauges the buyer's *likelihood of repaying debt*.

The most prevalent third-party provider of algorithm-based credit scores is **FICO**, formerly known as the Fair Isaac Corporation. Fannie Mae and Freddie Mac require the use of FICO scores on mortgages delivered/sold to them; the Federal Housing Administration also requires FICO scores on mortgages it insures.

Different FICO algorithms exist, depending on the type of credit request and the lender's preference. The majority of mortgage lenders use a FICO score-based algorithm.[1]

FICO's algorithm assigns credit scores in a range from 300 to 850. The higher the credit score, the better the buyer's access to credit – ability to borrow funds. Likewise, the lower the credit score, the worse the buyer's access to credit.

Lenders use credit scores to measure a buyer's likelihood of paying (or defaulting) on a mortgage, called **creditworthiness**. Other factors considered in a buyer's creditworthiness include employment history and cash reserves. A buyer's *creditworthiness* sets the bar for whether and how much a lender is willing to lend and at what rate.

creditworthiness
An individual's likelihood of repaying a mortgage, determined by their present income, wealth and previous debt payment history.

Establishing a FICO score

Now, we'll discuss what makes up a credit score, using the generic FICO algorithm as a benchmark. Here, the information is pulled from FICO's public website and conversations with FICO officials. The actual algorithm used to calculate FICO scores is proprietary, and thus not available for public analysis.

Additionally, many lenders use custom FICO score calculations which take into account different factors depending on the lender's need and credit

1 Fannie Mae Single Family Selling Guide Chapter B3-5.1-01; Freddie Mac Single Family Seller/Servicer Guide Chapter 5203.1

product (e.g., auto loans, mortgages). These scores weigh various types of credit and buyer activity differently, called *industry scores*. The variances across different types of credit scores is discussed below.

Before a FICO score can be established, a buyer needs:

- one reportable account at least six months old; or
- one undisputed account which has been reported to FICO in the last six months; and
- no report on record that the buyer is deceased.

Under the classic FICO score algorithm, only traditional credit accounts are considered. Traditional credit accounts are accounts reported to the credit bureaus, and include accounts like credit cards, bank accounts and mortgages.

Cell phone accounts, utilities and rental payments are nontraditional credit accounts. Nontraditional credit accounts are not reported to the credit bureaus or considered in the generic FICO score algorithm. So, the generic FICO score calculation does not reflect the positive impact of timely rental payments or utility payments, the bulk of a prospective buyer's monthly payments.

However, when such bills are delinquent, they may be reported to the bureaus by those creditors as delinquencies. If the accounts go into collection or a money judgment is recorded against the buyer, they have an adverse effect on a buyer's credit score.

The buyer's credit history

The generic FICO score is determined based on the following factors from a buyer's credit behavior:

- **35%** is based on **payment history**, including public records such as bankruptcies, judgments and liens and payment history including delinquencies, how severe the delinquencies are and how long ago they occurred;
- **30%** is based on **amounts owed**, including the number of accounts with balances, and the proportion of credit lines used or installment mortgage balances outstanding;
- **15%** is based on **length of credit history**, including time since an account was opened and time since there was activity on the account;
- **10%** is based on **new credit opened**, including the number of recently opened accounts in proportion to the existing accounts, the number and timing of recent inquiries and the re-establishment of positive credit history following payment problems; and
- **10%** is based on **type of credit used**, including the percentage difference in types of accounts, e.g. credit cards, retail accounts, installment mortgages, mortgages, etc.

FICO provides the scoring formula to the three credit bureaus in a "black box." Thus, the bureaus do not have access to the FICO's proprietary algorithm. The three bureaus in turn apply the encoded formula to an individual's credit history to determine the credit score. The bureaus then market and sell the resulting scores as a service to lenders. FICO receives a royalty each time a credit score is calculated using their formula.

Thus, scores vary across the three bureaus, depending on the debt information each has on file for an individual. Lenders buying the score from a bureau then use the figure as they wish in their mortgage underwriting decisions. Typically, a lender pulls an individual's credit score from all three bureaus. The lender then averages them or uses the middle score to set the score they consider when analyzing the individual's mortgage application.

Impact of derogatory events on FICO scores

An example of how identified events in a person's credit profile *might affect* their credit score is disclosed on FICO's consumer website, *http://www.MyFICO.com*. These numbers are elusive since they are given in a range, and the ranges vary greatly as they are highly dependent on a buyer's current credit score. Usually, negative credit events penalize buyers with higher credit scores more than those with lower credit scores. [See Figure 1]

30-day mortgage **delinquencies**, like other credit delinquencies, stay on a buyer's file for seven years. A 30-day delinquency *might reduce* a score by between 60-110 points. For 60-day or 90-day delinquencies, the credit reduction migrates to a range closer to that of foreclosure detailed below.

Both judgments and accounts in collections cause a drop in credit scores in the range of 85-160 points, similar to the point drop for a mortgage foreclosure.

Foreclosures stay on a buyer's file for *seven years*, and can negatively impact a score between 85-160 points. However, a buyer who makes timely payments on other obligations, such as auto loans and credit cards, and keeps the use of additional credit in check can see their credit score rebound after as little as two years.

Regardless of the type of **bankruptcy** petition filed, the reduction in the FICO score is the same — around 130-240 points. **Chapter 13 bankruptcies** stay on file for *seven years* from the date paid (or ten years if not completed), and **Chapter 7 bankruptcies** stay on file for *ten years* from the date filed.

Bankruptcies do the most damage to FICO scores. They typically encompass the restructuring or charging-off of multiple credit accounts as opposed to one debt on a mortgage foreclosure.

Editor's note — FICO scores look at a prospective buyer's entire credit makeup to arrive at a FICO score. However, for the purpose of clarification, the discussion of FICO scores which follows treats each event as though all other events remain unchanged, i.e., the impact of a foreclosure is only based on that event, and does not include the credit score impact of the inherent delinquencies or modifications leading up to the foreclosure.

Figure 1

Credit events' potential impact

FICO Starting Score	680	780
Inquiries	680-672*	780-772*
30-Day Delinquency	600-620	670-690
Mortgage Modification	Varies widely^	Varies widely^
Short Sales, Deeds-in-Lieu (same impact as foreclosure)	575-595	620-640
Foreclosure	575-595	620-640
Bankruptcy	530-550	540-560

Data Source: MyFICO.com, the public consumer subsidiary of FICO

* Uncoordinated multiple inquiries have a greater negative impact than isolated single inquiries. See below for discussion.

^ The drop for mortgage modification inquiries varies depending on how the lender reports the modification. See below for discussion.

Also, the effect of a negative item on a credit score dissipates over time after it first appears on the credit report. The credit impact ranges depict the initial impact of each event, not the impact that the event has, say six months or a year later.

Types of inquiries

Two kinds of inquiries exist:

- **soft inquiries**, which include:
  - self-run credit inquiries;
  - inquiries run by credit card companies when offering promotional credit card offers; and
  - inquiries run by creditors with whom the prospective buyer has current relationships; and
- **hard inquiries** run in connection with applications for credit, including:
  - mortgages (including pre-approvals, or even pre-qualifications which entail a credit check);
  - auto loans; and
  - credit cards.

Only hard inquiries drop FICO credit scores, and do so in the range of 0 to 8 points.

Hard inquiries stay on a FICO score for two years. However, the buyer's FICO score is based on the number of inquiries in any 12-month period. Important to note is when a buyer applies for a mortgage with multiple lenders within a 45-day period, their credit score will only be negatively impacted for one event. Thus, the FICO score drop of zero to eight points will only occur once.

Editor's note — In the 1990s, the FICO algorithm only allowed for a 14-day "shopping" period, and later a 30-day shopping period. The current FICO algorithm, which went into effect in the early 2000s, allows for a 45-day shopping period. This longer period is more consistent with the Department of Housing and Urban Development (HUD)'s encouragement for buyers to shop several lenders for a mortgage.

According to FICO, most lenders who choose to pull credit scores are choosing to pull those using the new algorithm which recognizes a 45-day shopping period, but some may still be using older formulas.

Additional mortgage inquiries made over more than 45 days usually take fewer than five points off a FICO score. However, this is also dependent on a buyer's specific credit position. Buyers with less credit available (called *thin credit*) and a higher number of inquiries within the 12-month reporting period will experience a greater negative impact for inquiries than those with more available credit and fewer overall inquiries.

FICO's reasoning is based on research finding that people with six inquiries or more on their credit report can be up to eight times more likely to declare bankruptcy than people with no inquiries. Inquiries right after delinquencies or defaults also purportedly raise a red flag with the FICO formula, and result in greater credit score drops. Individuals exhibiting these types of activities are classified as high risk and can experience FICO score reductions ranging from 10-24 points per inquiry.

Mortgage modification effects

A **mortgage modification** reduces credit scores, but a pre-established point drop depends on how the lender reports the modification to the credit bureaus.

Mortgage modification encouraged by government-sponsored programs was especially damaging for those seeking help when they were first implemented. Guidelines encouraging lenders to use comment code "*AC*" when reporting mortgage modifications has been released by the *Consumer Data Industry Association (CDIA)*. Code AC indicates the account is repaid under a partial or modified payment plan. In FICO score language, this translates into a **possible reduction** of over 100 points off a credit score.

Editor's note — CDIA guidelines are not law; their use is optional for lenders when reporting mortgage modifications.

Another credit scoring comment code of "*CN*" used specifically for designating a mortgage modification has been added. However, FICO does not give any weight to this designation. FICO has not determined what, if any, predictive power mortgage modifications have on a buyer's future proclivity to pay their debts.

Editor's note — This does not mean that an owner who enters into a mortgage modification arrangement does not experience credit score impacts. In recent history, lenders simply waited until a mortgage was delinquent for 60 to 90 days before they would even consider a modification. Thus, for an *owner to enter into mortgage modification negotiations, they had to make a decision to damage their credit scores by defaulting and creating mortgage delinquencies.*

The effects of foreclosure alternatives on credit scores

Short sales, **deeds-in-lieu** and other foreclosure alternatives (separate from the mortgage modifications, as discussed above) are treated similarly to foreclosures when it comes to the corresponding point drop in FICO scores. The generic FICO formula has no way to differentiate any of these non-foreclosure events from an actual foreclosure sale.

The reason no difference can be determined for FICO scoring is lenders merely report to bureaus that the mortgage was *"not paid as agreed."* This reporting is in spite of the fact they have been and are now being paid as agreed under default conditions required by the lender.

Remember: this discussion isolates the impact of each separate credit event. Keep in mind that each owner will have a different credit profile before the foreclosure, deed-in-lieu or short sale event. Some owners will have been delinquent only 60 days when they successfully short sell their properties (and thus discharge the underlying debt).

Still others may have been delinquent for an entire year before being foreclosed upon. The change in their credit scores prior to the foreclosure event will create differing impacts when the foreclosure occurs. The actual single event of the foreclosure or foreclosure alternative, when reported as "not paid as agreed," is the same, according to FICO.

Now, if the lender chooses to report the foreclosure alternative with a designation other than "not paid as agreed" the impact of the action will be different from a foreclosure. With credit scoring, there is no universal reporting requirement. (Recall that credit reporting itself is a voluntary process.)

Different types of credit scores

Even within the FICO system, dozens of different credit scoring products exist, each designed to specialize in determining risk for different types of credit. Additionally, there are different versions of each type of FICO score, as FICO updates their algorithms. Lenders are not required to update their systems with each update of the FICO algorithm.

So, each algorithm will give buyers a different score. And each time the credit score is pulled, the score will likely be different, as even the passage of time will cause credit accounts to mature (a longer credit history is better!) and negatives to fall off the credit reports.

FICO advertises a consumer educational credit score on their website for buyers. In addition to this FICO score, each of the three bureaus has its own credit score algorithm it uses. Collectively, the three bureaus have also paired up to create the *VantageScore*, a FICO alternative.

In addition, the three bureaus each market their own version of an "educational" credit score. (Colloquially, these non-FICO alternative credit scores are referred to as "FAKO" scores.) Just like the numerous FICO scores, these different calculations of credit score will provide different scores, at different times, for the same buyer.

The Consumer Financial Protection Bureau (CFPB) compared credit scoring models used by lenders against those commercially available to the public. The CFPB reviewed 200,000 credit files from each of the three bureaus. For all these individuals, the CFPB pulled the generic FICO score, the educational scores marketed by the bureaus, the VantageScore, the FICO Auto Loan industry-specific score and the FICO BankCard industry-specific score.

So, did the scores match?

No. But the CFPB found that the scores gave similar results 90% of the time. Around 78-86% of the time, the distribution of the scores was in the same 10% of the credit scoring range (FICO runs on a scale of 300-850, while at the time VantageScore credit scores used a 500-990 scale). Usually, educational scores and the different FICO models still land within the ballpark.

However, mortgage brokers are to take care when advising clients to rely on these non-lender credit score sources. They are educational tools, and should not be relied on as qualifying information with lenders. This is especially true if the educational credit scores pulled by the applicant are close to the minimum credit scores required by Fannie Mae, Freddie Mac or the Federal Housing Administration (FHA).

For best results when counseling a client, MLOs need to focus their energies on the credit report itself. Clients may dispute any errors with the credit bureaus. Documentation about the dispute, and any other negative items on the client's credit report, may be provided with the mortgage application. This method will not only provide the lender's underwriter with an explanation of negative credit items, but impact the score the lender ultimately relies on when making a decision on the mortgage. [See Chapter 12]

As for the educational scores — the CFPB suggested that vendors of these educational scores disclose that the scores are likely different from those a lender will use in determining whether to make a mortgage. While it is not yet a federal mandate to do so, mortgage brokers can do their part to pass on the information. When discussing credit with clients, inform them of the difference between scores pulled online, and the scores a lender will use.

Chapter 11 Summary

Understanding credit and credit scores is intrinsic to understanding mortgage products. The factors that build a credit report include:

- the number of credit accounts a buyer holds;
- the length of time credit accounts have been held;
- the amount of debt owed;
- the buyer's payment history; and
- general financial history (such as the existence of judgments, or bankruptcies).

Each vendor's presentation of the credit report is slightly different. However, credit reports usually contain:

- information identifying the buyer, such as name, date of birth, Social Security number and address;
- file alerts, such as fraud alerts or notifications of active military duty; and
- credit history, including:
    - public records, such as bankruptcies and judgment liens;
    - collections;
    - trade accounts, such as credit cards and mortgages; and
    - inquiries.

The most prevalent third-party provider of credit score algorithms is the FICO, formerly known as the Fair Isaac Corporation.

There are two types of inquiries: hard inquiries and soft inquiries. Only hard inquiries drop FICO credit scores, and do so in the range of zero to eight points.

Chapter 11 Key Terms

Chapter 12

Repairing damaged credit

Learning Objectives

After reading this chapter, you will be able to:

- identify credit repair schemes and scams;
- understand how credit repair companies purport to raise a prospective buyer's credit score; and
- explain how the Credit Repair Organizations Act (CROA) protects prospective buyers against credit repair fraud.

Key Terms

credit repair

credit repair organization

Credit Repair Organization Act (CROA)

Section 609 credit dispute

Answering our society's need to borrow

In the wake of the Great Recession and unfolding mortgage crisis, many individuals saw their credit scores drop — some substantially — for causes beyond their control. The aftermath saw more prospective buyers with lower credit ratings than before. This in turn brought on federal reinstatement of fundamental mortgage underwriting guidelines.

As expected in our borrower-supported economy, enterprising individuals came up with ways of reaching out to credit-damaged prospective buyers with offers of **credit repair** services. *Credit repair* advertisements claim they can help raise credit scores and remove bad credit with planning — for a fee.

credit repair
A service purporting to raise credit scores and remove bad credit.

Prospective homebuyers unable to qualify for residential mortgages due to bad credit were pulled in by these offerings in hopes of bringing their credit scores up, enabling them to borrow and buy a home.

credit repair organization
A person or company that offers to improve a buyer's credit history, record or rating in exchange for a fee.

For perspective, a **credit repair organization** is any individual or company who offers or provides services to improve a buyer's credit history, record or rating in exchange for a fee. *Credit repair organizations* do not include bona fide nonprofits, lenders who restructure consumer mortgages they hold, banks or credit unions.[1]

Protecting consumers

Borrowers using credit repair are indirectly protected against fraud perpetrated by credit repair organizations by the **Credit Repair Organization Act (CROA)**. [2]

Credit Repair Organization Act (CROA)
A federal law protecting credit repair consumers from fraud perpetrated by credit repair organizations.

Buyers may not waive the protections against credit repair scams in CROA. Attempts to obtain a waiver of these rights and protections violate CROA.[3]

CROA prohibits the counseling of a buyer to submit misleading or false information regarding the buyer's creditworthiness to any credit bureau or lender. In other words, a credit repair organization may not simply lie about a buyer's credit history to aid in "repairing" the credit.[4]

CROA casts a wide net for those aiding in repair.

For example, consider a business which provides credit scores, reports and credit monitoring services to buyer/owners. Its business includes selling tools to its clientele representing that the use of the tools will result in improved credit.

The business does not perform any credit repair work itself, though a consumer claims it represented through advertisements that it does perform credit repair.

Here, selling a tool advertised to improve credit was considered providing credit repair services. The business was ordered to adhere to CROA rules.[5]

Credit repair organizations are also not allowed to advise the buyer or aid the buyer in creating alternate identification in order to create a new credit history or "cover up" a negative credit history.

One common unlawful credit repair tactic is to recommend that the buyer create a new credit identity by applying for an Employee Identification Number (EIN). The buyer then uses this in place of the Social Security number to hide their negative personal credit history.[6]

Further, credit repair organizations may not advertise they can "improve a score 90 points in 90 days!" Each buyer's credit history is a different experience, making such a claim a misrepresentation on its face.[7]

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1 15 United States Code §1679a(3)
2 15 USC §1679b(a)
3 15 USC §§1679f(a)-(b)
4 15 USC §1679b(a)(1)
5 **Stout** v. **FreeScore, LLC** (9th Cir. 2014) 743 F3d 680
6 15 USC §1679b(a)(2)
7 15 USC §1679b(a)(3)

Finally, credit repair organizations may not require payment of advance fees for credit repair services.[8]

Right to cancel

Before a credit repair organization may provide services, they need to enter into a written agreement with the client. Further, the client may cancel the agreement within three business days after signing it. The credit repair organization may not commence credit repair services until the three-business-day period has passed.[9]

Credit repair contracts are to contain:

- the terms for payment and the total amount of all payments;
- a detailed description of the services to be performed, including all guarantees, and an estimate of either:
    - the date for completion of the services; or
    - the length of the period for performing their services;
- the credit repair organization's name and principal business address; and
- the following statement, in bold, near the client's signature space on the agreement: **"You may cancel this contract without penalty or obligation at any time before midnight of the third business day after the date on which you signed the contract. See the attached notice of cancellation form for an explanation of this right."**[10]

Non-conforming agreements are unenforceable.[11]

Credit repair rarely works

Credit repair organizations work by stoking fears that most **credit reports** are littered with errors. In truth, only a small percentage of reports contain errors large enough to dramatically affect a buyer's credit. O*ne in five* borrowers has an error in their credit report according to a 2012 executive report by the Federal Trade Commission (FTC). Further, only 2.2% of borrowers had errors in their credit reports dramatic enough to negatively affect their access to higher credit.

Disputing credit information

More importantly, borrowers may dispute the accuracy of any information within their credit report under the **Fair Credit Reporting Act (FCRA)**. This protects buyers from inaccurate or fraudulent items that appear on their credit reports. [See Chapter 31]

To dispute credit information, the buyer first sends a request to the credit bureau. The credit bureau has 30 days from the receipt of the request to verify the accuracy of the negative item. If they fail to act, which is common, the disputed item is required to be removed from the credit report.[12]

8 15 USC §1697b(b)
9 15 USC § 1679d(a)
10 15 USC §1679d(b)
11 15 USC §1679f(c)
12 15 USC §1681i(a)(1)(A)

The credit repair business hinges on the existence of the buyer's right to dispute items in a credit report. However, credit repair organizations need never be involved.

Here's how it works: credit repair organizations request a buyer's credit report on behalf of the buyer. They then comb through the report finding any negative items.

At this point, the credit repair organizations either assist the buyer in drafting a letter of dispute or simply have the buyer sign a stock letter regarding each negative item. The modus operandi is to dispute as many items as possible, and count on at least a handful of items being removed from the buyer's credit report for failure of the agency to respond within 30 days. When the disputed items are removed, the buyer's credit score goes up.

Thus, the credit repair organizations bet on the bureaus' complacence or inability to verify each dispute within the 30-day timeline.

However, items that the bureaus verify as accurate cannot be permanently removed. What credit repair organizations don't typically disclose is that a credit bureau can (and will) reinstate a deleted derogatory item if it later verifies the existence and accuracy of that item.[13]

Of course, the removal of an item from a credit report does not eliminate the underlying debt. An outstanding debt is not forgiven by a lender simply because the debt item is removed from a buyer's credit report.

Thus, even when a credit repair organization is able to raise a buyer's credit score by disputing accurate items on a credit report, in most cases the fix is only temporary. The disputed items — and the negative impact they have on credit scores — are likely to reappear in the future.

Credit repair can be deceitful

The blanket dispute campaign is not the only method employed by credit repair organizations. Another "credit repair" tactic involves disputing outdated and unverifiable derogatory information. This is known as a **Section 609 credit dispute**.[14]

Section 609 credit dispute
A credit repair tactic which disputes outdated and unverifiable derogatory information.

This is how a *Section 609 credit dispute* works: a lender — let's say a bank which holds a mortgage — reports the mortgage to the credit bureaus. This places a burden on the credit bureaus to verify the existence of the mortgage debt. The verification takes the form of a signed note.

However, bureaus either don't request this information before reporting the debt (imagine the sheer volume of paperwork), or they bury the paperwork they receive in warehouse archives.

With all the borrowers in the nation, and all the debt, what are the odds a credit bureau is able to retrieve and present evidence of the debt?

13 15 USC § 1681i(a)(5)(B)(i)
14 15 USC §1681g(c)(2)(E)

Or perhaps a better question is: what's a credit bureau's cost of storing literally billions of signed debt agreements vs. the cost of simply removing the debt from the buyer's credit report?

Most of the time, the credit bureaus simply remove the item from the credit report. Voila: the credit score rises. If this buyer demand for verification doesn't compel the credit bureaus to remove the disputed items, credit repair organizations then elevate the complaint to the California attorney general. In response, the attorney general compels the bureaus to either produce the paperwork, or remove the disputed item.

Using these methods, credit repair organizations may advertise they can remove short sales, foreclosure, judgments, even bankruptcies. Some organizations claim they can remove these blemishes for up to six months. Still others purport to have a proprietary means of keeping them off for longer. The cost? Around $100 a month.

Credit repair organizations coerce the credit bureaus to drop the "disputed" item from the buyer's credit report. However, if a debt is legally collectible from the individual buyer — purchase-assist mortgages for a home are not — the debt remains even though no longer reflected on the credit report.

Additionally, when a homebuyer prepares a mortgage application and the lender inquires about debt or other past negative financial history, the applicant will be asked to disclose this information.

Here, it is deceptive to remain silent about such information even if it was "removed" from the credit report. MLO brokers and agents know the standard residential loan application (the Fannie Mae 1003 or the Freddie Mac 65) asks if the applicant has outstanding judgments against them. MLOs are barred from counseling an applicant to omit information about judgments even if the applicant has had the information temporarily removed through credit repair.[15]

Editor's note — Judgments do not occur on nonrecourse debts, such as a purchase-assist mortgage that funds the acquisition of the buyer's home. [See Chapter 37]

The MLO broker's role

Part of the responsibility of a MLO broker or agent is to be upfront and honest with buyers seeking mortgage assistance. Thus, MLO brokers aware of credit repair organizations operating in an unlawful manner expose themselves to liability if they involve themselves with the credit repair, even by a referral.

Consider an attorney who shares their office with a credit repair organization and guarantees the services of the credit repair organization. The credit repair organization engages in deceptive practices violating the CROA. Is the attorney liable to the buyer for the credit repair organization's deceptive acts?

15 15 USC §1679b(a)

Yes! Even though the attorney did not engage in the deceptive practice, the attorney was aware of the credit repair organization's misrepresentations and is therefore liable.[16]

Under CROA, individuals may not act directly or *indirectly* to produce results that constitute fraud. Thus, MLO brokers and agents put themselves at risk when referring buyers to credit repair organizations.[17]

Furthermore, MLO brokers and agents are barred from accepting (or paying) fees to a credit repair organization for referring business when a buyer's mortgage origination is involved.[18]

16 **Federal Trade Commission** v. **Gill** (9th Cir. 2001) 265 F3d 944
17 15 USC §1679b(a)(4)
18 12 Code of Federal Regulations §1024.14(b)

Chapter 12 Summary

Prospective homebuyers unable to qualify for residential mortgages due to bad credit are pulled in by offerings of credit repair in hopes of bringing their credit scores up, enabling them to borrow and buy a home.

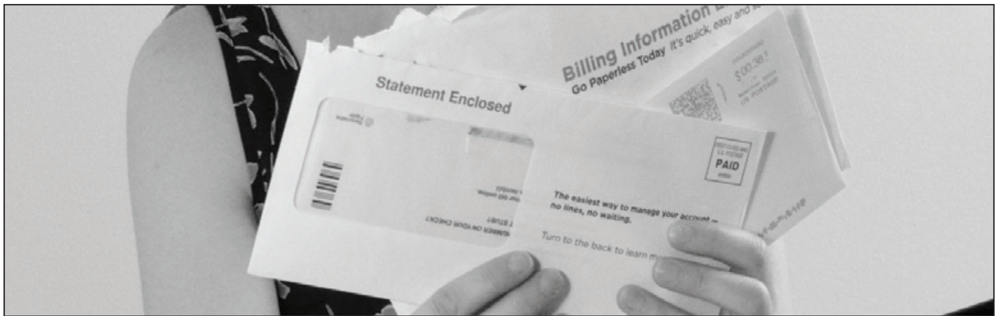
Buyers using credit repair are indirectly protected against fraud perpetrated by credit repair organizations by the Credit Repair Organization Act (CROA).

Credit repair organizations work by stoking fears that most credit reports are littered with errors. In truth, only a small percentage of reports contain errors large enough to dramatically affect a buyer's credit.

The blanket dispute campaign is not the only method employed by credit repair organizations. Another "credit repair" tactic involves disputing outdated and unverifiable derogatory information. This is known as a Section 609 credit dispute.

Mortgage loan originators (MLOs) aware of credit repair organizations operating in an unlawful manner expose themselves to liability if they involve themselves with the credit repair, even by a referral.

Chapter 12 Key Terms



Nontraditional credit scoring

Chapter 13

Learning Objectives

After reading this chapter, you will be able to:

- understand how to use nontraditional credit references to qualify a buyer for a consumer mortgage;
- identify the minimum standards for the use of nontraditional credit references for mortgages guaranteed by Fannie Mae and Freddie Mac; and
- determine minimum buyer qualifications when using nontraditional credit references for Federal Housing Administration (FHA)-insured mortgages.

Key Terms

consumer reporting agency

nontraditional credit

residential mortgage credit report (RMCR)

unusable credit

usable credit

Nontraditional credit works for homebuyers

What can a mortgage loan originator (MLO) do when a homebuyer in need of a purchase-assist mortgage does not have traditional debt references sufficient for FICO to generate a traditional credit score?

In such cases, Fannie Mae, Freddie Mac and the Federal Housing Administration (FHA) allow for the use of **nontraditional credit** sources when no or insufficient credit lines exist to get a FICO rating. Note that a mortgage lender can refuse to lend based on *nontraditional credit* ratings, or tighten up underwriting to accommodate a buyer with nontraditional debt activity. (Ironically, rent, utilities and business accounts are traditionally classic debt relationships — but no trustworthy bank is involved).

nontraditional credit
Accounts other than traditional mortgage, loan, credit card and bank accounts, used to analyze a consumer's ability to repay debt.

However Fannie Mae's, Freddie Mac's and the FHA's guidelines include minimum requirements allowing a mortgage lender to use nontraditional debt as a basis for qualifying a homebuyer for a consumer mortgage.

First, the use of nontraditional credit cannot be used to enhance the traditional credit history of a buyer who actually has a poor payment record. The purpose for using nontraditional debt history is to provide an alternative to a "thin" recent credit reporting record, not in lieu of a bad credit history.[1]

Fannie Mae and nontraditional credit

Fannie Mae has two ways for an MLO to qualify mortgages for Fannie Mae purchase:

- Fannie Mae's automated underwriting system, *Desktop Underwriter (DU)*; or
- manual underwriting.

Editor's note — Documents containing the information input into an automated underwriting system are always reviewed by an individual underwriter. When documentation confirms information in the application and the DU gives it an "Approve" status, the mortgage will be accepted for purchase by Fannie Mae. DU "Approve" status may also shorten the list of documentation required from the buyer and the processing time.

These days, most lenders use automated underwriting systems as the first step for processing a mortgage application. If an application comes back with other than an "Approve" status, the lender may move the application on to a manual underwriter for a deeper review before a final decision.

DU may be used to approve a mortgage application if at least one co-borrower has a *FICO* score based on traditional credit. The remaining co-borrowers can rely on a nontraditional credit analysis/rating to qualify. If any buyer relies on nontraditional credit to qualify, DU places the following restrictions on the mortgage:

- the mortgaged property must be a one-unit principal residence;
- all buyers will occupy the property;
- the mortgage must be either purchase-assist financing or a limited cash-out refinance;
- the mortgage amount may not exceed mortgage limits;
- the mortgage may not be a high-balance mortgage;
- the maximum debt-to-income (DTI) ratio is 36%;
- the income used to qualify may not be self-employment income; and
- the buyer with traditional credit must contribute more than 50% of the qualifying income.[2]

1 Fannie Mae Single Family Selling Guide Chapter B3-5.4-01; Freddie Mac Single Family Seller/Servicer Guide Chapter 37.4(a)(2); HUD Handbook 4155.1 Chapter 1.C.5.d

2 Fannie Mae Single Family Selling Guide Chapter B3-5.1-01

If DU classifies the mortgage application as other than "Accept", the lender may have the application underwritten manually. Likewise, if no buyers have traditional credit scores, or the lender prefers to skip DU for buyers with nontraditional credit, the mortgage may be manually underwritten.

Fannie Mae restricts manually underwritten mortgages which rely upon nontraditional debt payment history:

- the mortgaged property must be a one-unit principal residence;
- the mortgage is to be either purchase-assist financing or a limited cash-out refinance;
- the mortgage amount may not exceed mortgage limits;
- the mortgage may not be a high-balance mortgage;
- the income used to qualify may not be self-employment income; and
- the maximum debt-to-income ratio (DTI) is 36%.[3]

These are similar, but not identical, to restrictions placed on the mortgage by DU.

Fannie Mae: nontraditional credit sources

The use of a *nontraditional mortgage credit report* from **consumer reporting agencies** is required by Fannie Mae. Consumer reporting agencies compile debt information from credit bureaus and other credit sources and sell credit reports to consumers or lenders.

consumer reporting agency
Companies that compile debt information from credit bureaus and other credit sources and sell credit reports to consumers or lenders.

To meet Fannie Mae's guidelines for a nontraditional credit source, the consumer reporting agency must:

- check all three credit bureaus to verify the buyer's credit history;
- conduct an informational interview with the buyer to identify the sources of credit the buyer has obtained within the most recent 12 months;
- only consider credit references which require regular, periodic payments with intervals no greater than every three months);
- pass on all information collected from contacting the buyer's credit references; and
- specify whether the report meets Fannie Mae's nontraditional mortgage credit report requirements.

When the lender obtains a list of the buyer's sources of credit, the consumer reporting agency is not required to interview the buyer. Instead, it is the lender who is to contact each creditor to verify the buyer's payment history.[4]

Fannie Mae accepts nontraditional credit evaluations for qualifying a consumer mortgage borrower. Priority treatment is given to each type of debt, stacking them in tiers. The debts as credit sources are batched by tiers to determine whether mortgage credit will be approved.

3 Fannie Mae Single Family Selling Guide Chapter B3-5.1-01
4 Fannie Mae Single Family Selling Guide Chapter B3-5.4-01

- **Tier I** nontraditional credit includes payments for housing-related services and utilities not included in the rental payment, such as electricity, gas, water and telephone or cable services;
- **Tier II** nontraditional credit includes payments for medical insurance, auto insurance, life insurance and household or renter's insurance; and
- **Tier III** nontraditional credit includes payments to local stores, rental payments connected with durable goods (like cars), payment of medical bills, payment of school tuition, payment for child care or payments of mortgages from individuals, provided the mortgage repayment terms are in writing.[5]

Fannie Mae requires at least four credit sources from Tier I, or a combination of Tier I sources and *traditional* credit sources. A 12-month payment history is required.

If the buyer has fewer than four Tier I and traditional credit sources, the consumer reporting agency is to contact Tier II payment sources, then Tier III payment sources for a total of four to six sources.

However, for the nontraditional mortgage credit report to be acceptable to Fannie Mae, at least one of the payment sources must be housing-related, from Tier I.[6]

Freddie Mac and nontraditional credit

Similar to Fannie Mae, Freddie Mac allows lenders to choose between underwriting mortgage applications in an automated underwriting system or manually. Freddie Mac's automated underwriting system is called *Loan Prospector*. To understand how Freddie Mac views credit, a review of a couple of definitions is needed.

usable credit
Freddie Mac's designation that an applicant has enough accurate traditional credit history to generate a valid credit score.

unusable credit
Freddie Mac's designation of credit other than usable credit, e.g., nontraditional debt.

Usable credit under Freddie Mac guidelines is for:

- mortgages submitted to Loan Prospector with enough accurate traditional credit history to generate a valid credit score; or
- manually underwritten mortgages with a FICO score based on sufficient, accurate information containing at least three **tradelines**.

A *tradeline* lists the buyer's types of debt and associated information, such as the date the credit line was opened and the credit line's balance and payment history. Any type of debt history which falls outside of the definition of usable credit, such as *nontraditional debt*, is labeled **unusable credit**.

Editor's note — The terms "usable" and "unusable" do not refer to whether a mortgage will be purchased by Freddie Mac. They're merely agency terms used to differentiate two types of credit.

5 Fannie Mae Single Family Selling Guide Chapter B3-5.4-02
6 Fannie Mae Single Family Selling Guide Chapter B3-5.4-02

Loan Prospector underwrites mortgages for buyers relying on nontraditional credit — unusable credit — subject to restrictions:

- at least one buyer on the transaction has usable (traditional) credit, as determined by Loan Prospector;
- the mortgage is either purchase-assist financing or a limited cash-out refinance;
- the mortgaged property must be a one-unit principal residence;
- all buyers must occupy the property;
- the buyer with usable credit must contribute more than 50% of the total monthly income; and
- the buyer is not self-employed.[7]

When a mortgage for buyers relying solely on nontraditional unusable credit is manually underwritten:

- the mortgage must be either purchase-assist financing or a limited cash-out refinance;
- the mortgaged property must be a one-to-four unit principal residence; and
- the mortgage amount must be conforming.[8]

For both Loan Prospector and manually underwritten mortgages, the lender is to verify that nontraditional credit references used by buyers have satisfactory payment histories and that the payments are included in the monthly DTI. Freddie Mac calls these nontraditional credit sources **noncredit payment references,** a misnomer is ever there was one.[9]

Noncredit payment references acceptable to Freddie Mac include utilities, rent and insurance payments. These references must show periodic payments made at least quarterly.[10]

Regular *voluntary* payments, such as deposits to a savings account, contributions to a payroll savings plan or contributions to a stock purchase plan (payroll deductions for a *mandatory* retirement program don't count) may also be used. These payments need to be made at least quarterly and evidence a growing balance.[11]

Unlike Fannie Mae and the FHA (discussed below), Freddie Mac does not require or have guidelines for compiling a nontraditional credit report to be included in the mortgage application file. Instead, Freddie Mac either requires the lender to independently verify nontraditional credit history or verify nontraditional credit history using a **residential mortgage credit report (RMCR)**. An RMCR is a detailed account of the credit, employment and residence history of the buyer(s).

residential mortgage credit report (RMCR)
A detailed account of a buyer's credit, employment and residence history.

7 Freddie Mac Single Family Guide Chapter 37.4(a)-2
8 Freddie Mac Single Family Guide Chapter 37.5
9 Freddie Mac Single Family Guide Chapter 37.4(a)-2; (b)
10 Freddie Mac Single Family Guide Glossary
11 Freddie Mac Single Family Guide Chapter 37.11(c)

Editor's note — The RMCR is NOT the same as a "merged credit report". While an RMCR does contain a merged credit report, an RMCR also has information about employment, residential history and nontraditional credit history.[12]

Freddie Mac requires all buyers to have at least three tradelines. If the buyer lacks three tradelines, they must have:

- four noncredit payment references; or
- a combination of four tradelines and noncredit payment references (traditional credit references) and noncredit payment references.

Each of the noncredit payment references must have existed for at least 12 months. In the case of housing history, reference may be from more than one source if the buyer has moved in the preceding 12-month period.[13]

Freddie Mac: Direct verification

If the direct verification is provided by a source other than a professional business, the lender is required to obtain supporting documentation such as canceled checks, statements of deposit or receipts.[14]

Valid direct verification may be:

- completed on a verification form; or
- computer-generated and obtained by the lender directly from the creditor, and signed by the verifying individual.

The documentation needs to be sufficient to establish:

- the name and address of the creditor;
- the name of the buyer;
- the name and title of the person providing the credit reference;
- the telephone number of the creditor;
- the account number (if applicable);
- the type of obligation (such as rent, utilities, insurance, etc.);
- the highest credit balance (if applicable)
- the amount of the payment due;
- the outstanding balance; and
- the current and past status of the account, including the number and specific duration of late payments, e.g., "0 x 30, 0 x 60, 0 x 90 days late" is written to show the buyer has had *zero payments late* by 30, 60 and 90 days.

For housing rent or sales contract payments directly verified, the documents must also indicate the duration of the housing payment history if it is less than 12 months old.

General reference letters without the above information are not sufficient documentation.[15]

12 Freddie Mac Single Family Guide Chapter 37.10(d)-(e)
13 Freddie Mac Single Family Guide Chapter 37.4(b)
14 Freddie Mac Single Family Guide Chapter 37.11(c)
15 Freddie Mac Single Family Guide Chapter 37.11(c)(i)

Freddie Mac: Other verification

In lieu of direct verification or an RMCR, the buyer may provide canceled checks or account statements, accompanied by documentation that lays out the terms of the repayment, such as a lease agreement. The documents need to identify all the same information required to be identified by direct verification.[16]

Receipts are okay when the payments were made in cash instead of via check or direct bank transfer.[17]

If a mortgage is eligible for automated underwriting, Loan Prospector will determine whether the credit is sufficient. If a mortgage is manually underwritten, the buyer's credit is considered on a case-by-case basis in relation to the other strengths and weaknesses of the mortgage file.

FHA and nontraditional credit

Both Fannie Mae and Freddie Mac purchase FHA-insured mortgages, and thus each company's automated underwriting system analyzes mortgages intended for FHA insurance. However, since an FHA-insured mortgage is basically unmarketable without meeting FHA guidelines for insurance, we'll go straight to the FHA for FHA guidelines about nontraditional credit.

The FHA has a long history of accepting buyers with nontraditional credit. The *Department of Housing and Urban Development (HUD) Housing Handbook* explicitly states that a lack of credit history may not be the basis for rejection of a mortgage application. Like Fannie Mae, the FHA accepts nontraditional mortgage credit reports.[18]

Also like Fannie Mae, the FHA batches nontraditional credit references into two tiers, called Group I and Group II. Group I consists of rental housing payments and utilities. Group II are all other nontraditional credit sources (similar to Tier II and Tier III payment credit sources under Fannie Mae's requirements). Examples of Group II credit references include insurance premiums not automatically deducted from pay, school tuition, cell phone bills, automobile leases, etc.

An acceptable Group II source can also include a documented 12-month history of savings deposits, provided that:

- the deposits increased the balance of the account (i.e., the deposits were not simply replenishing amounts withdrawn and used by other accounts);
- the deposits are made regularly, at least once every quarter;
- the deposits were not deducted directly from payroll; and
- the deposits did not cause insufficient funds in other accounts.[19]

If a nontraditional mortgage credit report is not available, the FHA allows the lender to document and verify the buyer's credit history from nontraditional

16 Freddie Mac Single Family Guide Chapter 37.11(c)(ii)
17 Freddie Mac Single Family Guide Chapter 37.11(c)(iii)
18 HUD Handbook 4000.1 Chapter II.A.5.a.ii(B)
19 HUD Handbook 4000.1 Chapter II.A.5.ii.B.1

debt sources. Verification of payment history for these nontraditional debt sources must be made through a published address or phone number. Lenders may not rely solely on information provided by the buyer.

The payment history is to be backed up with the most recent 12 months' cancelled checks. For rental references, a payment history from a property management company may be used in lieu of the canceled checks.[20]

The FHA can insure mortgages for two types of mortgage buyers who lack traditional credit references:

- those with a *sufficient* number and mix of nontraditional debt sources; and
- those with an insufficient number and mix of debt sources.

To be considered *sufficient credit*, a buyer's credit history must have at least three credit references. At least one of the three credit references must be from Group I. In compiling the nontraditional credit report, Group I credit references are exhausted before Group II credit references are considered.[21]

Debt references previously overlooked

A specialized version of the FICO scores analyzes both traditional and nontraditional credit references as sources of debt information to set a credit score. This broader debt analysis into nontraditional sources of debt with payments for establishing creditworthiness is called **CreditIQ**.

Unlike the traditional FICO scores, CreditIQ considers a buyer's non-institutional debts including rental payment history, evictions, child support obligations and property tax payments when setting the score. Thus, a credit score can be generated when the buyer has few or no traditional forms of debt for analysis of a payment history.

Also, *CreditIQ* shortens response time from the standard 60-90 days to three weeks or less. Thus, mortgage lenders have knowledge of a buyer's consumer financial obligations in time to avoid a delay in buyer pre-approval or closing a sales escrow.

The main beneficiaries of CreditIQ's supplemental credit information are homebuyers who have a thin credit record with traditional references but otherwise have a one-year record of promptly making periodic payment of household debts and need a consumer mortgage.

Prior homeowners who **strategically defaulted** on a mortgage during the Great Recession but now have a history of paying their monthly household expenses on time will be evaluated by mortgage lenders for approval.

Buyers who promptly pay their monthly rental payments, utility and cellphone bills will have an upper hand under CreditIQ. Other buyers need CreditIQ scoring because they have simply deleveraged and pay cash for shelter and services they need — all a result of a past financial crisis, national or family.

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20 HUD Handbook 4000.1 Chapter II.A.5.ii.B.2

21 HUD Handbook 4000.1 Chapter II.A.5.ii.B.3

However, Fannie Mae, Freddie Mac and the FHA have not endorsed the new CreditIQ score as acceptable for use in lieu of the generic FICO score algorithm and acceptable nontraditional debt payment references. Thus, use of CreditIQ is restricted to mortgages to be purchase by private investors and/or lenders as part of their underwriting/pricing guidelines.

FHA: Once the credit history has been determined

Buyers who have nontraditional and/or **insufficient credit** are still eligible for maximum FHA-insured financing. However, buyers who have insufficient credit are subject to tighter **DTI** and cash reserves rules. The qualifying ratios for buyers with insufficient credit histories:

- are computed only for the buyer who occupies the property and executes the mortgage; and
- may not exceed 31% for the mortgage *payment-to-income ratio (PTI)* or 43% for the total DTI.[22]

For buyers who have *sufficient nontraditional credit histories*, the credit history is satisfactory for FHA insurance if the nontraditional credit report:

- covers at least a 12-month period;
- shows the buyer has had no history of delinquency on rental housing payments;
- shows the buyer has had no more than one 30-day delinquency on payments to other creditors; and
- shows the buyer has had no collection accounts or other court records (other than medical) filed in the last 12 months.[23]

For buyers with *insufficient credit histories*, the credit history is satisfactory for FHA mortgage insurance premium (MIP) default insurance if the credit references:

- cover at least a 12-month period;
- show the buyer has had no more than one 30-day delinquency on payments to Group II references; and
- shows the buyer has had no collection accounts or other court records (other than medical) filed in the last 12 months.[24]

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22 HUD Handbook 4000.1 Chapter II.A.8.iii
23 HUD Handbook 4000.1 Chapter II.A.5.iii
24 HUD Handbook 4000.1 Chapter II.A.5.iii

Chapter 13 Summary

Fannie Mae, Freddie Mac and the Federal Housing Administration (FHA) allow for the use of nontraditional credit when no or insufficient credit lines exist.

Note that each lender can either refuse to underwrite buyers with nontraditional credit, or overlay stricter underwriting guidelines for nontraditional credit. The use of nontraditional credit is not allowed by any of these entities to enhance the traditional credit history of a buyer with an otherwise poor payment record. Nontraditional credit is allowed as an alternative to a "thin" credit file, not in lieu of a bad credit file.

FICO has partnered with CoreLogic, a data analysis company, to create a new type of credit report which takes into account both traditional and nontraditional credit sources, called CreditIQ. Use of CreditIQ is restricted to mortgages to be purchase by private investors and/or lenders as part of their underwriting/pricing guidelines.

Buyers who have nontraditional and/or insufficient credit are still eligible for maximum FHA-insured financing. However, buyers who have insufficient credit are subject to tighter debt-to-income ratio (DTI) and cash reserves rules.

Chapter 13 Key Terms

Chapter 14

The appraisal report

Learning Objectives

After reading this chapter, you will be able to:

- understand the purpose and function of an appraisal report to provide an opinion of a property's value;
- discuss appraiser licensing requirements;
- differentiate the three appraisal methods used to analyze the property data collected;
- identify the main components of the Fannie Mae Form 1004 Uniform Residential Appraisal Report (1004); and
- understand a mortgage loan originator (MLO)'s use of an appraisal report.

Key Terms

appraisal
appraisal report
appraised value
capitalization approach
comparable property
comparative market approach
cost approach
desk review
fair market value (FMV)
field review

The appraisal and a consumer mortgage

An **appraisal** is an appraiser's *opinion or estimate* of a property's value on a specific date, reduced to writing in an **appraisal report**. The *appraisal report* contains data collected and analyzed by the appraiser. The content of the appraisal report serves to substantiate the appraiser's opinion of the property's **fair market value (FMV)**.

appraisal
An appraiser's opinion or estimate of a property's value on a specific date, reduced to writing in an appraisal report.

fair market value (FMV)
The price a reasonable, unpressured buyer would pay for property on the open market.

appraised value
The fair market value (FMV) arrived at by an appraiser.

The *FMV* of a property is the highest price on the date of valuation a willing seller and buyer would agree to, both having full knowledge of the property's various uses. The FMV arrived at by the appraiser is known as the property's **appraised value**.[1]

The issue of value arises when a buyer locates a property and contracts to pay a price to buy it which is contingent on obtaining a purchase-assist mortgage to fund payment of the price. Here, the property needs to qualify as *collateral* before a lender will make the mortgage. To qualify, the property's value needs to provide adequate security for the lender to recover the full amount of the mortgage if the buyer defaults.

As collateral, lenders rely on the *appraised value* of the property to verify the property has value equal to or greater than the purchase price agreed to between the seller and the buyer.

The appraisal to set the FMV of a property is prepared based on data gathering and reporting guidelines in the Uniform Standards of Professional Appraisal Practice (USPAP). In California, appraisers are regulated by the California Office of Real Estate Appraisers (OREA).

Appraiser licensing

All appraisers are required to hold a license or certification issued by the offices of the supervisor of appraisers in the state of California.

The license/certification categories for appraisers include:

- **Trainee appraiser** – allows the trainee to work on the appraisal of properties under the direct supervision of an appraiser licensed to appraise those properties. To obtain a trainee license, a minimum of 150 hours of appraisal education is required. As part of the education requirement, the trainee licensee must complete the 15-hour National USPAP course taught by an instructor certified by the Appraisal Qualification Board (AQB).
- **Residential appraiser** – allows the appraisal of one-to-four residential units up to $1 million and commercial property up to $250,000. To obtain a residential license, the licensee needs 2,000 hours of full time experience over a 12-month period, plus 150 hours of appraisal education including the 15-hour USPAP appraisal practice course.
- **Certified residential appraiser** – allows the appraisal of residential properties of any dollar amount and commercial property up to $250,000. To obtain a certified residential license an individual needs 2,500 hours of experience over a minimum 30-month period. Also required is 200 hours of appraisal education including the 15-hour USPAP appraisal practice course and either an associate's degree or 21 credits in an appraisal-related subject.
- **Certified general appraiser** – allows the appraisal of any type of real estate and value or complexity. To obtain a certified general license an individual needs 3,000 hours of experience over a minimum 30-month

1 Calif. Code of Civil Procedure §1263.320

period, 1,500 hours of which is on commercial properties. Also required is 300 hours of appraisal education including the 15-hour USPAP appraisal practice course and either a bachelor's degree or 30 semester credits in appraisal related courses.

A licensee needs to complete a seven-hour *National USPAP Update Course* every two years as continuing education. Also, a total of 56 hours of continuing education, including the USPAP Update Course, is required with the renewal application every four years.

FHA Appraiser Roster

To appraise properties in connection with a Federal Housing Administration (FHA)-insured mortgage, an appraiser needs to be on the FHA Appraiser Roster. To qualify, appraisers need to apply to the FHA and:

- be a state-certified appraiser;
- not be suspended, debarred or excluded, or subject to a suspension or loss of standing as a certified appraiser in any state; and
- not be listed on HUD's Limited Denial of Participation (LDP) List or HUD's Credit Alert Verification Reporting System (CAIVRS).[2]

Determining property value

Factors an appraiser considers to determine a property's value include:

- **utility** – the property's possible uses;
- **scarcity** – the availability of similar properties;
- **demand** – the number of buyers for the property;
- **transferability** – the seller's ability to transfer good title to a buyer clear of all encumbrances itemized in a title insurance policy, such as covenants, conditions and restrictions (CC&Rs), easements, trust deeds, etc.;
- **physical considerations** – the property's proximity to commercial amenities, access to transportation, the availability of freeways, beaches, lakes, hills, etc.;
- **social considerations –** the preferences and expectations of buyers reflected in the prices and rents paid;
- **economic considerations** – rents in the area, vacancies and the percentage of homeownership; and
- **political considerations** – property taxes, zoning and building codes.

An appraiser's determination of a property's value may not take into consideration factors such as the present owner's:

- acquisition cost;
- listing price;
- mortgage financing; and
- equity in the property.

2 HUD Handbook 4000.1 Chapter I.B.1.c.i.(A)

Economic principles in appraisal

Appraisers use several economic concepts to develop their opinion of value for a property. These concepts are called *principles of appraisal* and include:

1. The **principle of supply and demand**: The principle of supply and demand holds that when the supply of available homes decreases, the value of homes increases if the number of people demanding the available homes does not decrease. This principle correlates to the density of the population and its level of income.
2. The **principle of change**: The principle of change holds that property is constantly in a state of change. The change a property goes through is seen in its **life-cycle**. The *life-cycle* of a property has three stages: **development, maturity** and **old age**.

   Development of the property includes the subdivision of lots, improvements constructed and the start of a neighborhood community.

   The *maturity stage* of a property, such as a home within the community, starts when the homes become older and the children grow up and move out of the community.

   The *old age stage* starts when the oldest buildings begin to deteriorate, lower social or economic groups move into the community and larger homes are converted into multiple family use.
3. The **principle of conformity**: The principle of conformity holds that when similarity of improvements is maintained in a neighborhood, the maximum value of a property can be realized on a sale. Zoning regulations and CC&Rs tend to protect homeowners by narrowing the uses and excluding nonconforming uses of the property.
4. The **principle of contribution:** The principle of contribution holds that the value of one improvement is measured in terms of its contribution to the value of the whole property. For example, a property's FMV may increase if additions, such as a swimming pool, are constructed.
5. The **principle of substitution**: The principle of substitution holds that a buyer will not pay more for a property if it will cost less to buy a similar property of equal desirability.
6. The **principle of regression**: The principle of regression holds that the value of the best property in a neighborhood will be adversely affected by the value of other properties in the neighborhood. For example, this principle applies to over-improved homes. When an owner makes extensive renovations, such as adding additional rooms and landscaping, and the other neighbors do not, the house is no longer as similar to the others. On the sale of the over-improved home, the owner will not receive the full value of the cost of over-improvements.
7. The **principle of progression**: The principle of progression is the opposite of the principle of regression, holding that a smaller and lesser maintained property in a well-kept neighborhood will sell for more than if the home were in an area of comparable properties.

Steps in the appraisal process

The appraisal process consists of four steps:

1. identifying and defining the appraisal effort to be undertaken by the appraiser;
2. data collection;
3. applying the data; and
4. determining the value of the property.

Defining the appraisal effort

The appraiser's first step in the appraisal process is to identify the questions they are to deal with in the valuation analysis for a particular property.

The questions to be responded to in preparation of the report and developing the opinion of value include:

- What is the purpose of the appraisal?
- What interest in the property is being evaluated?
- What is the description and location of the property to be appraised?
- Who owns or holds an interest in the property being appraised?
- What is the highest and best use of the property in light of zoning and CC&Rs?
- What encumbrances affect the condition of title to the property?
- Are there any facts that the appraiser needs to clarify?
- What is the appraiser's fee?

Gathering data

The background information gathered by the appraiser on the property necessary for them to conduct an appraisal is separated into two categories:

1. **General data**: Information on the region, city and neighborhood surrounding the property; and
2. **Specific data**: Information on the property itself such as the location, lot and improvements.

The *general data* provide an overview of the property. Data on the local and regional economies are included since they influence the value of property located within the local real estate market. Regional considerations include geography, jobs, quality of school systems and public facilities.

The collection of **specific data** about a property includes information on the size of the parcel, lot type, the improvements on the property and the uses permitted.

The data on the physical aspects of a lot include:

- dimensions, the size and shape;
- topography, the slope, drainage and soil;
- view, exposure to sun and weather; and
- improvements, the type, use and condition.

Applying the data

The third step in the appraisal process is to subject the data collected to one or more of the three appraisal methods, which are:

1. The **comparative market approach** (market data method);
2. The **cost approach** (replacement method); and
3. The **capitalization approach** (income method).

Comparative market approach

comparative market approach
An appraisal method used by an appraiser to arrive at a property's value based on the current selling prices of similar properties.

The *comparative market approach* is the most commonly used to establish the FMV of real estate. Applying the comparative market approach, the appraiser reviews the current selling prices of *similar properties* to help establish the comparable value of the property appraised. Adjustments are made for any differences in the similar properties, such as their location, lot size, improvements, obsolescence and condition.

For example, a property owner's neighbor recently sold their residence for $345,000. The neighbor's house is of a similar age, size and condition as the owner's house, except it has a fireplace worth $3,000 which the owner does not have. Adjusting for the difference in the improvements (the fireplace) between the owner's and neighbor's house would establish the value of the owner's house at $342,000.

To produce a more reliable appraisal report, it is better to gather data on as many comparable sales and listings, frequently called "**comps**," as are available. Then compare each against the property being appraised for their similarities. Sales information is obtained from multiple listing services (MLSs), assessor's records, electronic databases on recordings and title insurance companies.

The comparative market approach is most commonly used in connection with the evaluation of a single family residence for a consumer mortgage.

Cost approach

cost approach
An appraisal method used by an appraiser to arrive at a property's value based on the present cost of constructing the present improvements and acquisition of the land.

Appraisers setting value using the *cost approach* calculate the current construction cost to replace the improvements. The appraised market value under the cost approach is the result of totaling the value of the lot plus the cost to replace the improvements, minus the obsolescence and physical deterioration (depreciation) experienced by the property appraised.

The cost approach is best used when valuing *new buildings* and *special* or *unique structures,* such as churches and factories.

An appraiser may also use the cost approach when recent comps are not available or the property has no income.

Capitalization approach

The *capitalization approach*, also known as the *income approach*, determines a property's value based on the property's *net operating income (NOI)*, a product of future income and operating expenses the property is likely to experience.

Property appraised using the income approach includes:

- apartments;
- office buildings;
- industrial buildings;
- retail properties; and
- other income-producing property.

The first step to establish value using the capitalization approach is to gather rental data and determine the property's **effective gross income**. A property's *effective gross income* is its scheduled rental income minus vacancies and collection losses. [See **RPI** Form 352]

capitalization approach
An appraisal method used by an appraiser to arrive at a property's value based on the present worth of a property's future net operating income.

The second step is to document the property's **operating expenses** and deduct the amount from the effective gross income. The result is the property's NOI, the base figure used to set value.

The third and decisive step is to divide the property's NOI by an appropriate **capitalization rate (cap rate).** The cap rate is comprised of a prudent investor's expected annual *rate of return* on all sums of money invested in this type of property (adjusted for inflation and risk premiums), say 5%, and a *rate of recovery* of their invested monies allocated to the improvements, say 2.5%, also called *depreciation*.

For example, if a property's NOI is $100,000 annually, and a capitalization rate of 10% is judged appropriate for the current market conditions, the property's value under the income approach would be $1,000,000.

The appraisal process for MLOs

The appraisal is ordered and completed as part of the consumer mortgage application process.

The **mortgage loan originator (MLO)'s** first step in the mortgage application process is to take the buyer's consumer mortgage application. This includes the gathering of documents used as evidence of the buyer's current financial condition. Once the application and the buyer's documents have been gathered, the MLO submits the application to a mortgage lender who is willing to accept their business.

Once the mortgage application is submitted, the appraisal is ordered. The request for an appraisal is initiated by the lender through the appraisal management company (AMC) hired by the lender.

On a consumer mortgage, an MLO may not select, employ or compensate an appraiser. Their role in the appraisal process is to coordinate the buyer's payment of appraisal fees to be handed to the lender. In turn, the lender pays the AMC which hires and pays the appraiser. The appraisal fee is paid up-front, or added to the buyer's mortgage closing costs.

Lenders and their agents are to compensate *fee appraisers* at a rate that is reasonable in the market area of the property being appraised. A fee appraiser may charge a fee for complex assignments that reflects the increased time, difficulty and scope demanded to perform the work.[3]

The appraisal report and opinion of value is completed in the lender's name and solely for their use. An appraisal ordered directly by the MLO or the buyer may not be relied upon by a lender to set value in connection with a consumer mortgage.[4]

Within three business days of the mortgage lender receiving the application for a first mortgage on a one-to-four unit residential property, the lender is required to provide the buyer with a written notice of the buyer's right to receive the appraisal report paid for by the buyer. If the mortgage is a junior lien, the written notice is to be provided within 15 days of receipt of the mortgage application. Notification of the buyer's right to a copy is made in 10-point boldface type.[5]

On first lien consumer mortgages, the actual appraisal report is required to be delivered to the buyer no later than three business days before closing.[6]

Reading the appraisal report

Once the appraisal report is complete, the MLO has two main concerns in connection with an appraisal report:

- whether the appraisal report adequately meets the lender's minimum content requirements; and
- whether the appraisal report and opinion of value justifies the purchase price.

appraisal report
Documentation of an appraiser's findings, including the purpose and scope of the appraisal.

To determine this, the MLO reviews the contents of the appraisal report. The **appraisal report** is the documentation of the appraiser's findings.

The appraisal report form used by an appraiser in connection with consumer mortgages is Fannie Mae Form 1004, the Uniform Residential Appraisal Report (1004) and Fannie Mae Form 1004MC, the Market Conditions Addendum to the Appraisal Report. [See **RPI** Form 200; see Fannie Mae Form 1004MC]

The following information is included in the 1004:

- the **subject property's** description, including a property address, legal description, the purpose of the appraisal and whether the property was offered for sale in the 12 months prior to the appraisal date;
- an analysis of the terms of the **purchase agreement** connected to the appraisal, including the agreed-to purchase price and any financial assistance provided to the buyer, such as costs paid or conceded by the seller or another person in the transaction;

3 12 Code of Federal Regulations §1026.42(f)
4 12 CFR §1026.42(d)
5 12 CFR §1002.14(a)(2); Calif. Business and Professions Code §11423
6 Bus & PC §10241.3; 12 CFR §1002.14(a)

- a description of the **neighborhood**, including the age and price range of the properties and economic, governmental and environmental factors impacting the value of the property;
- a description of the **site** on which the property is situated, including size, a determination of whether the property constitutes the highest and best use of the property, zoning and utilities information;
- an overview of the **improvements** on the subject property, including a general description of the property and living area, notes about the foundation, an exterior and interior description, appliances, number of rooms, the conditions of the improvements and a comparison of the improvements with those found in the neighboring properties;
- a **sales comparison analysis** of at least three properties sold or listed in the same area as the subject property within the last 12 months, including a summary of the weight given to each comparable and a comparison with the subject property, with adjustments for differences in improvements and conditions;
- a **reconciliation** of the facts gathered in the report to determine value, including the date of the valuation;
- an alternative analysis using the **cost approach**;
- an alternative analysis using the **income approach** (not used on consumer mortgages);
- **PUD information, condo and co-operative property information,** if applicable, including information about the homeowners' association, number of units and more information about a project;
- the **appraiser's** name, address, type of license and signature;
- a statement about the **scope of the work**, **intended use**, **intended user**, definition of **market value** and the **assumptions and limiting conditions of the document**;
- the **appraiser's certification**;
- **location maps**;
- a **building sketch** showing the dimensions and calculations used to determine the property size;
- **color photos** of the subject property's interior and exterior capturing each room and any improvements, deterioration, amenities and overall condition of the subject property;
- color photos of the front exterior of the **comparable properties** [See **RPI** Form 200]; and
- a synopsis of recent **market conditions** and trends. [See Fannie Mae Form 1004MC]

comparable property
A recently sold or listed property which has characteristics similar to the subject property being evaluated.

When the value comes in high

If the appraised value comes in at or above the purchase price set by the purchase agreement and the lender has no objections regarding the value in the appraisal report, the MLO proceeds with the mortgage origination process.

However, the appraisal report is a common point of contention between the buyer and the lender. A lender's underwriter may ask the appraiser to further justify the value indicated in the report if:

- the appraised value is much higher than the purchase price, without an analysis of the terms in the purchase agreement;
- the appraised value is much higher than values found in the immediate neighborhood;
- the underwriter believes the unsupported by the chosen comparable properties; or
- the appraisal report contains internal inconsistencies, such as a failure to properly adjust for defects shown in the photos accompanying the appraisal report.

desk review
A second appraiser's review of an appraisal report to verify and evaluate the findings.

field review
A second appraiser's independent visual inspection of the property to verify and evaluate the findings of the original appraisal report.

If the underwriter is not satisfied with the appraiser's response to their inquiries, the underwriter is able to request a second appraiser's opinion of the appraisal report. The second opinion comes in two forms:

- a **desk review**; or
- a **field review**.

A *desk review* involves a second appraiser's review of the appraisal report. In a desk review, the second appraiser does not visit the property. The second appraiser is provided with the appraisal report and attempts to verify the facts and analysis contained in the appraisal report. They then evaluate and comment on the facts and analysis presented. The original appraiser is then required to address any comments made by the second appraiser.

A *field review* calls for the second appraiser to visit the property. The second appraiser does an exterior, street inspection of the property and the neighborhood. The second appraiser then provides their comments on the appraisal report based on their own visual inspection of the property.

Reviews may or may not result in an adjustment to the appraised value of the property.

When discrepancies in the original appraisal report are severe, a lender may call for a second appraisal report to completely replace the existing appraisal report.

The buyer is responsible for paying for the cost of an appraisal report review or a second appraisal. These costs may be equal to or greater than the cost of the original appraisal.

When the value comes in low

When real estate prices are flat or falling, the appraised value may come in at a figure less than the agreed-to purchase price. Lenders will not make a loan as a percentage of a purchase price higher than the appraised value of the property. To do so increases their mortgage's loan-to-value ratio (LTV) based on the appraised value. Thus, the risk of loss on a buyer default is increased to an unacceptable level.

In this case, the buyer is faced with three options to keep the transaction alive:

- negotiate with the seller to reduce the purchase price to the appraised value;
- increase the down payment to make up the difference between the purchase price and the appraised value; or
- challenge the appraisal report and the opinion of value.

Most sellers, having found a buyer who agrees to a price, are unwilling to drop the price. Frequently the buyer is unable to raise the money to increase the down payment. It's then up to the buyer, the transaction agents and the MLO to rebut the appraiser's valuation by:

- reviewing the report for errors or misapplied adjustments;
- finding and providing additional comparable properties to justify the purchase price; or
- requesting a second appraisal.

For example, if the appraiser used the wrong square footage, the MLO's duty is to request a correction and adjustment of the appraised value.

Comparables

Most frequently, a buyer challenging the appraisal requires them to find additional recent comparable sales. The agents of the seller and buyer are the individuals who need to find comparable sales for the MLO's submission to the lender for the lender's consideration.

The source and verification of comps may be found in:

- the MLS;
- recorded deeds;
- assessor's records;
- unrelated real estate agents or brokers;
- builders; or
- other appraisers or appraisal reports.

The search for new comparable properties is bound by general appraisal guidelines. A comparable found in an area outside a neighborhood's boundaries is only acceptable if an explanation of its use is included. A review of the conditions in the other neighborhood is to be included for out-of-area comps.

Additionally, appraisers do not adjust for events that take place after the date of the appraisal report.

For example, consider an appraisal report which uses a neighboring property listed for sale at $200,000 as a comparable. The agent for the comparable property specifically under-priced the property in order to obtain multiple offers.

After the date the appraisal report is completed, the comparable property sells for $230,000.

Here, the appraiser will not adjust that comparable property to a $230,000 value, since the new value was assigned after the date of the appraisal report on the subject property. In this case, a second appraisal is the only way to capture the comparable property's new value.

Appraisal report portability

Occasionally a buyer cancels a mortgage application with one lender for their failure to be competitive in their rates and charges at the time of closing. The buyer then either has submitted or submits a mortgage application to another lender. Here, the appraisal report, subject to lender consent, may be transferred to the new lender.

Both Fannie Mae and Freddie Mac allow appraisal reports to be transferred between lenders, if:

- the appraiser independence rules are observed; and
- the appraisal report is less than four months old on the note date or less than 12 months old, with a reevaluation of the property exterior and neighborhood condition.[7]

However, a strange consent condition exists before the new lender may use the appraisal report. Both the original lender and new lender need to consent to the transfer of the appraisal report. Lenders have their own restrictions and procedures for choosing appraisers, as well as having a conflicting financial interest in the AMC they use to hire appraisers.

Thus, an appraiser acceptable to one lender may not be acceptable to another for reasons other than the competency of the appraiser involved. So a delay in lender funding and closing is to be anticipated for the likely lack of consent and need for another appraisal. On conventional mortgages, lenders are not compelled to consider the transfer of appraisal reports.

In contrast, when a buyer changes from lender to lender on an application for an FHA-insured mortgage, the original lender is required to release the appraisal report to the new lender within five business days of the buyer's request.[8]

It is the MLO's responsibility to investigate and arrange the transfer of the appraisal report on behalf of the FHA-insured buyer. On FHA-insured mortgages, the original appraisal report and any appraisal report reviews or second appraisal reports are to be provided to the new lender with explanations. On conventional mortgages, the lender may also request information about appraisal report reviews and second appraisals.

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7 Fannie Mae Selling Guide Chapter B4-1.2-02; Freddie Mac Single Family Seller/Servicer Guide Chapter 5601.8

8 HUD Handbook 4000.1 Chapter II.A.1.a.7

Appraiser independence

No one with an interest in a real estate transaction may interfere with an appraiser's independence. Wrongful interference includes:

- coercing, extorting, colluding with, instructing, bribing or intimidating any appraisal professional into appraising property at a value based on any factor other than the independent judgment of the appraiser;
- mischaracterizing the appraised value of a property to secure a mortgage;
- influencing or encouraging an appraiser to meet a targeted value – the buyer's purchase price — for a property; or
- withholding or threatening to withhold payment for an appraisal report or service.

For example, conditioning the amount of fees the appraiser may receive based on their appraised value of a property is a violation of appraiser independence.[9]

A DRE licensee who violates appraiser independence while performing real estate activities is subject to DRE discipline for violation of licensing laws.[10]

However, the prohibitions against appraiser influence do not prohibit anyone with an interest in the transaction from asking an appraiser to:

- consider *additional relevant property information*, including information regarding comparable properties;
- provide *further explanation* for the valuation;
- *correct errors* in the appraisal report;
- provide a copy of the purchase agreement entered into by the buyer and seller regarding the property being appraised;
- obtain *multiple valuations* in order to assure reliability in value assessment; or
- *withhold compensation* due to breach of contract or inferior service.[11]

An appraiser or appraisal company may not have a financial or other interest in the property being appraised.[12]

If a lender is aware of a violation of appraisal independence, they are prohibited from using that appraisal report to make a loan, unless the lender has confirmed that the appraisal report does not misrepresent the value of the property.[13]

9 Calif. Civil Code §1090.5; Bus & P C 11345.4
10 CC §1090.5(c)
11 CC §1090.5(c)
12 Bus & PC §§11323, 11345.7
13 12 CFR §1026.42(e)

Chapter 14 Summary

An appraisal is an appraiser's opinion or estimate of a property's value on a specific date, reduced to writing in an appraisal report. The appraisal report contains data collected and analyzed by the appraiser. The content of the appraisal report serves to substantiate the appraiser's opinion of the property's fair market value (FMV).

Appraisers use several economic concepts to develop their opinion of value for a property. These principles of appraisal include the principle of supply and demand, the principle of change, the principle of conformity, the principle of contribution, the principle of substitution, the principle of regression and the principle of progression.

The appraisal process consists of identifying and defining the appraisal effort to be undertaken by the appraiser, data collection, applying the data and determining the value of the property.

A mortgage loan originator (MLO)'s two main concerns in connection with an appraisal report are whether the appraisal report adequately meets the lender's minimum content requirements and whether the appraisal report and opinion of value justifies the purchase price.

No one with an interest in a real estate transaction may interfere with an appraiser's independence.

Chapter 14 Key Terms

Chapter 15

The Uniform Residential Loan Application

Learning Objectives

After reading this chapter, you will be able to:

- understand the components of the Uniform Residential Loan Application (URLA);
- guide your buyer on preparing the mortgage application;
- advise on the disclosures a mortgage lender is required to make; and
- distinguish the purposes of the different aspects and steps in the mortgage packaging process.

Key Terms

balance sheet
buyer mortgage capacity
creditworthiness
debt-to-income ratio (DTI)
loan-to-value ratio (LTV)
Real Estate Settlement Procedures Act (RESPA)
transaction agent (TA)
Truth in Lending Act (TILA)
Uniform Residential Loan Application (URLA)

Fundamentals of the Uniform Residential Loan Application

Home sales transactions are typically contingent on the buyer-occupant obtaining a purchase-assist mortgage, known as a **consumer mortgage**. With it, they fund the price they will pay to buy the residence they intend to occupy. Further, a consumer mortgage may also be needed by:

- an owner of vacant land to construct their home;
- a homeowner to improve or renovate the home they currently occupy;
- a homeowner to refinance an existing consumer mortgage; or

Uniform Residential Loan Application (URLA)
A standardized mortgage application completed by the buyer with the assistance of the transaction agent and the mortgage lender's representative.

transaction agent (TA)
The term lenders use to identify the buyer's agent in a sales transaction.

- a residential tenant on a long-term lease who makes significant **tenant improvements** (TIs) to their residence.

After shopping lenders and selecting one as their primary lender, the buyer authorizes the lender to start the *mortgage packaging process* by preparing and submitting a **Uniform Residential Loan Application (URLA)** with the assistance of their buyer's agent, called a **transaction agent (TA)** by lenders. [See Figure 1]

Editor's note — This chapter reviews the revised URLA which may be used beginning July of 2019, and is mandatory beginning February of 2020.

Typically, the lender who will fund the mortgage is the loan processor, but not always. In some cases the loan processor who receives the loan application is a broker with a mortgage loan originator (MLO) endorsement. If the buyer's broker is affiliated with the lender, whether it is an in-house or independent lender sharing in profits, proper business affiliation disclosures are required since the buyer's broker will share in any profits of the lending operation. [See Chapter 30]

The URLA provides the lender with necessary information about:

- the buyer who is taking out the mortgage; and
- the residence to be encumbered by the mortgage.

The title of the *URLA* implies it is intended to be used to apply for mortgages secured by residential properties, such as:

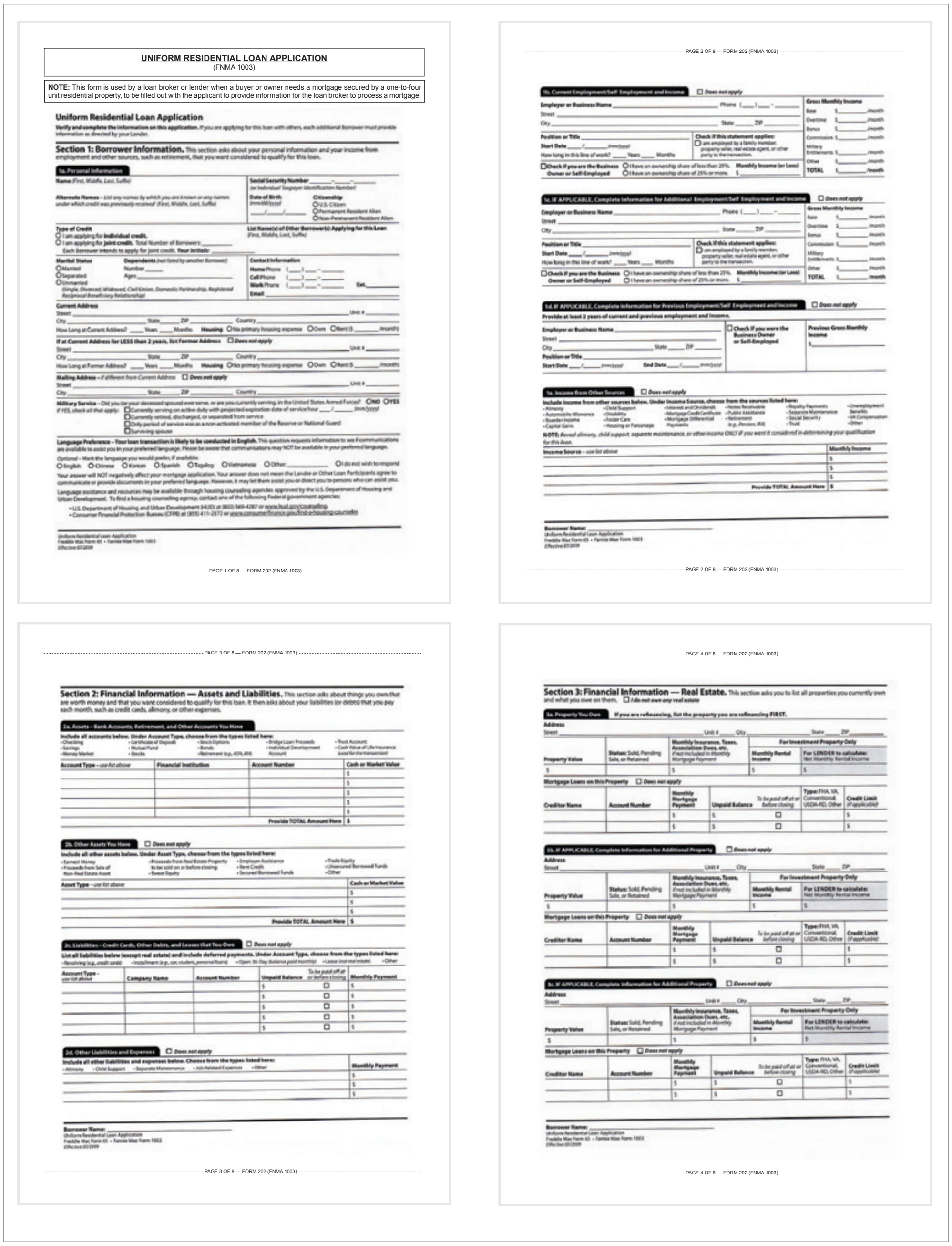
- a one-to-four unit residential property;
- condominiums (attached or detached); or
- rental property of any size which is exclusively residential.

However, the URLA is a generic mortgage application for arranging or making all types of mortgage originations. Thus, it is used by all MLOs and mortgage loan brokers (MLBs) when taking an application for a mortgage funding any purpose, consumer or business/investment/agriculture, secured by any type of property. The URLA contains all the information required for arranging mortgages secured by any type of real estate. The type of property intended to be purchased or improved by use of the mortgage funds is the property described in the mortgage application.

Components of the URLA

Once the buyer's agent has reviewed the mortgage process with the buyer, all part of a buyer's agent's counseling activity, the application needs to be completed and submitted to the lender.

While the application is designed to be completed with the lender, it is crucial the buyer's agent also be present during this step. The agent's involvement is imperative as completing and submitting the mortgage application is the significant activity remaining for the buyer to acquire the property after entering into a purchase agreement with the seller.


UNIFORM RESIDENTIAL LOAN APPLICATION
(FNMA 1003)

NOTE: This form is used by a loan broker or lender when a buyer or owner needs a mortgage secured by a one-to-four unit residential property, to be filled out with the applicant to provide information for the loan broker to process a mortgage.

Uniform Residential Loan Application

Section 1: Borrower Information.

Section 2: Financial Information — Assets and Liabilities.

Section 3: Financial Information — Real Estate.

Figure 1

Form 202

Uniform Residential Loan Application — FNMA 1003

Buyer information

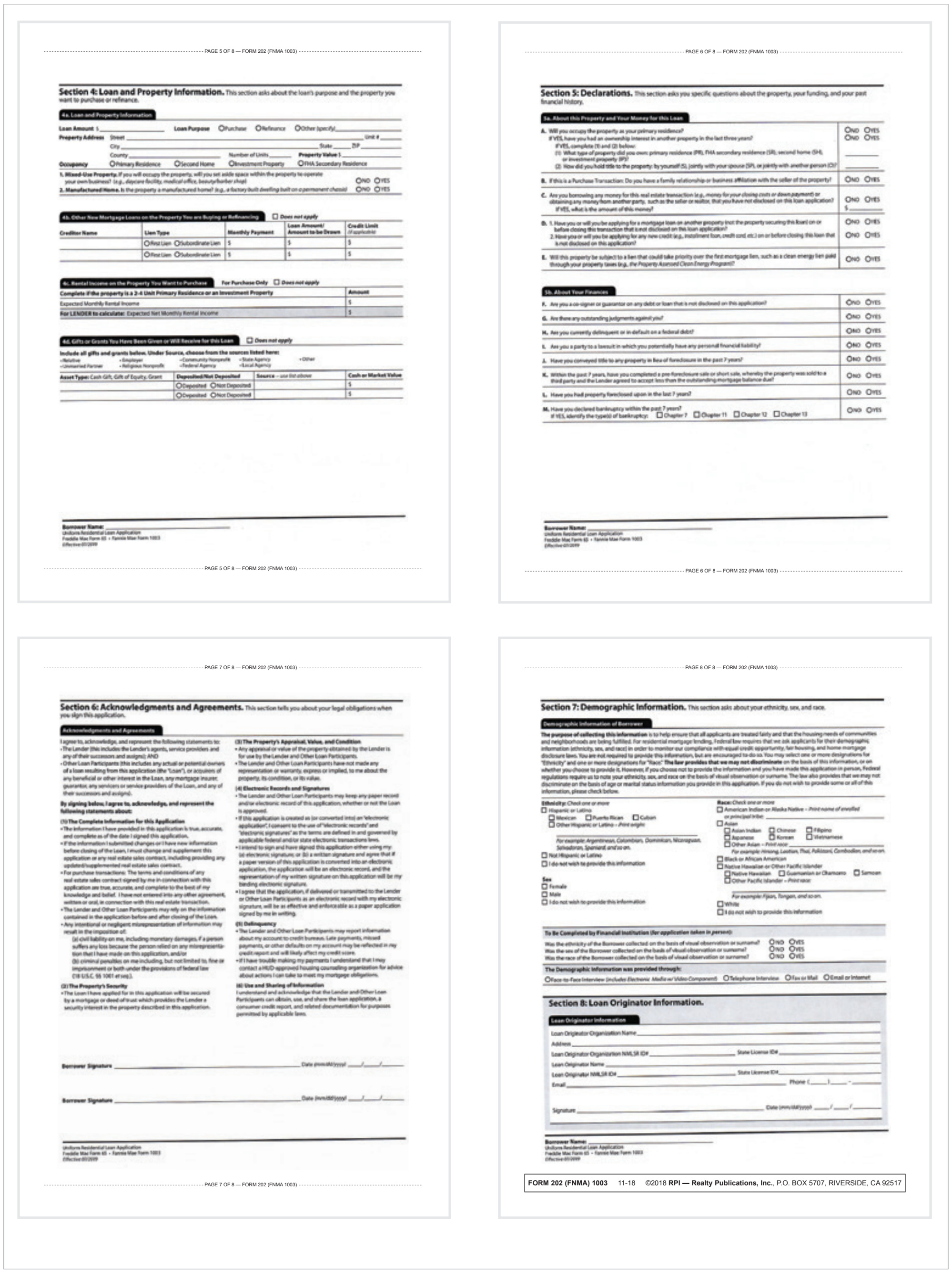
Information identifying the buyer, such as their *name* and *Social Security number*, is entered in Section1. Space is provided to insert any co-borrower information if the income, assets and liabilities of a co-borrower are to be considered for mortgage qualification purposes.

The 2019-2020 URLA also includes new fields for military service and language preference. The language preference field does not guarantee the lender will be able to communicate and provide documents in the preferred language. However, it provides important support when non-English resources are available. In turn, this increases access to the mortgage market.

Figure 1

Form 202 Cont'd

Uniform Residential Loan Application — FNMA 1003



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Section 4: Loan and Property Information.

PAGE 6 OF 8 — FORM 202 (FNMA 1003)

Section 5: Declarations.

PAGE 7 OF 8 — FORM 202 (FNMA 1003)

Section 6: Acknowledgments and Agreements.

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Section 7: Demographic Information.

Section 8: Loan Originator Information.

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Employment and income information

The buyer's (and co-borrower's) **employment and income information** identifying their source of income are also entered in Section 1 of the URLA.

Employment and income information includes:

- the employment currently held by the buyer;
- the buyer's job title;
- years spent at that specific job and within that profession; and
- gross income. [See Figure 1]

When the buyer is self-employed, they indicate this by checking the self-employed box. [See Figure 1]

Assets and liabilities

The buyer's **assets** and **liabilities** are entered into Section 2. This discloses the *buyer's net worth*. The information is pertinent since the buyer's *liabilities* affect their ability to repay the mortgage. However, the buyer may not want to disclose all their *assets*. Thus, a balance needs to be struck between maintaining financial privacy and disclosing enough assets to get **creditworthiness** clearance so the mortgage will be funded on the advantageous terms sought by the buyer. [See Figure 1]

A separate form may be used to disclose to the lender the applicant's assets and liabilities if:

- the assets and liabilities result from separate property owned by a co-borrower;
- the co-borrower is part of the transaction when the property to be encumbered is considered community property; or
- the co-borrower is to be a co-signer of the note as a primary borrower.

The buyer and co-borrower need to prepare a **balance sheet** when their assets and liabilities are sufficiently joined to make one combined statement viable. If not, each co-borrower prepares a separate asset and liabilities balance sheet for individual consideration by the lender. [See **RPI** Form 209-3]

balance sheet
An itemized, dollar-value presentation for setting an individual's net worth by subtracting debt obligations (liabilities) from asset values.

Real estate information

In Section 3 of the URLA, the buyer lists all the properties they currently own, and their financial obligation on these properties. First-time buyers will check the box stating, "I do not own any real estate."

The information called for on this page includes:

- the property address;
- property value; and
- mortgage loans which encumber the property, including the monthly payment and outstanding balance.

If the borrower owns multiple properties, space is provided for the entry of this parallel real estate data.

Loan and property information

Section 4 of the URLA calls for the **loan amount**, information about the **purpose of the mortgage sought** and **identifying information about the property** they intend to purchase or refinance with the funds.

The buyer also indicates:

- the property's value;
- the intended occupancy of the property;
- whether it is mixed-use or manufactured housing;
- other new mortgages which will be secured by the property;

- rental income on the property to be purchased, when applicable; and
- gifts or grants received by the buyer that will be used towards obtaining the mortgage.

Declarations

The buyer (and any co-borrower) declares relevant *property, funding or creditworthiness issues* in Section 5 of the mortgage application. [See Figure 1]

In this section, the buyer responds to questions about numerous conditions, including whether:

- the property will be occupied as represented in the application;
- the buyer has family or business affiliations with the seller of the property;
- the buyer received undisclosed loans for the down payment or closing costs; and
- other mortgages or liens against the property exist or are being obtained. [See Figure 1]

A second set of questions inquires about debt enforcement or debt avoidance the buyer has experienced.

Agreements and signatures

In Section 6, the buyer and any co-borrowers sign the application to acknowledge and agree to the numerous conditions. These conditions and acknowledgments include:

- the property will be occupied as represented in the application;
- the buyer will amend the application and resubmit it to the lender if the facts originally stated substantially change;
- the lender may report information about the borrower's account to credit bureaus; and
- the lender is authorized to verify all aspects of the mortgage application as represented by the buyer.

Government monitoring information

On the very last page, the buyer completes Section 7: Demographic Information, concerning the borrower's ethnicity, sex and race, also known as government monitoring information. The 2019-2020 URLA includes expanded race and ethnicity categories.

This information is collected to ensure all mortgage applicants are treated fairly and that the housing needs of all communities and neighborhoods are being fulfilled.

MLO identification

Finally, the URLA concludes with Section 8: Loan Originator Information, where identifying loan originator information is supplied.

Types of mortgages

The typical conventional mortgage is a 30-year amortized mortgage with a fixed rate of interest, known as a fixed rate mortgage (FRM).

The buyer's monthly payment remains the same during the life of the FRM. FRMs offer greater long-term stability for the buyer than adjustable rate mortgages (ARMs) where the interest rate and payment amounts changes periodically based on an index for short-term consumer rates, plus a profit margin. ARMs cause the buyer's monthly payment to periodically adjust. [See Chapter 20]

Other financing options and features include:

- *rate buy-downs where the buyer receives an initial interest rate which is periodically increased, along with the monthly payment, to a fixed rate within a few years, called a graduated payment mortgage (GPM);*
- *the length of the mortgage, which is typically 15 or 30 years, although some lenders offer mortgages with irregular terms;*
- *assumable mortgages allowing resale to a creditworthy buyer, with or without a rate adjustment [See Chapter 20];*
- *bi-weekly mortgages with payments made every two weeks to reduce the total amount of interest paid on the mortgage; and*
- *private mortgage insurance (PMI) where a qualifying buyer obtains a mortgage with less than a 20% down payment while paying a premium for insurance to cover the lender's risk of loss created by the smaller down payment. [See Chapter 17]*

RESPA and TILA disclosures

Mortgage lenders active in the secondary mortgage market disclose all **mortgage related charges** on mortgages used to purchase, refinance or improve one-to-four unit residential properties, a mandate of the **Real Estate Settlement Procedures Act (RESPA)**.

Mortgage related charges include:

- origination fees;
- credit report fees;
- insurance costs; and
- prepaid interest.

Real Estate Settlement Procedures Act (RESPA)
A federal law governing the behavior of service providers on a federally related mortgage which prohibits them from giving or receiving unlawful kickbacks.

RESPA is now administered and enforced by the **Consumer Financial Protection Bureau (CFPB).**

When the buyer takes out an ARM containing an interest rate that changes periodically, the lender informs the buyer not only of the interest rate, but also the:

- index the rate changes are tied to;
- the lender's margin; and
- any payment and interest rate adjustment floors and caps. [See **RPI** Form 320-1]

Since a consumer mortgage lender is considered a RESPA lender, they also provide the buyer with:

- a **Loan Estimate** of all mortgage terms quoted by the lender within three business days of the lender's receipt of the buyer's mortgage application (this replaced the old *good faith estimate* of costs and initial Regulation Z (Reg Z) disclosure form previously required);[1]
- a special information booklet published by the CFPB to help the buyer understand the nature and scope of real estate settlement costs within three business days after the lender's receipt of the buyer's application;[2]
- a **Closing Disclosure**, which summarizes the "final" mortgage terms and details, provided by the lender at least three days before they fund the mortgage;[3] and
- a list of **homeownership counseling** organizations.[4]

Editor's note — A list of homeownership counseling organizations approved by HUD can be found on the CFPB's website.

When the buyer arranges financing through a mortgage broker, the broker (not the lender) provides a copy of the special information booklet to the buyer.[5]

However, the booklet does not need to be given to the buyer when the mortgage funds:

- the refinance of an existing mortgage;
- a closed-end mortgage in which the lender takes a subordinate lien;
- a reverse mortgage; and
- any consumer mortgage used to fund the purchase of other than a one-to-four unit residential property.[6]

The lender is also to provide buyers with a written list of homeownership counseling organizations within three business days of receiving the loan application.[7]

Buyers are not required to take part in the counseling. Homeownership counseling is only compulsory if the mortgage is a Section 32 high-cost mortgage or allows for negative amortization.[8] [See Chapter 29]

Property appraisal

On the lender's receipt of a mortgage application, the property is **appraised**. [See **RPI** Form 207]

The *appraisal* determines whether the property is of sufficient value to function as adequate security for recovery of the mortgage amount in

1 12 CFR §1026.37
2 12 CFR §1026.19(g)
3 12 CFR §1026.19(f)(ii)
4 12 CFR §1024.20
5 12 CFR §1024.6(a)(1)
6 12 CFR §1024.6(a)(3)
7 12 CFR §1024.20(a)(1)
8 78 Federal Register 6964-6966

the event of a default. Thus, the property needs to support the amount of financing the buyer requests. The lender uses the appraisal to gauge whether the **loan-to-value ratio (LTV)** meets the lender's standards. [See Chapter 14]

loan-to-value ratio (LTV)
A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property's fair market value (FMV).

Generally, an acceptable *LTV* for conventional mortgages is 80% of the property's value. An LTV of 80% requires the buyer to make a minimum 20% down payment. When permitted, the buyer might make a lesser down payment using a piggyback mortgage to fund the remainder of the 20% equity beyond the first mortgage amount. A greater LTV than 80% compels the lender to require the buyer to obtain **private mortgage insurance (PMI).** [See Chapter 17]

The 80% LTV ceiling is used to limit mortgage amounts originated during downturns in the market value of real estate, rather than during a rapidly rising market. Thus, swings in values throughout an economic cycle are exacerbated by the volatile conduct of lenders, including their financial accelerator activity. Regulations setting parameters for mortgage lending are designed to narrow the cyclical swings and thus eliminate the economic damage brought on by unregulated lender conduct.

The mortgage application package

Once a lender approves a property as security for a mortgage amount based on an appraisal, the lender or MLO processing the application assembles a **mortgage package** and sends it to their mortgage underwriter for review.

The *mortgage package* prepared by the lender or MLO includes:

- the URLA [See Figure 1];
- the property appraisal report [See **RPI** Form 200];
- a credit report on the buyer;
- the lender's verification of the information provided on the mortgage application [See **RPI** Form 210, 210-1, 211, 212, 212-1, 213 and 214];
- the purchase agreement, escrow instructions and condition of property disclosure statement handed to the buyer by the seller and seller's broker [See **RPI** Form 150, 304 and 401]; and
- other documentation needed to support the buyer's request, including operation balance sheets, tax returns, IRS Form 4506, title reports and bank statements.

Truth in Lending Act (TILA)
A federal consumer mortgage law which controls the terms of a consumer mortgage and requires lenders to disclose mortgage rates and charges.

"Willing and able" to pay

A lender evaluating a mortgage package considers a buyer's *willingness* and *capacity* to pay. To comply, buyer/owners applying for a *consumer mortgage* are evaluated by the lender for their **ability-to-repay**, part of *Reg Z*, which implements the **Truth in Lending Act (TILA)**.[9] [See Chapter 27]

Generally, the **debt-to-income ratios (DTI)** for conventional mortgages, also called the **debt-to-income standards**, limit the buyer's:

debt-to-income ratio (DTI)
The percentage of monthly gross income that goes towards paying debt.

9 12 CFR §§1026.43 et seq.

- monthly payments for the maximum purchase-assist mortgage, including impounds for hazard insurance premiums and property taxes, to approximately 31% of the buyer's monthly gross income; and
- monthly payments on long-term debt to a maximum of 43% of the buyer's gross monthly income. [See **RPI** Form 229-1, 229-2 and 230]

buyer mortgage capacity
A buyer's ability to make mortgage payments based on their debt-to-income ratios (DTI).

Lenders use the *DTI* to evaluate the buyer's ability to make timely mortgage payments. This is referred to as **buyer mortgage capacity**. [See **RPI** Form 230]

creditworthiness
An individual's likelihood of repaying a mortgage, determined by their present income, wealth and previous debt payment history.

The buyer's willingness to make mortgage payments is evidenced by the **credit report**. The credit history demonstrates to the lender whether or not the buyer has sufficient propensity to pay, called **creditworthiness**.

The DTIs can be increased by the lender depending on one or more compensating factors, including whether the buyer has:

- ample cash reserves;
- a low LTV; or
- spent more than five years at the same place of employment.

Mortgage approval

A mortgage approval issued by a lender is often conditioned on a buyer providing more information or taking corrective actions. For example:

- the physical condition of the property may need correction;
- title may need to be cleared of defects;
- derogatory entries on the buyer's credit report may need to be eliminated; or
- the buyer's long- or short-term debt needs to be reduced.

Once conditions for funding are met and verified by the lender, the mortgage is classified as *approved*. Escrow calls on the lender or MLO for mortgage documents and funds, and on receipt of the funds, the sales transaction is closed.

Transaction agents working with buyers need to remind themselves that the degree of risk each lender finds acceptable is different. More often than not, a lender in the stable real estate market does exist who will make a mortgage of some amount under some conditions to nearly *any buyer*. Remember: it is the business of lenders to lend.

Chapter 15 Summary

The Uniform Residential Loan Application (URLA) prepared by the buyer with the mortgage loan originator (MLO) supplies the lender with necessary information about the buyer and the property securing the mortgage. It also gives the lender authorization to start the mortgage packaging process.

The URLA calls for the buyer, with the assistance of the mortgage representative and MLO, to enter information such as:

- the buyer's name and employment information;
- the buyer's monthly income and housing expenses;
- the buyer's assets and liabilities;
- the identity of the property used to secure the mortgage;
- the type of mortgage sought; and
- relevant miscellaneous creditworthiness issues to be disclosed to the lender.

A Real Estate Settlement Procedures Act (RESPA)-controlled lender needs to provide the buyer with a Loan Estimate and Closing Disclosure.

Federal Truth in Lending Act (TILA) disclosures are also given to the buyer, providing mortgage information in a standardized format for easy comparison of terms between mortgages offered by different lenders.

Once a lender approves a property as security for a mortgage amount based on an appraisal, the lender or MLO processing the application assembles a mortgage package and sends it to their mortgage underwriter for review.

Once mortgage conditions are met and verified, the mortgage is classified as approved. Escrow calls for mortgage documents and funds. On funding, the sales transaction is closed.

Chapter 15 Key Terms

Notes:

Chapter 16

Mortgage advertising

Learning Objectives

After reading this chapter, you will be able to:

- distinguish between California law applying to both consumer and business mortgages, and federal law applying to only consumer mortgages;
- understand the use of specific terms and related disclosures in mortgage advertisements;
- comply with mortgage advertising practices and terminology prohibitions; and
- identify features of a mortgage advertisement which violate mortgage advertising rules.

Key Terms

first-point-of-contact materials

Mortgage Acts and Practices — Advertising

triggering terms

State and federal marketing guidelines

Mortgage advertising is regulated by both state and federal mortgage law. State laws and regulations regarding mortgage advertising apply to both consumer mortgages and business mortgages.

Federal mortgage advertising rules are concerned only with consumer mortgages.

Mortgage Acts and Practices — Advertising
A federal law governing consumer mortgage advertisements.

Federal standards of conduct governing consumer mortgage advertisements are established by the **Mortgage Acts and Practices — Advertising** rule, known as **Regulation N (Reg N)**. *Reg N* was established in 2009 to protect homebuyers and homeowners from deceptive claims in consumer mortgage advertisements.[1]

The Consumer Financial Protection Bureau (CFPB) has responsibility for enforcing Reg N and reviewing mortgage advertisements for violations.

Additionally, the federal Truth in Lending Act (TILA) and its related Regulation Z (Reg Z) also impose advertising restrictions on consumer mortgages.[2]

License identification disclosure

Department of Real Estate (DRE) licensees need to disclose on all marketing materials advertising consumer and business mortgages:

- whether they are a broker or salesperson;
- their DRE license number; and
- when advertising a consumer mortgage, their Nationwide Mortgage Licensing System (NMLS) identification number.[3]

The license identification information provided may be no smaller than the smallest typeface on the marketing and solicitation materials in the advertisement.[4]

Mortgage advertisement materials subject to the DRE license and NMLS identification disclosure include:

- printed advertisements;
- radio and television advertisements; and
- electronic advertisements, including websites and emails.[5]

Also, advertisements of mortgage products intended to solicit buyers need to:

- identify the licensing authority, using "Department of Real Estate" or "Dept. of Real Estate"; and
- include the employing broker's DRE license number and NMLS identification number.[6]

An example of proper license identification, when the advertisement of a consumer mortgage product is involved, is:

Jane Smith

Real Estate Broker, Department of Real Estate

License #00000000

NMLS ID #000000

1 12 Code of Federal Regulations §§1014 et seq.
2 12 CFR §1026.24
3 Calif. Business and Professions Code §10140.6(b)
4 Calif. Department of Real Estate Regulations §2773(a)(4)
5 Bus & P C §10235.5, 10236.4
6 DRE Regs. §§2773, 2847.3(a)

First-point-of-contact information rules

Materials used to solicit or create a client relationship with prospective mortgage borrowers are known as **solicitation materials**, or **first-point-of-contact materials**.

These advertising materials for marketing a mortgage service include:

- business cards;
- stationery;
- emails;
- websites controlled by the licensee; and
- flyers.[7]

first-point-of-contact materials
Materials used to solicit or create a client relationship with prospective mortgage borrowers.

First-point-of-contact materials need to include:

- the DRE license number for each licensee named;
- the NMLS ID for each licensee named, if applicable; and
- the DRE number of the employing broker.[8]

First-point-of-contact materials do not need to identify the DRE as the licensing authority. [See RE 858]

Prohibition of misleading terms

Mortgage advertisements a licensee generates may not include terms or representations which mislead a buyer into believing the mortgage offered is something it is not.[9]

All interest rates, fees, costs, taxes, insurance, prepayment penalties and other special aspects of a mortgage presented in a mortgage advertisement need to be the truth.[10]

The prohibition against using misleading terms and the rules for proper use of mortgage loan originator (MLO) terms apply to all mortgage advertisements, including:

- labels, packages and package inserts;
- radio, television, cable television, films and infomercials;
- newspapers, magazines and catalogues;
- brochures, pamphlets and leaflets;
- circulars, mailers and letters;
- book inserts, free standing inserts and point of purchase displays;
- posters, charts, billboards, public transit cards and slides;
- audio programs transmitted over a telephone system;
- telemarketing scripts, on-hold scripts and upsell scripts;
- training materials provided to telemarketing firms; and
- the internet and mobile networks.[11]

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7 Bus & P C §10140.6(b)(2); DRE Regs. §2773(a)
8 DRE Regs. §2773(a)
9 Bus & P C §10235
10 DRE Regs. §2848; 12 CFR §1014.3
11 DRE Regs. §2848; 12 CFR §1014.2

Mock Ad Analysis #1

The consumer mortgage advertisement above was created by the Federal Trade Commission (FTC) to illustrate some common violations or potential violations of Reg N.

The violations include:

1. *The advertisement guarantees the recipient approval without specifying any criteria for approval.*
2. *The advertisement states a monthly payment — a triggering term — without providing the required disclosures. In fact, no details are provided about the terms or features of the advertised mortgage at all.*
3. *The advertisement claims to offer "low rates," without indicating the rates available.*

For California use, this consumer mortgage advertisement also requires the licensee to identify the "California Department of Real Estate", the licensee's status as a broker or agent, and the mortgage loan originator (MLO)'s Nationwide Mortgage Licensing System (NMLS) ID number.

SOURCE: FTC "Mock Ads" public domain document

DRE and the CFPB each have separate authority to investigate and request verification of representations made in mortgage advertisements.[12]

Any disclosure about terms made in a consumer mortgage advertisement is to be clear and conspicuous to the recipient. If the advertisement is online or televised, the disclosures may not be obscured or shaded. For radio advertisements, the speed of the delivery of information by voice may not be so rapid as to make the disclosure incomprehensible.[13]

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12 15 United States Code §1607; DRE Regs. §2848

13 12 CFR §1026.24(b); Official Interpretation of 12 CFR §1026.24(b)

When an advertisement for any type of mortgage includes a payment amount, interest rate, annual percentage rate (APR) or other specific mortgage term, it then needs to indicate whether the mortgage advertised will be in a first lien or junior lien.[14]

Availability of advertised mortgages

If a mortgage advertisement provides specific mortgage terms, the licensee must actually have a mortgage available with the advertised terms.[15]

Further, advertisements misrepresenting the likelihood a homebuyer or homeowner will be approved for the advertised consumer mortgage violate Reg N.[16]

Interest rates

An advertisement offering a consumer mortgage which states a simple interest rate also needs to state the APR with at least equal prominence to the rate stated. When a teaser rate applies, MLOs may advertise that rate if the term of its duration is also stated.[17]

Further, the DRE requires all mortgage advertisements offering "low rates" to include the actual interest rates available.[18]

Fixed vs. adjustable

To use the word "fixed" when advertising a consumer mortgage that is an adjustable rate mortgage (ARM):

- the phrase "adjustable rate mortgage," "variable rate mortgage," or "ARM" needs to appear first in the advertisement before any use of the word "fixed" and be at least as conspicuous in the advertisement as any use of the word "fixed"; and
- each use of the word "fixed" to refer to a rate or payment needs to include an equally prominent statement of the period for the fixed rate or payment and that the rate or payment may increase after the period.[19]

For example, advertising a consumer mortgage with a "fixed interest rate" without first stating the interest rate is variable and then clarifying that the rate is only fixed for an introductory period violates Reg N.[20]

Costs and fees

Advertisements using terms such as "no costs" or "no fees" are deemed misleading by both DRE and Reg N. Costs and fees are part of any mortgage transaction, whether they are paid up-front by the buyer or added to the mortgage amount and presented as an increased APR.

14 DRE Regs. §2848(a)(6)
15 DRE Regs. §2848; 12 CFR §1026.24(a); Official Interpretation of 12 CFR §1026.24(a)
16 12 CFR §1014.3(q); 12 CFR §1014.3(r)
17 12 CFR §1026.24(c); Official Interpretation of 12 CFR §1026.24(c)-2, 4
18 DRE Regs. §2848(a)(2)
19 12 CFR §1026.24(i)(1)(i)
20 12 CFR §1014.3(g)

For instance, a consumer mortgage advertisement may not claim that the mortgage offered has "No fees!" if fees are charged and simply bundled into the mortgage amount.[21]

Triggering terms

triggering terms
Words and phrases in consumer mortgage advertisements which trigger the need for additional disclosures.

The use of some words or phrases in consumer mortgage advertisements trigger the need to include additional disclosures in the advertisement. Called **triggering terms,** these words and phrases needing disclosures include:

- the amount or percentage of any down payment, e.g., "For as little as 3.5% down!";[22]
- the number of payments or period of repayment, e.g., "30-year mortgage";[23]
- the amount of any payment, e.g., "$500,000 mortgage for just $1,650 per month";[24] or
- the amount of any finance charge, e.g., "$50,000 mortgages, two points to the borrower."[25]

If any of the *triggering terms* are present in the consumer mortgage advertisement, the following disclosures need to be included in the advertisement:

- the amount or percentage of the down payment (e.g. "10% cash required from the buyer");
- the number, amount and period of payments over the full term of the consumer mortgage, including any allowable balloon payment;
- the "annual percentage rate," using that term; and
- whether the rate may be increased after closing.[26]

Further, if a specific periodic payment amount is stated in the advertisement, it needs to include:

- the principal amount;
- the simple annual interest rate; and
- if the mortgage is an ARM, the maximum interest rate, how often the interest rate can change and the ARM caps.[27]

Envelopes, banner advertisements and pop-up advertisements are exempt from the full rate and payment disclosures.[28]

Prohibited advertising

Prohibited under both state and federal mortgage laws is the use of:

- false lender identification;
- false government identification;

21 12 CFR §§1014.3(c)-(d)
22 Official Interpretation of 12 CFR §1026.24(d)(1)-1
23 Official Interpretation of 12 CFR §1026.24(d)(1)-2
24 Official Interpretation of 12 CFR §1026.24(d)(1)-3
25 Official Interpretation of 12 CFR §1026.24(d)(1)-4; 12 CFR §1026.24(d)(1)
26 12 CFR §1026.24(d)(2)
27 DRE Regs. §2848(a)(5), (17)
28 12 CFR §1026.24(f)(4)

- simulated checks; and
- discriminatory content.

False lender identification

Prohibited in all mortgage marketing is any use of the name or logo of the addressee's current mortgage holder, or the addressee's current mortgage number, unless the advertisement:

- discloses with equal prominence the name of the person sending the advertisement; and
- includes a clear and conspicuous statement that the person advertising is not associated with or acting on behalf of the current mortgage holder.[29]

Further, the name the licensee uses as the sender may not be so close to the name of the addressee's current mortgage lender that a reasonable person might believe they are the same entity or affiliates.[30]

However, fair use of the existing mortgage holder's name is allowed. For example, an advertisement which clearly identifies and differentiates the licensee from the addressee's existing mortgage holder may use the name and logo of the existing mortgage holder when comparing products and services of the two mortgage lenders.[31]

Violation of the false identification prohibitions exposes the DRE licensee to liability for:

- any actual money losses suffered by the recipient;
- court costs; and
- attorney fees.[32]

False government identification

A DRE licensee may not use a seal, emblem, insignia, symbol, trade or brand name which implies a connection to or approval by any government or military organizations, unless the licensee:

- has an express connection to or approval from a government agency; or
- displays the following disclosure conspicuously on all advertisements, including television commercials:

  "THIS PRODUCT OR SERVICE HAS NOT BEEN APPROVED OR ENDORSED BY ANY GOVERNMENTAL AGENCY, AND THIS OFFER IS NOT BEING MADE BY AN AGENCY OF THE GOVERNMENT."

If mailed, the envelope of the advertisement is to state:

> "THIS IS NOT A GOVERNMENT DOCUMENT."[33]

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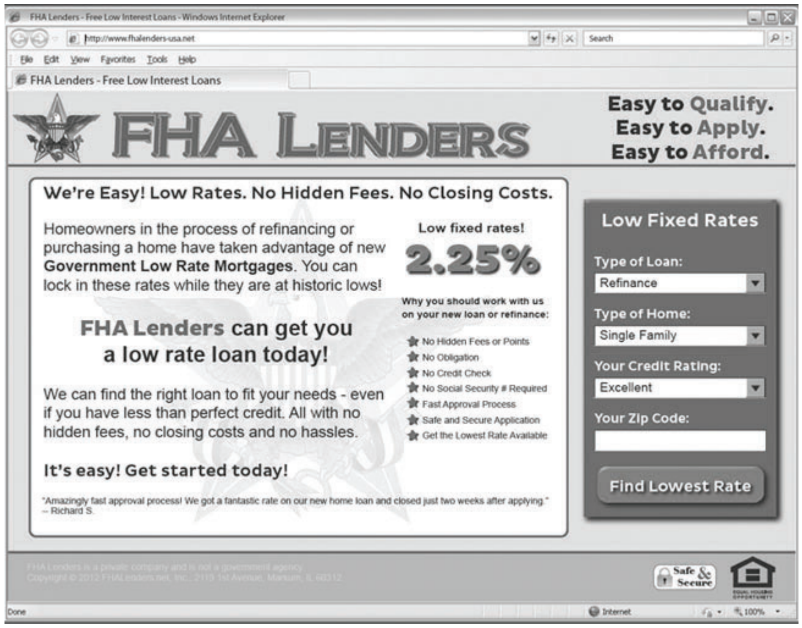
29 Bus & P C §§14701(a), 14702; 12 CFR §1014.3(o), 12 CFR §1026.24(i)(4)
30 Bus & P C §14701(b)
31 Bus & P C §14703
32 Bus & P C §14704
33 Bus & P C §17533.6; 12 CFR §1014.3(o)

Mock Ad Analysis #2



This second Federal Trade Commission (FTC) advertisement features a website with several Regulation N (Reg N) violations.

The violations in this mock consumer mortgage website include:

1. *The advertisement uses imagery and logos that make the advertiser look like a government agency. The printed text which indicates the lender is not a government entity is printed in tiny print at the bottom of the website. Further, the light text color on the light background makes the disclosure difficult to read.*
2. *The advertisement offers "Government Low Rate Mortgages" without clearly identifying a government-insured or -guaranteed mortgage program.*
3. *The advertisement offers "low fixed rates" without clarifying whether the rate advertised is a teaser rate for a limited period or that the rate is fixed for the life of the loan.*
4. *The advertisement states "No Credit Check", and offers a low interest rate without indicating the qualification requirements.*
5. *The advertisement provides an interest rate, but does not make the required APR disclosure.*

Similar to the other FTC advertisement, this mock consumer mortgage website is missing the required license identification data required of Department of Real Estate (DRE) licensees.

SOURCE: FTC "Mock Ads" public domain document

Further, unless a mortgage is endorsed or sponsored by a federal, state or local government entity, federal law prohibits advertising a mortgage as a "government loan program", "government-supported loan", or as endorsed or sponsored by any federal, state, or local government entity.[34]

34 Bus & P C §17533.6; 12 CFR §1026.24(i)(3)

Mock Ad Analysis #3

This mortgage advertisement features several violations and potential violations of Department of Real Estate (DRE) mortgage regulations, including:

1. *The advertisement is a simulated check.*
2. *The advertisement claims the addressee has been preapproved for a mortgage providing cash back or other type of extension of credit.*
3. *The advertisement leads the addressee to believe they are guaranteed money that they have not qualified for.*
4. *The advertisement does not spell out the terms and additional steps needed to acquire the advertised cash or credit.*

Simulated checks

Use in any mortgage marketing of paperwork resembling a check that is not a negotiable instrument is prohibited in California.[35]

These *simulated checks* mislead the addressee to believe they have received or are guaranteed money that is not immediately available to them.

Violation of the simulated checks prohibition exposes the DRE licensee to a civil penalty of $100 per violation.[36]

Other prohibitions

DRE licensees are prohibited from making or using mortgage marketing advertisements which in any way discriminate based on race, color, sex, religion, ancestry, physical handicap, marital status or national origin.[37]

Prohibited advertisements include any claim the consumer mortgage offered will eliminate debt or result in a waiver or forgiveness of an existing mortgage held by another lender.[38]

35 Bus & P C §22433(a)
36 Bus & P C §22433
37 DRE Regs. §2780
38 12 CFR §1014.3(m), 12 CFR §1026.24(i)(5)

Use of the term "counselor" is prohibited in an advertisement for a consumer mortgage when referring to a for-profit mortgage broker or mortgage lender. For instance, an advertisement by a for-profit MLO may not state the MLO's "government loan housing counselors are standing by!"[39]

Additionally prohibited is the stating of information in a consumer mortgage advertisement about some triggering terms in a foreign language when information in the same advertisement about other triggering terms is provided only in English.[40]

DRE review

DRE licensees may submit their mortgage advertisements to the DRE for approval. The cost of the advertising review is $40 per advertisement.[41] [See RE 884]

DRE approval is not mandatory, but can avoid the exposure to producing, printing and running an advertisement that is later deemed unacceptable.

DRE advertising approval is good for five years.[42]

DRE's advertising review only checks for adherence to DRE regulations and related state real estate law. DRE approval of mortgage ads does not in any way ensure compliance with federal consumer mortgage advertising rules.

39 12 CFR §1026.24(i)(6)
40 12 CFR §1026.24(i)(7)
41 DRE Regs. §2847
42 Bus & P C §10232.1

Chapter 16 Summary

Mortgage advertising is regulated by both state and federal mortgage law. State laws and regulations regarding mortgage advertising apply to both consumer mortgages and business mortgages.

Federal standards of conduct governing consumer mortgage advertisements are established by the Mortgage Acts and Practices — Advertising rule, known as Regulation N (Reg N).

Materials used to solicit or create a client relationship with prospective mortgage borrowers are known as solicitation materials, or first-point-of-contact materials. First-point-of-contact materials need to include the Department of Real Estate (DRE) license and, if applicable, the Nationwide Mortgage Licensing System (NMLS) IDs for each licensee named.

If a mortgage advertisement provides specific mortgage terms, the licensee must actually have a mortgage available with the advertised terms.

The use of some words or phrases in consumer mortgage advertisements trigger the need to include additional disclosures in the advertisement. Called triggering terms, these words and phrases needing disclosures include:

- the amount or percentage of any down payment;
- the number of payments or period of repayment;
- the amount of any payment; or
- the amount of any finance charge.

Prohibited under both state and federal mortgage laws is the use of:

- false lender identification;
- false government identification;
- simulated checks; and
- discriminatory content.

Chapter 16 Key Terms

first-point-of-contact materials .... pg. 163
Mortgage Acts and Practices — Advertising .... pg. 162
triggering terms .... pg. 166

Notes:

Chapter 17

Private mortgage insurance

Learning Objectives

After reading this chapter, you will be able to:

- advise your homebuyers who have a down payment smaller than 20% about the availability of private mortgage insurance (PMI) on consumer mortgages;
- review the qualification and approval process for your buyer to obtain PMI; and
- explain the cost differences between PMI and FHA mortgage insurance premiums (MIP) for a consumer mortgage.

Key Terms

lender-paid mortgage insurance (LPMI)

private mortgage insurance (PMI)

Risk reduction for the mortgage lender

A lender originating a mortgage takes on the risk they might lose on their investment in the mortgage if the buyer defaults. To shift this risk, **private mortgage insurance (PMI)** coverage is taken out to indemnify the mortgage lender in case of a loss.[1]

The lender's recoverable losses under PMI cover include:

- principal on the debt;
- any deficiency in the value of the mortgaged property; and
- foreclosure costs.

1 Calif. Insurance Code §12640.02

private mortgage insurance (PMI)
Default mortgage insurance coverage provided by private insurers for conventional loans with loan-to-value ratios (LTVs) higher than 80%.

PMI insurers are privately owned, unrelated to government-created insurance agencies which also insure or guarantee mortgages. The government insurance agencies which cover losses on mortgages made to qualified buyers include:

- the Federal Housing Administration (FHA); and
- the U.S. Department of Veterans Affairs (VA). [See Chapters 21 and 23]

PMI is not **mortgage life insurance.** Life insurance pays off the insured mortgage in the event a buyer dies, becomes disabled, or loses their health or income.

PMI coverage

PMI insures the lender for losses incurred up to a percentage of the mortgage amount. In turn, the mortgage amount represents a percentage of the property's value, called the **loan-to-value ratio (LTV)**, which is used to judge risk.

PMI is available in California through two primary insurers:

- *Mortgage Guaranty Insurance Corporation (MGIC)*; and
- *Genworth Financial*.

Who pays for PMI coverage?

The buyer usually pays the PMI premiums, not the lender (although the lender is the insured party and is the holder of the policy).

lender-paid mortgage insurance (LPMI)
Default mortgage insurance provided by private insurers in which the lender pays the mortgage insurance premium and recovers the cost through a higher interest rate.

However, some lenders and PMI insurers offer a **lender-paid mortgage insurance (LPMI)** program. When LPMI is issued by the PMI insurer, the lender pays the mortgage insurance premium and charges the buyer a higher interest rate on their principal payments to pass on the cost of the coverage. When a lender is willing to absorb the risk of loss on high LTV mortgages, they will charge a higher interest rate (the risk premium), and simply retain the increase over a par rate to cover losses PMI covers.

Further, LPMI cannot be cancelled, while buyer-paid PMI may be cancelled or automatically terminated. LPMI only terminates upon a refinance or other total payoff of the mortgage.[2]

Editor's note — The discussion of PMI in this chapter assumes the traditional buyer-paid PMI, unless otherwise noted.

PMI cancellation

Premium rates for PMI coverage are set as a percentage of the mortgage balance. PMI premiums are calculated in the same manner as interest rates on the mortgage balance.

When the owner is current on PMI payments and has not taken out other mortgages on their property, they may terminate their PMI coverage when the equity in their property reaches 20% of its value at the time the mortgage

2 12 United States Code §4905(c)(1)

was originated. Once the equity in the property reaches 22% of the home's value, PMI is automatically cancelled (unless the mortgage is a piggyback 80-10-10).[3]

Premiums charged by PMI insurers do not include an up-front fee on origination like FHA, only an *annual fee* calculated as a percentage of the mortgage balance and payable monthly with principal and interest payments.

Buyer PMI qualification standards

Depending on the specific guidelines unique to each insurer, the buyer needs to meet PMI qualification standards such as:

- a minimum credit score of upwards of 620;
- a back-end debt-to-income ratio between 41% and 45%;
- two months principal, interest, taxes and insurance (PITI) payments in cash reserves;
- employment full time during the past two years, a current pay stub, written *verification by employer* (VOE form), and telephone confirmation of employment at closing, unless self-employed;
- financial statements when self-employed for the two prior years and year-to-date, plus federal tax returns;
- legal residence in the United States;
- all documents and title vestings to be in the name of the buyer as an individual;
- a limit of two mortgages with PMI coverage in the name of the buyer;
- completion of a homeowners' course of education on mortgage debt obligations;
- no bankruptcy within four years, unless excused by extenuating circumstances;
- no short sale within four to seven years; and
- no foreclosure or deed in-lieu within five to seven years.

The PMI investigation and documentation takes place after submission of a mortgage application. Documentation is generally limited to verification of all the buyer's representations on the application.

PMI's type of property

PMI coverage varies by provider and according to market conditions. Generally, PMI covers:

- single family residences (SFRs);
- two-unit properties;
- co-operatives; and
- manufactured housing.

3 12 USC §4902(b)

Also, SFRs are further categorized as either:

- *detached*; or
- *condos*.

The distinction between types of properties is reflected in the amount of down payment required for PMI.

For a mortgage to qualify for PMI, its terms and conditions need to meet the insurer's criteria, such as:

- a mortgage amount no greater than $484,350;
- 97% LTV for a detached or attached SFR, which may be located within a common interest development (CID); and
- for adjustable interest rate mortgages (ARMs), the rate is fixed for the first three years and the ARM has no possibility of negative amortization.

Defaulting buyer and PMI recourse

Most PMI contracts do not authorize the insurer to seek **indemnity** from the buyer for claims made on the policy by the lender. This is distinct from FHA insurance programs which place homeowners at a risk of loss beyond the amount of their down payment.

Most insured mortgages are **nonrecourse mortgages** made to buyer-occupants to acquire their principal residence. As a *nonrecourse mortgage*, recovery is limited to the value of the real estate securing the mortgage.[4]

In the case of *fraud* on recourse or nonrecourse mortgages, the PMI insurer is not barred by anti-deficiency statutes from recovering losses. Thus, they may enforce collection of their losses against the buyer for material misrepresentations, such as the property's value or employment status or income of the buyer.

The PMI credit check

To qualify for PMI, the buyer needs to:

- be a natural person, not a corporation, partnership or limited liability company (LLC); and
- take title as the vested owner of the property.

The lender, when qualifying the buyer for a mortgage to be covered by PMI, applies the more restrictive PMI insurer's requirements regarding the buyer's:

- liquid assets after closing;
- debt-to-asset ratio;
- debt-to-income ratio (DTI); and
- regard for financial obligations.

A buyer required to qualify for PMI before a lender funds a mortgage undergoes an in-depth *risk analysis* based on the PMI insurer's eligibility requirements.

4 Calif. Code of Civil Procedure §580b

The ***mortgage insurance premium (MIP)*** *offered by the Federal Housing Administration (FHA) insures lenders against losses on a default in mortgages originated with homebuyers who make a down payment of less than 20% (typically 3.5%-5%). [See Chapter 21]*

Private mortgage insurance (PMI) is the only alternative to mortgage insurance issued by the FHA (and other government programs). PMI insurers require higher down payments and have more stringent credit score requirements than the FHA. However, they have lower, less expensive premium rates.

Unlike the FHA, PMI insurers do not usually require the routine recurring monthly/annual ownership expenses incurred by the homebuyer to be included in the impound amount before applying the 31% debt-to-income ratio (DTI).

Thus, the total amount of mortgage money available for purchasing a home when using PMI is greater than with an FHA-insured mortgage. This exclusion of ownership expenses raises the purchasing power delivered by a maximum mortgage amount since it is set by the limit for payments at 31% of the buyer's gross income. By applying for PMI coverage, the homebuyer directs a higher proportion of their total monthly payment toward principal and interest, allowing them to borrow more money.

Further, PMI companies are required by law to cancel PMI payments at 80% LTV, upon the buyer's request. [12 United States Code §4901(2); 12 USC §4902(a)]

The FHA's cancellation policy is significantly more stringent, requiring buyers to pay annual MIPs for:

- *the lesser of 11 years or the entire mortgage term for loan-to-value ratios (LTVs) less than or equal to 90% on origination; and*
- *the lesser of 30 years or the entire mortgage term for LTVs greater than 90% on origination. [HUD Handbook 4000.1 Appendix A]*

FHA or PMI?

At a minimum, the buyer is required to submit documents for review by the PMI insurer, including:

- a copy of the mortgage application;
- a credit report current within 90 days and covering a minimum of two years; and
- an appraisal of the real estate to be purchased.

However, the PMI carrier may also require additional documentation to verify the mortgage transaction fulfills the insurer's underwriting requirements, including:

- verification the buyer will occupy the property;
- verification the land value of the property does not exceed 40% of the total value of the property;
- a copy of the signed purchase agreement;
- verification of funds for closing;
- verification of the buyer's salary, including overtime and second jobs; and
- verification of employment.

The buyer's credit rating and disposable income need to clearly support their ability to make the monthly payments on the low down payment mortgage.

Chapter 17 Summary

Private mortgage insurance (PMI) indemnifies a lender for loss on a loan secured by an interest in real estate, called a mortgage, when a buyer whose down payment is less than 20% defaults.

The lender's recoverable losses include:

- principal on the debt;
- any deficiency in the value of the mortgaged property; and
- foreclosure costs.

A buyer required to qualify for PMI before a lender funds a mortgage undergoes an in-depth risk analysis based on the PMI insurer's eligibility requirements.

Chapter 17 Key Terms

lender-paid mortgage insurance (LPMI)............................ pg. 174
private mortgage insurance (PMI)...................................... pg. 174

Chapter 18

Impound accounts: funds for taxes and insurance

Learning Objectives

After reading this chapter, you will be able to:

- apply the federal and state schemes governing impound accounts for consumer and business mortgages;
- identify the components of an impound account;
- explain the procedures for establishing, managing and terminating an impound account; and
- calculate the appropriate initial and monthly deposits for an impound account.

Key Terms

computation period

impound account

impound account provision

Tax and insurance reserves

An **impound account** is a money reserve funded monthly by the property owner and maintained by the mortgage holder to pay annual recurring ownership obligations.

impound account
A money reserve funded monthly by the property owner and maintained by the mortgage holder to pay annual recurring ownership obligations.

The *impound account* is funded by the property owner making an initial deposit with the mortgage lender when the mortgage is originated. To maintain sufficient funds in the account, the owner makes further deposits monthly together with payments of principal and interest installments.

The funds impounded in the account maintained by the lender belong to the owner. However, the mortgage holder — not the property owner — disburses the funds to pay annually recurring property ownership expenses.

The property ownership expenses paid with the impound account include:

- property taxes;
- insurance premiums;
- bonded improvements
- water stock assessments; or
- maintenance assessments for common areas or easements.

To fund the impound account, a *pro rata* amount of anticipated costs for annual taxes and insurance premiums (known as TI) is collected on origination and with each monthly payment on principal and interest (PI) – collectively known as **PITI**.

The TI portion of the owner's monthly PITI payment is *excluded* from the computation of any late charge amount on a delinquent payment of the monthly installments of PITI.

The purpose of an impound account

An owner of real estate encumbered by a mortgage is obligated by its terms to timely pay the taxes, bond assessments and insurance premiums, among other obligations. Timely payment protects the mortgage holder against **impairment** of their security interest in the property.

With an *impound account*, the mortgage holder's security interest in the property will not be impaired by defaults in the payment of property taxes, bond assessments and insurance premiums. An impound account is created when the property owner agrees to the terms of an **impound account addendum** attached to the mortgage holder's trust deed. [See Form 455 accompanying this chapter]

Mortgages that do not contain provisions for impounding obligate the owner to independently pay property taxes, insurance premiums, assessment liens and similar charges (the TI portion of the PITI payment) in a timely manner.

From the homeowner's perspective, impound accounts are useful to break up large, annual or semi-annual insurance and tax payments into more manageable monthly installments included with the mortgage. Thus, even if the mortgage does not require an impound account the homeowner may request one.

Impounds mandated, required and elected

Depending on the mortgage type, an impound account may be mandatory, optional or prohibited.

Impound accounts are **mandatory** for Section 35 higher-priced consumer mortgages.[1] [See Chapter 26]

1 12 CFR §1026.35(b)

On the flipside, a mortgage holder is **not permitted to require** an impound account at origination on a first mortgage secured by an owner-occupied one-to-four unit residential property when the loan-to-value ratio (LTV) is less than 90% (regardless of purpose).[2]

Besides those two rules, a mortgage holder **may require** an impound account on other mortgages secured by any type of real estate.

Rules for terminating enforceable impound accounts vary based on the mortgage holder's policies. There are no universal requirements for terminating an impound account that mortgage holders are required to follow.

After origination, the mortgage holder may demand and enforce the establishment of an impound account on a mortgage secured by a one-to-four unit residential property when the owner is delinquent on two or more consecutive property tax payments.[3]

At or after origination, the owner of any type of real estate may request the mortgage holder set up an impound account if the mortgage holder provides this service.[4]

Components of an impound account

An **impound account provision** in a trust deed or attached addendum establishes rules for handling:

- **initial and monthly deposits** to be paid in amounts based on the owner's annually recurring obligations;
- **reserves** initially deposited as extra funds, used in the event monthly impound payments are insufficient to cover payment of a TI obligation;
- **interest** to be paid by the mortgage holder to the property owner on the impound account balance held by the mortgage holder;
- **surpluses** in an impound account when the balance is greater than necessary to satisfy TI disbursements and reserves, which are either returned to the owner or credited toward the next year's impound account payments;
- **deficiencies and shortages**, arising when the impound account balance is insufficient to pay upcoming TI obligations (a shortage) or the impound account has a negative balance after a TI payment (a deficiency); and
- **accountings**, statements and analyses prepared and delivered to the property owner at least once yearly.

impound account provision
A trust deed provision establishing a reserve of the owner's funds for the payment of annually recurring ownership expenses.

Rules common to all impound accounts

When provisions in a mortgage encumbering **any type** of real estate establish an impound account for taxes and insurance premiums, the mortgage holder is required to:

- set the amount of the **initial deposit** and **monthly deposits** to be made into the impound account; and

2 Calif. Civil Code §2954(a)(1)(A)-(G)
3 CC §2954(a)(1)(C)
4 CC §2954(a); **Kirk** v. **Source One Mortgage Services Corporation** (1996) 46 CA4th 483

- from the funds received, pay property taxes before they are delinquent and insurance policy premiums before they are cancelled.[5]

The **initial deposit** into an impound account on a mortgage secured by any type of real estate is capped at:

- the pro rata amount of annual property taxes and insurance premiums for the period beginning when they were last due and ending on the date of the first installment due on the mortgage; plus
- a reserve of **one-sixth** of this pro rata amount.

Further, the **monthly impound deposit** made with a principal and interest (PI) payment is capped at:

- one-twelfth of the estimated annual payments for taxes and insurance; plus
- any deficiency in the one-sixth reserve for the account.[6] [See Form 455]

However, the mortgage holder or servicer may call on an owner of any type of real estate to pay additional amounts to cover any **deficiency** that develops in the impound account.[7]

Further, the holder of a mortgage secured by an **owner-occupied single family residence (SFR)** may not increase the monthly payments to cover a deficiency until the mortgage holder delivers to the owner:

- an itemized accounting of the amount currently in the impound account;
- notice of the new monthly impound payment; and
- a statement of the reasons the increase is necessary.[8]

Consumer mortgage deposits, reserves and interest

Consumer mortgages are a federal class of debts:

- incurred to fund a personal, household or family purpose; and
- secured by a one-to-four unit residential property.

The formulas for setting initial impound deposits, monthly TI payments and limits on reserves for any mortgage, consumer mortgages included, are set by California law.[9]

The consumer mortgage holder — like the holder of any mortgage secured by one-to-four unit residential property — is required to pay 2% annual **simple interest** on any balance in the impound account. The 2% *simple interest* accrues annually and is credited to the account balance when annual adjustments are made. When a deficiency exists, the mortgage holder may apply the interest to the deficient balance.

5 CC §2954.1
6 CC §2954.1(a); 12 CFR §§1024.2, 1024.17
7 CC §2954.1(c)
8 CC §2954(b)(3)
9 CC §2954.1(a); 12 CFR §1024.17

Form 455

Impounds Addendum

IMPOUNDS ADDENDUM
Taxes and Insurance

Prepared by: Agent ____________________ Phone ____________________
Broker ____________________ Email ____________________

NOTE: This form is used by a transaction agent, loan broker or escrow officer when originating a mortgage for a lender or carryback seller with an impound account for taxes, insurance and other fixed ownership costs, to document as a trust deed addendum the additional impound payments to be made with the monthly installments of principal and interest.

DATE: ____________, 20______, at ______________________________, California.
Items left blank or unchcked are not applicable.

FACTS:

1. This is an addendum of the Deed of Trust
   1.1 ☐ of same date, or dated ______________, 20_____, at ______________________, California,
   1.2 executed by ____, as the Trustor,
   1.3 naming ____ as the Beneficiary.

AGREEMENT:

2. Trustor will pay Beneficiary, in addition to regular monthly installments on the Note secured by the Deed of Trust, a sum equal to one-twelfth ($^1/_{12}$) of the annual taxes levied on the property and the annual premiums for hazard insurance, mortgage insurance and other insurance required by the Beneficiary.
3. An initial deposit of $__________________ is required to establish the impound account.
4. Beneficiary will disburse money maintained in the impound account for the payment of taxes, assessments, and insurance premiums.
5. Any surplus amounts will be applied toward payment of the principal amount of the Note or future advances secured by the Deed of Trust.

I agree to the terms stated above.

Date: ______________, 20_______

Trustor's Name: ____________________________ Trustor's Name: ____________________________

Trustor's Signature: ____________________________ Trustor's Signature: ____________________________

Trustor's Name: ____________________________ Trustor's Name: ____________________________

Trustor's Signature: ____________________________ Trustor's Signature: ____________________________

FORM 455 03-11

To accrue, the interest will need to be determined for each month of the accounting period based on the account balance at the end of the month. To achieve the 2% annual rate, the minimum required interest is computed at $1/12^{th}$ of 2% on each end-of-month balance. Any fee charged for maintaining the impound account may not cause the interest received on the account to fall below 2%.[10]

Consumer mortgage surpluses, deficiencies and shortages

In the event the consumer mortgage holder discovers a surplus of funds during an initial, annual or disbursement analysis of the impound account, the mortgage holder needs to:

- refund the amount to the owner within 30 calendar days of the analysis when the excess is $50 or greater; or
- either refund the amount to the owner or credit the excess funds against the next year's impound payments, when the excess is less than $50.[11]

10 CC §2954.8(b)
11 12 CFR §1024.17(f) (2)(i)

However, when a scheduled payment is more than 30 days delinquent at the time of the account analysis and discovery of the surplus, the consumer mortgage holder may retain the surplus in the impound account if provided by the mortgage trust deed.[12]

When an impound account analysis reveals a *shortage* of less than one month's TI payment, the consumer mortgage holder may:

- allow a shortage to exist and do nothing;
- require the shortage be repaid within 30 days; or
- require the owner to repay the shortage amount in equal monthly payments over a period of 12 or more months.[13]

When the accounting reveals a shortage equal to or greater than one month's TI payment, the consumer mortgage holder has the option to:

- allow the shortage to exist and do nothing; or
- require repayment in equal installments over 12 or more months.[14]

When an impound account analysis confirms a deficiency, the consumer mortgage holder may:

- take no action, allowing the deficiency to exist;
- require the homeowner to repay the deficiency in at least two equal monthly payments; or
- require the homeowner to repay the deficiency within 30 days, when the deficient amount is less than one month's regular TI installment. [15]

When the consumer mortgage holder discovers a shortage in the impound account, they need to notify the homeowner at least once during the calendar year. This notice may be included with the annual impound accounting statement or it may be separate.[16]

Consumer mortgage impound accounting

A consumer mortgage holder will complete an analysis of the initial and monthly impound deposit amounts and deliver an **initial impound account statement** to the homeowner within 45 calendar days after:

- the close of the escrow; or
- the establishment of the impound account, when the account is requested by the owner either at or after origination.[17]

The initial impound account statement includes:

- the total monthly mortgage payment;
- the portion of the total monthly payment going into the impound account;

12 12 CFR §1024.17(f)(2)(ii)
13 12 CFR §1024.17(f)(3)(i)
14 12 CFR §1024.17(f)(3)(ii)
15 12 CFR §1024.17(f)(4)(i), (ii)
16 12 CFR §1024.17(f)(5)
17 12 CFR §1024.17(g)(1), (2)

- an itemization of the estimated TI obligations the mortgage holder expects it will pay from the impound account; and
- the anticipated disbursement dates of those charges.

The initial impound account statement also indicates the amount of the one-sixth reserve, accompanied by a running trial balance for the account.[18]

Consumer impound account analysis

A holder of a consumer mortgage with an impound account will conduct an annual impound account analysis. The mortgage holder uses the annual accounting to:

- determine the amount of the property owner's monthly impound account payments for the following year;
- determine whether any surplus, shortage or deficiency exists; and
- prepare and submit an annual accounting statement to the property owner.[19]

The annual accounting provides a detailed history of activity of the impound account as well as projected deposits and disbursements for the coming year. The consumer mortgage holder sends the statement to the homeowner within **30 days** after the end of the **computation year** for the account, along with a copy of the prior year's accounting statement.[20]

computation period
For impound account analysis, the 12-month period beginning on the date of the initial impound deposit during which monthly deposits, disbursements and any applicable interest occur.

The accounting statement itemizes:

- the current monthly mortgage payment amount;
- the portion of the monthly payment going into the impound account;
- the prior year's monthly mortgage payment and impound account amounts;
- the total amount paid into the impound account over the *computation year*; and
- the total amount disbursed over the computation year to pay for property taxes and insurance premiums, identified separately.[21]

The statement also shows:

- the current impound account balance;
- an explanation of how the mortgage holder is handling any surplus, shortage or deficiency and how the homeowner is to pay a shortage or deficiency; and
- if applicable, an explanation of why the estimated monthly balance given in the prior year's projection was not attained.[22]

18 12 CFR §1024.17(g)(1)(i)
19 12 CFR §1024.17(c)(3)
20 12 CFR §1024.17(i)-(1)
21 12 CFR §1024.17(i)(1)(i)-(iv)
22 12 CFR §1024.17(i)(1)(v)-(viii)

Figure 1

Impound account deposit

Largest shortfall for disbursements

	pmt	disp	bal	
May	0	0	0	Close of escrow
June	0	0	0	
July	$400	0	$400	1st installment due
August	$400	0	$800	
September	$400	0	$1,200	
October	$400	0	$1,600	
November	$400	$2,050	-$50	
December	$400	0	$350	
January	$400	0	$750	
February	$400	$2,050	-$900	
March	$400	0	-$500	
April	$400	0	-$100	
May	$400	$700	-$400	
June	$400	0	0	

However, the holder of a consumer mortgage need not provide an annual impound account statement when:

- the owner is more than 30 days delinquent;
- the mortgage holder has begun the process of foreclosure; or
- the owner is in bankruptcy proceedings.

When the owner cures the default, the mortgage holder has 90 days to provide an accounting statement covering the period from the last annual accounting to the date the mortgage is brought current.[23]

23 12 CFR §1024.17(i)(2)

	pmt	disp	bal	
May	$900	0	$900	Close of escrow
June	0	0	900	
July	$400	0	$1,300	1st installment due
August	$400	0	$1,700	
September	$400	0	$2,100	
October	$400	0	$2,500	
November	$400	$2,050	$850	
December	$400	0	$1,250	
January	$400	0	$1,650	
February	$400	$2,050	0	
March	$400	0	$400	
April	$400	0	$800	
May	$400	$700	$500	
June	$400	0	$900	

Figure 2

Adjusted balances

Lowest initial impound balance

Business mortgages secured by one-to-four unit residential property

Business mortgages are not covered by the federal rules for consumer mortgages. However, when a business mortgage (that is, any mortgage not intended to fund a personal, family or household use) is secured by a one-to-four unit residential property, California law controlling the use of impound accounts applies.

Generally, impound accounts are uncommon for business mortgages. However, the mortgage holder may elect to require one when a business mortgage has an LTV greater than 90% and is secured by an owner-occupied one-to-four unit residential property.[24]

Also, when a business mortgage is secured by a one-to-four unit residential property, the mortgage holder is required to pay at least 2% annual simple interest on funds held in an impound account.[25]

24 CC §2954(a)(1)(A)-(G)
25 CC §2954.8(b)

Figure 3

Initial deposit for impound account

Advance deposit to build reserves

	pmt	disp	bal	
May	$1,700	0	$1,700	Close of escrow
June	0	0	$1,700	
July	$400	0	$2,100	1st installment due
August	$400	0	$2,500	
September	$400	0	$2,900	
October	$400	0	$3,300	
November	$400	$2,050	$1,650	
December	$400	0	$2,050	
January	$400	0	$2,450	
February	$400	$2,050	$800	
March	$400	0	$1,200	
April	$400	0	$1,600	
May	$400	$700	$1,300	
June	$400	0	$1,700	

Excess impound funds will be:

- refunded to the property owner within 30 days after the due date of the TI payment; or
- credited toward the next year's impound payments if previously agreed to.[26]

As with all mortgages secured by one-to-four unit residential property, an annual accounting of amounts deposited into and disbursed from an impound account is provided within 60 days after the end of the calendar year when the owner makes a written request for it. Instead of an annual accounting, the mortgage holder may provide an itemized monthly statement.[27]

26 CC §2954.1(b)
27 CC §2954.2

The homeowner is also entitled to more than one annual accounting, such as a monthly accounting, with a written request to the business mortgage holder and on payment in advance of a fee of:

- $0.50 per statement when requested in advance on a monthly basis for at least one year;
- $1 per statement when requested for only one month; and
- $5 for a single cumulative statement giving all the monthly information back to the last statement given.[28]

Business mortgages

For business mortgages, including carryback business mortgages, impound accounts are optional requirements for the mortgage holder, but are neither common nor compulsory.[29] [See Chapter 42]

When a property owner agrees to an impound account provision, the impound account is only subject to the rules common to all California mortgages discussed previously.[30]

No requirement for interest on business mortgage impound deposits exist when not secured by a one-to-four unit residential property.

Impounds and trust fund accounts

A holder of a mortgage on any type of real estate may deposit impound accounts in an out-of-state depository insured by the **Federal Deposit Insurance Corporation (FDIC)** when the mortgage holder is:

- Fannie Mae, Ginnie Mae, Freddie Mac, the Federal Housing Administration (FHA) or the U.S. Departments of Veterans Affairs (VA);
- licensed and certified under federal or state law to do business related to banking;
- a pension fund or profit sharing welfare fund worth $15,000,000 or more;
- a corporation with publicly traded securities;
- the California Housing Finance Agency (CalHFA) or any local housing authority;
- a **syndication** of the above investors organized to purchase promissory notes;
- a **real estate broker** selling all or part of the note to mortgage holders; or
- a licensed residential mortgage lender acting under the authority of its license.[31]

By contrast, on carryback transactions with no present transfer of legal title — called **land sales contracts** — the seller is required to hold the impounded

28 CC §2954(b)
29 12 CFR §1024.5(b)(2)
30 CC §2954.1(b); CC §2954.1(a)
31 CC §2955(b)

funds in a **trust account**. The carryback seller may only disburse trust funds for property taxes and insurance premiums unless the buyer and all lienholders of record agree otherwise. [See Chapter 45][32]

Calculating impound amounts

One method any mortgage holder may use to calculate an impound account balance is found in Appendix E to RESPA.[33]

Consider the origination of a business mortgage secured by any type of real estate. The business mortgage lender (or carryback seller) will also maintain an impound account.

The property owner will incur annual expenses totaling $4,800, consisting of:

- annual property taxes of $4,100, with the first half due on November 1st and the second half due on February 1st; and
- an annual hazard insurance premium of $700, due on May 15th.

The loan escrow will close on May 15th and the first payment is due to the mortgage holder (carryback seller) on July 1st.

The monthly impound balances are calculated to set the **initial deposit** necessary to avoid negative impound balances during any month due to disbursements.

The initial deposit and monthly installments for the impound account are calculated based on:

- the mortgage holder making timely disbursements from the impound account; and
- the property owner making monthly installments into the impound account equal to **one-twelfth** of the total annual property taxes and insurance premiums due. [See Figure 1]

From the balances calculated monthly in the impound account in Figure 1, an amount equal to the lowest monthly balance — a deficiency — is to be **initially deposited** by the property owner to keep the impound account balance from dropping below zero during any one month. [See Figure 2]

In our example, February has the largest deficit of $900. [See Figure 1]

Also, a permissible **reserve balance** equal to one-sixth of the total annual disbursements is added to the impound account balance.

Here, the reserve is $800 — one-sixth of the $4,800 in taxes and insurance premiums. Thus, the initial deposit in the impound account is the $900 deficiency (Figure 1) and the one-sixth reserve, which equals $1,700 (Figure 3).

During the first year of mortgage payments, the property owner's monthly payment into the impound account is $400.

32 CC §2985.4

33 12 CFR §1024 Appendix E

Chapter 18 Summary

The money in the impound account consists of funds the property owner advanced to the mortgage holder as an initial deposit, followed by regularly scheduled further deposits made with monthly principal and interest payments. The impound funds belong to the owner and are disbursed by the mortgage holder for periodically recurring property expenses, such as taxes.

Mortgages that do not contain provisions for impounding obligate the owner to independently pay property taxes, insurance premiums, assessment liens and similar charges in a timely manner.

The formulas for setting initial impound deposits, monthly tax and insurance payments and limits on reserves for any mortgage, including consumer mortgages and those carried back by sellers, are set by California law. Business mortgages are not covered by the rules for consumer mortgages. However, when a business mortgage is secured by a one-to-four unit residential property, California law controlling impound accounts applies.

When a consumer mortgage holder discovers a shortage or delinquency in the impound account, they are required to notify the homeowner at least once during the calendar year.

A holder of a consumer mortgage with an impound account conducts an annual impound account analysis, which provides a detailed history of activity of the impound account as well as projected deposits and disbursements for the coming year.

Monthly impound payments vary each year based on changes in property taxes and homeowners insurance. It's good practice to review these annual impound statements for common loan servicing mistakes.

Chapter 18 Key Terms

Notes:

Chapter 19

Conventional financing

Learning Objectives

After reading this chapter, you will be able to:

- define conventional financing and differentiate it from government-related financing;
- understand the adversarial relationship between a mortgage lender and homebuyer; and
- advise homebuyers of the financial advantage gained by submitting mortgage applications to multiple lenders.

Key Terms

Closing Disclosure
conforming mortgage
conventional mortgage
government-related mortgage
institutional lender
jumbo mortgage
lender overlay
Loan Estimate
loan level price adjustment
mortgage shopping worksheet
portfolio lender
super-conforming mortgage
warehouse lender

The conventional mortgage

Consumer mortgages are either:

- **conventional mortgages**; or
- **government-related mortgages**.

A *conventional mortgage* is any mortgage that is not made, insured or guaranteed by the federal government.

conventional mortgage
A mortgage that is not made, insured or guaranteed by the federal government.

government-related mortgage
A mortgage that is made, insured or guaranteed by the federal government.

A *government-related mortgage* is a mortgage insured by the Federal Housing Administration (FHA), guaranteed by the U.S. Department of Veterans Affairs (VA) or guaranteed or funded by the U.S. Department of Agriculture (USDA).

The terms of a conventional mortgage are set by:

- the investor who purchases the mortgage;
- the private mortgage insurer, if the loan-to-value ratio (LTV) exceeds 80% [See Chapter 17]; and
- the lender originating the mortgage.

In contrast, the terms of a *government-related mortgage* are set by:

- the FHA, VA or USDA [See Chapters 21 and 23]; and
- the lender.

Investor guidelines

The majority of conventional mortgages are sold to the *Fannie Mae* or the *Freddie Mac* after origination. Collectively, these entities are known as *government-sponsored enterprises (GSEs)*.

To be eligible for sale to Fannie Mae or Freddie Mac, a mortgage needs to meet minimum mortgage standards set by Fannie Mae or Freddie Mac. As the bulk of consumer mortgages are sold after origination, Fannie Mae and Freddie Mac guidelines effectively dictate the minimum features of conventional mortgages.

Lender guidelines

lender overlay
Lender-imposed standards on consumer mortgages to be met by applicants in addition to standards set by mortgage insurers and investors.

loan level price adjustment
Adjusted interest rates or fees based on the risk of default a mortgage poses.

A lender may also impose additional minimum requirements on top of PMI or investor guidelines, based on the lender's business strategy or tolerance to risk. These guidelines are called **lender overlays.**

Lender overlays come in the form of additional minimum underwriting guidelines. They may also adjust the interest rates or fees for certain products, depending on the level of risk of default it poses, adjustments known as **loan-level price adjustments (LLPAs).** These adjustments often reflect charges imposed by the GSEs for their purchase of the mortgage. [See Chapter 9]

For instance, when a lender chooses to hold a mortgage in their portfolio, rather than sell it into the secondary market, they may set *lender overlays* which impose a very high credit score requirement for LTVs above a certain threshold.

Private mortgage insurer guidelines

Frequently, a conventional mortgage has an LTV greater than 80%. To purchase these mortgages, Fannie Mae and Freddie Mac require the risk of loss on the mortgage be offset by private mortgage insurance (PMI). [See Chapter 17]

When applying for a conventional mortgage, a homebuyer has a choice of lenders to choose from, including:

- ***portfolio lenders*** *who fund the mortgage, and hold the mortgage to collect the interest income instead of selling the mortgage to investors in the secondary mortgage market;*
- ***institutional lenders****, such as banks, credit unions, insurance companies and trade association pensions, who fund a mortgage and may either hold it in their portfolio or sell it into the secondary mortgage market; and*
- ***warehouse lenders****, such as mortgage bankers, who fund a mortgage under an agreement to immediately resell the mortgage in the secondary mortgage market.*

Lenders may fall into more than one category. For instance, a bank is an institutional lender by its nature, but may fund mortgages to hold in its portfolio.

Portfolio and institutional lenders typically service their own mortgages. However, they often originate mortgages for immediate sale to an investor such as the ***Federal National Mortgage Association (Fannie Mae)****, the* ***Federal Home Mortgage Corporation (Freddie Mac)*** *or Wall Street bankers — while retaining the servicing.*

The business of servicing mortgages is also bought and sold. This causes the mortgage to appear to be changing hands. In most cases, the originating lender continues to service the mortgage when they sell the mortgage to an investor or another entity that becomes the mortgage holder.

Sources of conventional financing

portfolio lender
A lender who both funds and holds a mortgage to collect the interest income.

institutional lender
A lender which pools deposits and invests them by making mortgages, e.g. a bank, credit union or insurance company.

warehouse lender
A lender who fund a mortgage under an agreement to immediately resell the mortgage in the secondary mortgage market.

PMI providers set minimum guidelines to be met on a mortgage before they will insure it. Thus, these guidelines also control the terms on a conventional mortgage with an LTV exceeding 80%.

Down payment and mortgage insurance

The decision about whether to choose a conventional or government-related mortgage hinges on numerous factors, but the main factors are the *down payment* and *mortgage insurance* requirements.

A conventional mortgage often offers the best terms, interest rates and mortgage costs when the homebuyer's down payment is at least 20% of the purchase price of the property. With an 80% or less LTV on a conventional mortgage, a homebuyer is able to forego the cost of mortgage insurance altogether.

For conventional mortgage applicants with less than a 20% down payment, they pay PMI monthly until the LTV reaches 78%. Additionally, PMI rates are determined based in part on the homebuyer's credit score. Premiums paid by homebuyers with high credit scores are less than those paid by homebuyers with lower credit scores.

In contrast, FHA-insured mortgages require payment of up-front and annual mortgage insurance premiums (MIPs), regardless of the LTV or the homebuyer's credit score. Further, the annual MIP lasts for at least 11 years for an LTV of 90% or less, and for the duration of the mortgage for an LTV higher than 90%.[1]

Other mortgage features also play a role in determining whether a homebuyer is best served going with a conventional or government-related mortgage.

Mortgage amount

As the bulk of conventional mortgages (and nearly all with fixed rates) are sold to Fannie Mae or Freddie Mac, conventional mortgage principal amounts generally are limited to ceilings set by Fannie Mae and Freddie Mac.

Mortgages with principal amounts at or below these ceiling amounts and which meet Fannie Mae and Freddie Mac lending guidelines, are known as **conforming mortgages.**

conforming mortgage
A conventional mortgage with terms, conditions and a maximum principal amount set by Fannie Mae and Freddie Mac.

In 2019, the *conforming mortgage* amounts are:

- $484,350 for one-unit properties;
- $620,200 for two-unit properties;
- $749,650 for three-unit properties; and
- $931,600 for four-unit properties.

In 2008, the Housing and Economic Recovery Act (HERA) set higher maximum mortgage amounts in high-cost areas, including many counties in California. Mortgages which have a principal amount greater than the conforming mortgage amount and which meet Fannie Mae and Freddie Mac lending guidelines are known as **super-conforming mortgages**.[2]

super-conforming mortgage
A conforming mortgage with a maximum principal amount adjusted for a high-cost area.

The super-conforming mortgage amounts vary by county. However, in 2019, California's maximum *super-conforming mortgage* amounts were:

- $726,525 for one-unit properties;
- $930,300 for two-unit properties;
- $1,124,475 for three-unit properties; and
- $1,397,400 for four-unit properties.

Editor's note — Even higher super-conforming limits exist for Hawaii, Alaska, Guam and the U.S. Virgin Islands.

California counties which have super-conforming mortgage amounts include Los Angeles, Orange, San Francisco, Santa Clara and San Diego.

Mortgages with principal amounts exceeding the conforming mortgage amounts (or super-conforming mortgage amounts, in affected counties) are known as **jumbo mortgages**. *Jumbo mortgages* are not eligible for sale to Fannie Mae or Freddie Mac, and are instead sold to private investors on Wall Street.

jumbo mortgage
A conventional mortgage with a principal amount exceeding the conforming or super-conforming mortgage limits set by Fannie Mae and Freddie Mac.

1 HUD Handbook 4000.1 Appendix 1.0
2 12 United States Code §1454(a)(2)

Government-related mortgage amounts are limited to Fannie Mae and Freddie Mac conforming mortgage amounts (or super-conforming mortgage amounts, in affected counties).[3]

Interest rates and other costs

Mortgage interest rates fluctuate daily. The relationship between interest rates available on conventional mortgages and government-related mortgages also changes periodically depending on:

- the lender's secondary market goals;
- mortgage investors' demand for one product over the other; and
- homebuyers' demands for one type of product over the other fueled by economic conditions or fluctuations in MIPs required by the FHA.

Typically, FHA-insured mortgages have a lower base interest rate for a mortgage than a conventional mortgage. However, FHA-insured mortgages require the payment of default insurance premiums set as a percentage of the mortgage's principal balance. This effectively adds an additional MIP payment to the homebuyer's monthly payments, and an up-front payment at the time of origination. [See Chapter 21]

Lenders also use *LLPAs* to adjust the points and fees due on FHA-insured mortgages when an applicant has lower credit scores, which increases the up-front costs at the time of origination.

Thus, while the initial interest rate on a government-related mortgage may appear lower than those of a conventional mortgage, a conventional mortgage may lower up-front and monthly costs for some homebuyers.

Credit and asset requirements

The best terms and rates available on conventional mortgages require higher credit scores. For example, a buyer looking for a conventional mortgage with an 80% LTV may be able to qualify with a 620 credit score, but they may pay up to 3% more in points up-front in LLPAs.

On the flipside, a similar buyer who has a 740 credit score may qualify for both a conventional and an FHA-insured mortgage, but find their savings by avoiding the FHA's annual MIP is worth the higher interest rate on a conventional mortgage.

Government-related mortgages have less stringent credit and asset requirements than do conventional mortgages to actively promote the government's housing policy.

Property requirements

Both conventional and government-related mortgages finance the purchase price of one-to-four unit residential properties.

Conventional financing also allows homebuyers to finance the price paid for second homes, vacation homes and investment properties.

3 HUD Handbook 4000.1(II)(A)(2)(a)

Government programs exist for buyers to finance second homes and investment properties, limited to special programs and circumstances.[4]

Adversarial lender position

Each homebuyer's unique circumstances will dictate the best type of mortgage for them, whether conventional or government-related. However, the only way for the homebuyer to determine the best mortgage product for them is to shop several different lenders and look into various types of mortgages with the assistance of a mortgage loan originator (MLO) rather than on their own.

In shopping for a mortgage, it's important to remember the lender and the lender's representative are not agents, much less partners of the homebuyer in the funding and closing of the mortgage. Rather, the lender is the homebuyer's adversary. A mortgage lender's objectives and goals are diametrically opposed to those of the homeowner applying for purchase-assist financing — a debtor versus creditor relationship.

Separate applications to multiple lenders

Multiple applications keep lenders vying for the homebuyer's business. This competition assures the homebuyer that their preferred lender (resulting from shopping) will remain competitive as promised to the last minute – the moment of funding.

Thus, a homebuyer who submits applications to two lenders has a bargaining chip against the initially preferred lender who later:

- increases the fees and charges above originally estimated amounts or otherwise available in the market at the time of funding (if the rate floats); or
- is unable or unwilling to originate the mortgage on the terms initially disclosed to the homebuyer, or at the lower prevailing par rate available in the mortgage market at the time of closing.

Submitting a mortgage application to a lender, much less multiple lenders, does not obligate the homebuyer to choose that lender. Lenders only disclose reasonable and competitive cost estimates, mortgage rates and terms when the initial mortgage application is submitted.

Within three business days after a lender's receipt of the homebuyer's mortgage application, the lender is mandated to hand the homebuyer a prepared **Loan Estimate** form. [See Chapter 27]

Loan Estimate
An estimate of a buyer's settlement charges and mortgage terms handed to the buyer on a standard form within three business days following the lender's receipt of the mortgage application.

On this form, the lender discloses all mortgage related charges to be paid by the buyer if the mortgage were originated at the time of the application, such as:

- origination fees;
- credit report fees;
- insurance costs; and

4 HUD Handbook 4000.1(II)(A)(1)(b)(iii)

- prepaid interest. [See **RPI** Form 204, 204-1 and 204-2 (DRE 882, 883 and 885) and 204-5]

Lender representatives work up estimates of fees and charges and present them to homebuyers while they are shopping for a mortgage. On submitting a mortgage application to the lender, if the previously estimated mortgage costs are widely divergent from those furnished in *Loan Estimate*, the lender's true colors are instantly exposed. Little variation exists within the very few days involved between shopping for a mortgage and submitting a mortgage application, unless the lender's initial representations were deceitful. [See Chapter 27; see **RPI** Form 204, 204-1 and 204-2 (DRE 882, 883 and 885), 204-5 and 221]

The critical reason for submitting applications to two or more lenders is that, prior to closing, the lenders will hand the homebuyer a **Closing Disclosure**. The homeowner then compares the initial Loan Estimate against the last-minute *Closing Disclosure*, side-by-side and item by item. If the homebuyer discovers they are being overcharged, the homebuyer using an MLO is encouraged to have the lender adjust their fees to bring them in line. If the lender does not, then the homebuyer turns to the alternative application for funding their home purchase. [See **RPI** Form 204, 204-1 and 204-2 (DRE 882, 883 and 885) 204-5 and 221]

Closing Disclosure
A disclosure of the buyer's final settlement charges and mortgage terms handed to the buyer on a standard form within three business days before mortgage closing.

Governments support multiple applications

Multiple state and federal government agencies promote the practice of submitting multiple mortgage applications to multiple lenders. To assist the homebuyer with the task of comparing the products of two or more lenders, agencies such as the California Department of Financial Protection and Innovation, Freddie Mac, the Federal Reserve and the Federal Trade Commission publish **mortgage shopping worksheets**. Further, the Consumer Financial Protection Bureau (CFPB) offers guidance on what to expect when shopping for a mortgage.

These *mortgage shopping worksheets*, designed to be completed by the buyer with the assistance of an MLO or transaction agent (TA), contain a list of all the mortgage variables commonly occurring on origination and during the life of the mortgage.

mortgage shopping worksheet
A worksheet designed for use by buyers when submitting applications for a consumer mortgage to compare mortgages offered by different lenders based on a list of all the variables commonly occurring as costs at the time of origination and over the life of the mortgage.

After submitting mortgage applications to two lenders and receiving the corresponding Loan Estimates, the homebuyer will possess all the information needed to fill out a mortgage shopping worksheet for each lender. Once complete, the homebuyer and their representative can clearly compare the terms offered by the competing lenders. When, at the time of funding, the lender selected as the preferred lender remains competitive, the homebuyer can simply close with that lender.

The California Department of Financial Protection and Innovation mortgage shopping worksheet can be obtained through their website at *http://www.dfpi.ca.gov*.

Chapter 19 Summary

A conventional mortgage is any mortgage that is not made, insured or guaranteed by the federal government.

The majority of conventional mortgages are sold to the Fannie Mae or the Freddie Mac after origination.

Accordingly, the terms of a conventional mortgage are set by the investor who purchases the mortgage, the private mortgage insurer if the loan-to-value ratio (LTV) exceeds 80% and the lender.

The decision about whether to choose a conventional or government-related mortgage hinges on numerous factors, but the main factors are the down payment and mortgage insurance requirements. Other factors considered include the mortgage amount, the homebuyer's credit and assets, interest rates and mortgage costs and the property securing the mortgage.

To best protect the buyer, applications are to be submitted to at least two lenders. Shopping for a mortgage yields the best terms available in the market. Without a backup application concurrently processed by another lender, the homebuyer is left with no opportunity to reject the lender's changes.

Chapter 19 Key Terms

Chapter 20

Adjustable rate mortgages

Learning Objectives

After reading this chapter, you will be able to:

- review the history of the adjustable rate mortgage (ARM) in the United States;
- understand how ARMs work;
- know the different ARM products that influenced the real estate and financial markets in the last decade;
- recognize recent ARM developments in the consumer mortgage market; and
- identify disclosure requirements for mortgage loan originators (MLOs) and lenders originating an ARM.

Key Terms

adjustable rate mortgage (ARM)
conversion adjustable rate mortgage (ARM)
fully indexed rate
hybrid adjustable rate mortgage (ARM)
index
initial interest rate cap
interest-only adjustable rate mortgage (ARM)
introductory interest rate
lifetime interest rate cap
margin
negative amortization
option adjustable rate mortgage (ARM)
payment cap
periodic interest rate cap
prepayment penalty

The birth of the ARM

The most common type of home financing in the United States is the 30-year fixed rate mortgage (FRM) initiated in the 1930s to provide home sellers a method for cashing out of their current home to buy another home. Up until the early 1980s, the fixed rate mortgage was just about the only type of mortgage available to finance home sales.

After the 1974 recession, California authorized and some mortgage lenders adopted inflation-proof variable interest rate provisions, their interest rate range limited by statute. Federal de-regulation did not authorize **adjustable rate mortgages (ARMs)** until early 1982.

adjustable rate mortgage (ARM)
A variable interest rate note, often starting out with an introductory teaser rate which resets in a few months or years based on a particular index.

At the time, the main sources of mortgage funds were numerous financial entities known as **savings-and-loans (S&Ls)**. *S&Ls* operated by offering depositors interest on their deposits (that's the "savings" part), and in turn using the deposits to lend mortgage money at slightly higher interest rates (the "loans" part) than those paid to the depositors.

For instance, the S&Ls would pay a 5.5% interest rate to depositors, then turn around and charge 8.0% to a mortgaged homebuyer for a 30-year fixed rate mortgage, a 2.5% operating margin over their cost of funds. The S&Ls kept the **spread** between the two interest rates to cover expenses and provide a profit.

The arrangement was a simply business model, one that was perhaps too boring. And so the S&L cycle continued until it collapsed and disappeared in the late 1980s, consumed by a poisonous cocktail deregulation by Congress in late 1982.

Prior to the 1980s, federal housing policy prohibited S&Ls from dabbling in other types of consumer finance, so their sole source of income was mortgage lending. (The one-stop-shop mega-banks we are so familiar with today were unlawful then, too.) Thus, by their very structures, S&Ls were highly dependent on depositors as a source of funds to make mortgages and stay in business.

However, again, the mortgages made were 30-year FRMs. A lender making a 30-year FRM is making a commitment to lend money at a fixed interest rate over a long period of time. Depositors, on the other hand, were being paid interest rates at current market rates during the life of the S&Ls mortgages. Further, depositors had the right to withdraw their money at any time, except for those in certificates that paid higher rates where withdrawal without penalty required a one- to three-year holding period.

Everything worked fine for the S&Ls while their expenses (the interest paid on deposits) were less than their income (interest rate charged on mortgage mortgages). This business model left S&Ls highly vulnerable to interest rate fluctuations — mortgages at fixed rates for 30 years and rates on savings changing from day to day, and trended upward during the 30-year period prior to 1980.

Congress mitigated this vulnerability in 1966 by placing caps on the amount of interest an S&L was able to pay to depositors in exchange for guaranteed savings for depositors up to $10,000. By 1982, the average deposit account in an S&L was $8,300.

The interest rate cap on S&L savings accounts was set higher than the cap placed on commercial banks. Thus, depositors were encouraged to place their money with S&Ls, to ensure the mortgage money continued to flow. With excess funds, construction financing became a lucrative but riskier part of S&L portfolios. Each recessionary period over the past 70 years has brought on massive losses for these lenders for reason of *over-lending*, producing an excess supply of housing for the moment.

Then, economic conditions and monetary policies in the '70s allowed **inflation** to run sky-high. S&Ls remained restricted in their competition for deposits by the interest rate cap (until 1978 when money market rates were introduced). Other financial companies not subject to interest rate caps set by the federal government paid true market level interest. S&L depositors began pulling funds from the S&Ls in droves, to place their funds in higher-yield investments as protection against the Federal Reserve's failure to control inflation.

A Hail Mary attempt

In an attempt to save the moribund S&Ls, Congress and regulatory agencies did several things in the late 1970s and early 1980s:

- allowed S&LS to diversify by making other than 30-year FRMs;
- removed interest rate caps on depositor funds; and
- adopted regulations allowing S&Ls and banks to offer ARMs.

In contrast to FRMs, ARMs allow lenders to float interest rates they charge to match market rates they paid to obtain funds. By allowing mortgage rates to fluctuate with market rates, ARMs shifted inflationary and economic risk from the S&Ls to the *homebuyer*. Thus, a risk the S&Ls were unable to manage was now to be managed by far less informed homeowners. Regulators hoped this would equalize the expenses and incomes of S&Ls, and pull them out of the insolvency they faced.

It didn't. Ultimately, S&Ls went the way of the dodo, but the risky ARMs remained on the books. From the early 1980s onwards, the ARM has remained available to homebuyers. It has largely been as damaging to low- and mid-income homebuyers as it was ineffective in rescuing the S&Ls. The Millennium Boom is a pertinent example of the local and global destruction ARMs can wreak.

Editor's note — The impact of ARMs on homebuyers has been memorialized in some colorful language over the years. Veteran mortgage loan brokers from the 1980s remember when ARMs were called "topless mortgages" as it seemed their ceiling rates were set so high as to be meaningless. Other equally colorful names included the "Reverse Interest and Principal for

Optimum Fast Foreclosure (RIPOFF) mortgage" and the "Zero Ability to Pay (ZAP) mortgage." All titles were instructive, but none were heeded until 2010, too late to avoid the financial crisis of 2007.

ARMs in the Millennium Boom

The face of the ARM has changed over the years, most dramatically during the Millennium Boom.

20 years after ARMs became part of the American mortgage landscape of constantly declining interest rates, the housing market was experiencing an unprecedented pricing boom, which became known as the *Millennium Boom*. Fueled by ever lower interest rates, no down payment ownership, the financial accelerator effect from Wall Street funds and speculative momentum fever, housing prices skyrocketed.

Further, mortgage lending standards were fully relaxed. Part of the blame for this lax attitude was due to demand from bond market investors for ever more securitized mortgages (based in large part on the rating agency's conflicted miscalculation of risks). But also largely to blame was the widespread belief that home prices always rise, and therefore the collateral (the property), rather than the homebuyer, would carry the mortgage on a default.

When demand for mortgages peaked in mid-2005, Wall Street had perfected its vertically expanded business model for originating, gathering, bundling and reselling mortgages from loan application through to the **mortgage-backed bond (MBB)** market bought up by millions of investors worldwide, who kept none themselves while betting on a crash. Of course, meeting all this investor demand for MBBs was dependent on ever more new mortgages.

The most infamous of these new mortgage products were "subprime mortgages" and "no-doc mortgages." When the homebuyer could not afford a mortgage, it was the fault of the lender's underwriters, not the homebuyer's.

In the history of ARMs, we discussed that FRMs guarantee a rate over a long period of time. Lenders necessarily build into the FRM interest rate the cost of keeping an interest rate "locked-in" at that interest rate for 30 years. ARMs tended to have a lower initial "fixed rate" (if any) because the lender's cost of short-term funds was lower — a matter of a few months to one or two years, rather than 30 years. Thus, otherwise unqualified homebuyers were able to make monthly payments — but only at the time of origination. ARMs offered low initial interest rates to qualify and very low payment schedule options for up to ten years. Declining interest rates from their peak in 1980 to the zero-lower-bound range by 2010 made the rate and payment adjustments calculus look benign.

Since the Great Recession of 2008, ARM use for funding home purchases has remained relatively low. However, by 2014 their use was rising as home prices increased far faster than supporting wages and inflation. While interest rates lingered near historic lows in 2015 and into 2016, home prices again became significantly higher than the **mean price trendline** (a range to which home prices eventually return).

Unlike the 30 years preceding 2010, homebuyers who later take out ARMs will be at the mercy of inevitably rising interest rates over the next few decades. Their ARM payments will increase with rising interest rates, cutting into disposable income and standards of living for the massive *debtor class* of job-holding homeowners, as distinguished from the *rentier class* who have no debt and hold income producing assets.

In order to adequately inform homebuyers of the consequences ARMS will have on their payments going forward, mortgage loan originators (MLOs) need to be aware of the not-so-benign workings of these ARM products.

The purpose and popularity of ARMs

An ARM calls for periodic adjustments to both the interest rate charged and the dollar amount of scheduled payments. ARMs allow homebuyers to leverage the lower initial interest rate into a higher purchasing price through greater mortgage amounts when FRM rates rise before the Federal Reserve (the Fed) raises short-term rates.

In addition to the greater purchasing power an ARM initially provides a homebuyer, ARMs may attract homebuyers who plan to:

- sell the mortgaged home prior to the first adjustment on the ARM;
- refinance the ARM into a lower FRM and keep the home after they improve their credit; and/or
- use the money saved by the lower ARM interest rates to speculate in higher-yield investments.

Unfortunately, these plans didn't always bear out. During the Millennium Boom, many MLO brokers fell into the trap (more fees coming) of advising their homebuyers to obtain a short-term ARM with the expectation FRM refinancing would be available when the fixed rate period ended.

But when it came time to refinance, the house securing the property had lost value, or the homeowner had lost their job. Additionally, the terms on some of the more "creative" ARMs also contained financial time bombs built of interest-only payments, or less. When a refinance was not available, the resulting **re-amortization** often doubled monthly payments.

Basic ARM elements

All ARMs contain five components:

- an introductory interest rate;
- a ceiling and a floor rate;
- an index figure;
- an operating margin; and
- adjustment intervals for rates and payments.

Introductory interest rates

introductory interest rate
The initial rate of interest on an adjustable rate mortgage (ARM), typically lower than the fully-indexed note rate and lasting for a set introductory period. Also known as a teaser rate.

fully indexed rate
The highest rate possible on the adjustable rate mortgage (ARM) during the first five years of its term.

The **introductory interest rate** is the initial rate on the ARM. The introductory interest rate is sometimes called a *teaser rate*. The introductory interest rate stays fixed for a set amount of time, called the **introductory period.** The introductory period can be anywhere from a month to ten years, depending on the terms of the ARM.

The lender may set the introductory interest rate however it chooses, depending on whether it wants to attract homebuyers into ARMs.

In the past (and certainly during the Millennium Boom), most lenders qualified homebuyers' mortgage applications based on the low introductory interest rate payment. When the introductory interest rate adjusted, homebuyers were too often unprepared with sufficient income increases to cover the increase in payments, a phenomenon known as *payment shock.*

However, post-2010 ability-to-repay (ATR) rules require lenders to underwrite homebuyers based on a **fully indexed rate** (discussed shortly), or the highest rate possible on the ARM during the first five years of its term.[1]

The index

index
A regularly issued composite market interest rate for an investment such as Treasury Securities or inter-bank loans used to set the basis for periodic interest rate adjustments.

The **index** is the primary of two components which determine the adjusted interest rate after the introductory period. An ARM is said to be "tied" to an index. The index is basically a moving rate, called the *index figure*, which sets the periodic adjustment in the mortgage rate charged. As the index figure rises and falls, so does the ARM's interest rate in an equal degree.

ARM interest rate adjustments may be tied to any one of a variety of indexes. Each index adjusts based on different criteria, set by the "owner" of the index. Common indexes for ARMs are the:

- 11th District Cost-of-Funds Index (COFI);
- 12-month Treasury Average; and
- London Interbank Offered Rate (LIBOR).

The COFI is compiled monthly based on the previous month's cost of funds actually incurred by lenders. Since the COFI is set monthly, it is appropriate for ARMs. The COFI is a short-term benchmark and tracks the lender's costs to be passed on to the homebuyer.

The **12-month Treasury Average** is released as a weekly average by the Federal Reserve Board. It is based on the average yield on Treasury securities with 12 months of their maturity remaining. This yield is based on the amount paid by winning bidders on Treasury Securities in the over-the-counter stock market.

The **LIBOR** is set and released daily. Every day, 11-18 banks give an estimate for their cost of funds, or how much they are willing to pay to borrow funds. The data used is only three months forward to avoid abuse in the current market. Once the top and bottom 25% values are removed, the average of these estimates is rounded to the nearest 1/16 and used as the LIBOR index

1 12 Code of Federal Regulations §1026.43(c)(5)(A)

rate. The LIBOR is set for seven different maturities, from an overnight maturity to up to 12 months, produced in five different currencies, including the U.S. dollar, for a total of 35 rates published daily.

Editor's note — The LIBOR will fully phase out by 2021. Its replacement is the Secured Overnight Financing Rate (SOFR). Unlike LIBOR, SOFR relies on actual transactions. The SOFR debuted in April 2018, but has had a slow start due to initial errors in its calculation.

The more frequently an ARM's affiliated index figure changes, the more erratic its interest rate and thus monthly payments. Interest rates tied to the **11th District Cost of Funds Index** or the 12-month Treasury Average are more stable than those tied to the LIBOR. Their stability is better for consumers, but very boring for lenders.

Regardless of which index is used, the purpose of the index is the same: it is meant to be a proxy of the change in the cost of lending that is passed on to those homebuyers who insist on an ARM.

Regulation D requires the index used to be:

- readily available and verifiable by the homebuyer, and beyond the control of the creditor;[2] or
- based on a formula or schedule for the amount the interest rate may increase, and when a change in the rate may be made.[3]

Basically, the lender may not arbitrarily and opaquely make changes to a consumer's interest rate on an ARM. Changes are made in a transparent, agreed-to fashion set forth in the mortgage note.

The margin

The **margin** is the second component of the mortgage rate. When added to the index figure, it determines the interest rate charged after the introductory period, called the *note rate*. The margin consists of the interest points the lender adds to the index to cover its operating expenses and provide a profit. The margin varies with each lender, but unlike the index figure, it stays fixed for the life of the mortgage.

margin
The interest points added to an index by a lender as profit on the adjustment of an adjustable rate mortgage (ARM).

The ARM's interest rate, after the introductory period, is determined by adding the margin to the index figure (at set intervals, and subject to any caps), called a **fully indexed rate**.

For instance, an ARM with an index figure of 4%, and a margin of 2% has a fully indexed rate of 6% (the *note rate*). If the index figure later fell to 2%, the fully indexed rate would be 4%.

2 12 CFR §1004.4(a)(2)(i)

3 12 CFR §1004.4(a)(2)(ii)

The adjustment interval

The adjustment interval is the time period between changes in the ARM's interest rate and the monthly payments. ARMs may be scheduled to adjust every month, every year, every three years, etc. At the end of each adjustment interval, the interest rate on the mortgage will adjust to the current index figure plus the margin. For continued amortization of principal over the remaining term of the mortgage, monthly payment changes each time the ARM rate adjusts.

An ARM with payments scheduled to adjust every year is a 1-year ARM. An ARM with payments scheduled to adjust every three years is a 3-year ARM.

Rate caps and other ARM features

Some ARMs have other features which will impact how the interest rate or payments adjust. These features include:

- an initial interest rate cap;
- periodic interest rate caps;
- a lifetime interest rate cap and floor;
- periodic payment caps;
- conversion features; and
- prepayment penalties.

A "cap" is a ceiling on the amount of the interest rate, or payment adjustment. The "floor" is the rate below which the mortgage rate will not drop.

Interest rate caps

initial interest rate cap
A limit on the amount the interest rate may change on the first adjustment of an adjustable rate mortgage (ARM).

periodic interest rate cap
A limit on the amount the interest rate can increase with each future adjustment of an adjustable rate mortgage (ARM).

lifetime interest rate cap
A limit on the amount the interest rate can increase over the life of an adjustable rate mortgage (ARM).

The **initial interest rate cap** sets a limit on the amount the interest rate may change on the first adjustment. A **periodic interest rate cap** places a ceiling on the amount the interest rate can increase with each future adjustment. A **lifetime interest rate cap** is the maximum amount the lender can increase the interest rate throughout the life of the mortgage.

The **base rate** is the rate used to determine interest rate caps. For both the initial interest rate cap and the lifetime interest rate cap, the base rate is set at the *introductory interest rate*. For the periodic interest rate cap, the base rate is the interest rate from the prior interest rate charged, as it changes from period to period.

In response to the potential for never-ending future interest rate increases during the life of an ARM, all consumer-purpose ARMs now have lifetime interest rate caps (thus, regulations now defy the derogatory "topless mortgage" term predictive from the '80s). It is the lender who actually sets the caps. No regulations or guidelines set minimum or maximum allowable caps as was the case with the California 1970's variable rate mortgages (VRMs).[4]

The most common rate cap arrangements are 5/2/5 or 2/2/6. The first number refers to the initial rate increase cap over the base rate, the second number is the future periodic rate increase cap over the prior rate charged, and the third number is the lifetime rate increase cap over the base rate.

4 12 United States Code §3806(a)

For instance, for the 5/2/5 rate cap arrangement:

- the initial rate increase cannot exceed 5% over the introductory interest rate;
- future periodic rate increases cannot exceed 2% from one adjustment period to another; and
- the lifetime rate increase cannot exceed 5% over the introductory interest rate.

Payment caps

Another type of cap for an ARM is known as a **payment cap**. As the name suggests, this caps the total payments due on the mortgage at each adjustment. So, if your homebuyer had a mortgage payment of $1,000, and the mortgage has a payment cap of 10%, the maximum the payment can increase with the adjustment is $100, for a total payment of $1,100 — regardless of interest rate changes.

payment cap
A limit on the amount of increase in the borrower's monthly principal and interest at the payment adjustment date on an adjustable rate mortgage (ARM).

However — and here is the rub — with payment caps the additional interest due above the 10% payment cap is not simply forgiven. It is actually added to the mortgage balance and becomes part of the principal which bears interest. Thus, payment caps can cause **negative amortization** as unpaid interest is added to principal and thereafter bears interest — a deleterious compounding. Some ARMs have both interest rate caps, and payment caps.

Editor's note — Mortgages with the potential for negative amortization are only allowed under general ATR requirements. They are not permissible for any type of qualified mortgage.[5]

Conversion ARMs

Some ARMs allow them to be converted to an FRM during the mortgage term. The rules for exercising a conversion are set out in the mortgage documents. However, **conversion ARMs** have some drawbacks:

conversion adjustable rate mortgage (ARM)
An adjustable rate mortgage (ARM) which may be converted to a fixed rate mortgage (FRM) during the mortgage term.

- the interest rate when converted may be higher than the average FRM rate offered by other lenders;
- the lender may charge a higher interest rate during the ARM portion of the mortgage than for other mortgages without conversion features; and/or
- the lender might charge a fee for the conversion.

Conversion is not mandatory for the homebuyer. For example, a homebuyer who takes out a conversion ARM may either adopt a fixed interest rate five years into the mortgage term, or may choose to adhere to the traditional ARM terms, including periodic adjustments to the interest rate and monthly payment. The bet depends on whether interest rates are expected to move up or down.

However, lenders might charge a higher interest rate on a conversion mortgage. Thus, a homebuyer should be aware before they take on an ARM

5 12 CFR §1026.43(c)

whether or not a conversion option affects the ARM interest rate. As always, when opting to exercise the conversion, the homebuyer is best served by inquiring into refinancing with another lender, which likely will be cheaper.

Prepayment penalties

prepayment penalty
A levy charged by a mortgage holder to a borrower who pays off the outstanding principal balance on a mortgage prior to its maturity.

Prepayment penalties are fees charged by a mortgage holder when a homeowner pays off a mortgage early.

For business mortgages, prepayment penalties are usually limited to prepayments during the first three to seven years of the mortgage. When analyzing whether an investor may want to refinance, the prepayment penalty is taken into consideration by the investor and their agent.

Consider an investor who takes out a 3/1 business ARM in the amount of $200,000 with an initial rate of 6%. The mortgage has a prepayment penalty of six months' interest on the remaining principal balance.

Two years later, the investor decides to refinance and pay off the 3/1 ARM. The principal balance is $194,936. Under the prepayment penalty provision, the investor owes a penalty of $5,850, more than the principal reduction in two years of payments.

Not all ARMs have a prepayment penalty. When an ARM is secured by one-to-four residential units, the mortgage holder may not bar the owner's voluntary prepayment within 90 days of notification of a change in the rate.[6]

Additionally, under Regulation Z (Reg Z), consumer ARMs may not contain a prepayment penalty provision.[7]

Editor's note — State laws may restrict the charging of prepayment penalties. For example, in California a prepayment penalty may not be charged on a mortgage secured by an owner-occupied single family residence unless the homebuyer pays more than 20% of the unpaid balance in any 12-month period.[8]

Prepayment penalties on consumer mortgages secured by one-to-four unit residential properties are only allowed on qualified mortgages.[9]

Different types of ARMs

A plethora of ARMs, each with different terms, existed for 30 years before 2010. Reg Z now sets parameters for future consumer ARM originations. Common types of ARMs popular during the Millennium Boom included:

- hybrid ARMs;
- option ARMs;
- conversion ARMs; and
- interest-only ARMs.

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6 Calif. Civil Code §1916.5(a)(5)
7 12 CFR 1026.43(g)
8 CC §2954.9
9 12 CFR §1026.43(g)

ARM adjustment examples

Let's say your homebuyer started with a 3.25% fully-indexed interest rate on an adjustable rate mortgage (ARM) for $200,000. The ARM adjusts annually, and has a 5/2/5 cap structure. At the first adjustment, the index figure rises 3%. At the second year, the index figure rises another 3%. (NOTE: No impounds are included in this example.)

What is the interest rate on the mortgage after the second adjustment?

The interest rate after the second adjustment is 8.25%. The breakdown goes like this:

ARM Interest Rate	***Monthly Payment (Rounded to nearest dollar)***
1st year @ 3.25%	*$ 870*
2nd year @ 6.25%	*$ 1221*
3rd year @ 8.25%	*$ 1478*
3rd year @ 9.25% (without lifetime cap)	*$ 1614*

The first adjustment (the 2nd year rate) is within the 5% initial interest rate cap. With a 3% rise in the index figure, the interest rate increases to 6.25%. The second adjustment, also with a 3% rise in the index figure, is limited by the lifetime interest rate cap.

Here, the lifetime cap avoids the homebuyer paying an additional $136 monthly after the third year.

Additionally, some ARMs with interest rate caps have a ***carryover*** *feature. The carryover feature is contained in the mortgage note, and allows lenders to "carryover" interest rate increases which exceed the periodic interest rate increases to the next adjustment.*

Now consider a homebuyer with a 3.25% fully-indexed interest rate on an ARM for a $200,000 mortgage. The ARM adjusts annually, and has a carryover provision in the mortgage documents. There is no initial year interest rate cap, but the ARM has a 2% periodic interest rate cap and a 5% lifetime interest rate cap. At the first adjustment, the index figure goes up 3%. At the second year, the index figure goes down 1%. (NOTE: no impounds are included in this example.)

What is the interest rate on the mortgage after the second adjustment?

The interest rate after the second adjustment is 5.25%. The breakdown goes like this:

ARM Interest Rate	***Monthly Payment (Rounded to nearest dollar)***
1st year @ 3.25%	*$ 870*
2nd year @ 5.25%	*$ 1098*
3rd year @ 5.25%	*$ 1098*

The index figure goes up by 3%, but it is capped by the 2% periodic interest rate cap. The remaining 1% increase is carried over to the next adjustment period. At the second adjustment, the 1% carryover increase cancels out the 1% drop in the index figure. Thus, the interest rate remains 5.25%.

These examples are based on a fully-indexed initial interest rate, not the teaser rate. Most ARMs will start with discounted interest rates (ones which are not fully-indexed). If an ARM has a very low teaser rate – below the fully-indexed rate – and a 5/2/5 ceiling structure, the interest rate can increase by up to 5% over the introductory rate on the first adjustment — a payment shock for most homebuyers. Here, mortgage loan originators (MLOs) with homebuyers set on an ARM may search for other ARM products with a lower initial interest rate cap – say a 2/2/6, structure, which allows for more gradual interest rate increases.

Hybrid ARMs

hybrid adjustable rate mortgage (ARM) A type of adjustable rate mortgage (ARM) which features a fixed rate for an introductory period and thereafter a periodically adjusted interest rate based on a predetermined formula.

The **hybrid ARM**, also known as a "Canadian rollover," is a fusion of an FRM and an ARM. It's the "traditional" type of ARM in which the interest rate is fixed during an initial time period, then adjusts periodically afterward. Some hybrid ARMs are named after the initial fixed period and following adjustment periods.

For example, one of the most common types of hybrid ARMs is the **5/1 ARM**. With this type of mortgage, the interest rate is fixed for the first five years of the mortgage, typically at a low teaser rate. Then, the mortgage adjusts once a year after that initial period expires.

Other common hybrid ARMs using this naming convention include:

- 3/1 (fixed for three years, then adjusts annually);
- 7/1 (fixed for seven years, then adjusts annually); and
- 10/1 (fixed for ten years, then adjusts annually).

Similar hybrid arms are intended for those with less-than-perfect credit. The initial rate is lower than market. This allows the homebuyer to qualify for a mortgage. The homebuyer's intention is to improve their credit and refinance out of the hybrid ARM before the initial fixed rate period expires. Common hybrid ARMs named under this convention included:

- 2/28 (fixed for two years, adjustable for 28 years); and
- 3/27 (fixed for three years, adjustable for 27 years).

2/28 and 3/27 ARMs adjust every six or twelve months.

Hybrid ARMs can be qualified mortgages if they otherwise meet qualified mortgage requirements. Thus, this is one of the only types of consumer ARMs which survived introduction of the Reg Z ATR requirements.

The remaining ARM mortgages discussed below have been relegated back to their rightful place as niche products for extremely well-qualified homebuyers under ability to pay rules.

Interest-only ARMs

With an **interest-only ARM**, the homebuyer's monthly payments are only for the amount of interest due, there being no payment towards the reduction of principal. The interest-only payment schedule typically lasts for three to ten years.

interest-only adjustable rate mortgage (ARM) A type of adjustable rate mortgage (ARM) which features an initial period of interest-only payments.

After the interest-only period expires, the homebuyer's monthly payments are adjusted to include both interest and principal. However, because the homebuyer did not make any principal payments during the first years of the mortgage term, the principal payments are amortized over a shorter period of time.

For example: a homebuyer enters into a 30-year ARM, payable interest-only for the first three years. After three years, the interest rate is adjusted to the new index figure and the margin agreed to in the mortgage. On the **recast,** the principal is re-amortized to set the monthly payments for the ARM's remaining 27-year term. (Note: some interest-only mortgages also have periodic adjustments to the interest rate during the interest-only period.)

The longer the interest-only period, the greater the payments will be when the mortgage recasts.

Consider a homebuyer taking out a 30-year ARM with a five-year interest-only feature. The homebuyer's monthly payment during the first five years of the mortgage is $625. However, after the initial period runs, the mortgage is recast. The interest rate is reset at 5% and monthly payments increased to amortize the principal over the remaining 25 years of the mortgage. The homebuyer's monthly mortgage payment jumps to $1,461 in the sixth year of the mortgage, more than double the amount of the homebuyer's initial payments.

Option ARMs

Option ARMs were among the most insidious type of mortgage offered during the Millennium Boom. Option ARMs are so named because the homebuyer may choose any one of several different payment options each month. Also called *pick-a-pay ARMs*, option ARMs typically begin with a very low teaser rate. However, this rate only holds for a month or so before increasing with the index figure from month to month.

option adjustable rate mortgage (ARM)
An adjustable rate mortgage (ARM) giving the borrower the choice of a full monthly payment, an interest-only payment, and a minimum payment typically less than the interest due.

Each month, the homebuyer may choose to pay:

- principal and interest under a traditional amortization schedule for the full term of the mortgage (some option ARMs allowed the homebuyer to choose the amortization schedule for the payment — 15, 30 or even 40 years);
- interest-only; or
- a minimum payment, amounting to less than the interest due.

If the homebuyer chooses to pay the minimum amount, the unpaid interest due is added onto the total principal amount. This process in which accrued unpaid interest tacks on to the principal balance is called **negative amortization**.

negative amortization
The addition of unpaid interest to the principal balance of a mortgage due to insufficient monthly interest payments.

When the homebuyer chooses this payment option, their mortgage is recast after an agreed number of years (typically every five years) according to the new principal balance due — an amount now greater than the original mortgage. Payments caps do not restrict a recast needed to fully amortize the principal.

Some lenders placed **negative amortization caps** on mortgages which had the potential for negative amortization. The negative amortization cap places a ceiling on how high the principal balance was able to grow before a recast. A recast of payments occurred at this principal ceiling regardless of any pre-set recast time period. The typical negative amortization cap was set at 110% or 125% of the original mortgage amount. And, as with other recasts, the payment caps did not apply.

Option ARMs were often a lure for under-qualified homebuyers during the years leading up to the 2007 financial crisis. Low-income homeowners consistently paid the minimum amount due each month. As a result, their debt quickly snowballed. When their mortgages were recast, owners became overwhelmed with their adjusted payments and defaulted.

Recent ARMs history

In 1996-2002 the ARM-to-loan ratio moved parallel with FRM rates. This displayed ideal conditions for financing a stable housing market. Real estate prices rose at a sustainable rate for the duration of this period.

However, beginning in 2002, FRM rates dropped continuously for two years. In the meantime, the ARM-to-loan ratio began to rise. This inverse movement was brought on by **deregulation** of mortgage lenders. The unanchored rise in the ARM-to-loan ratio and the financial accelerator conditions that followed led directly to hugely excessive home price increases, which continued for nearly three years.

The ARM-to-loan ratio peaked in early 2005, and sales volume turned down in mid-2005. Home pricing reached its apex one year later in early 2006; sales volume tanked in 2007. No surprise for anyone aware of the triggering effect of periods with greater than inflation price rises, sales volume peaks and price peaks to bring prices crashing down.

Between 2005 and 2009, FRM rates remained flat while the ARM-to-loan ratio reversed course and dropped significantly. The declining ratio in ARMs to all loans alongside a flat FRM rate, an abnormal sequence, presaged a further decline in home prices.

In 2014, ARMs made up roughly 11% of mortgage originations in California. This is extremely low compared to the 77% peak ARM-to-total-loan ratio experienced at the height of the Millennium Boom. For comparison, the national peak ARM-to-loan ratio was only 36% during the Boom.

The disparity between the 2004 and 2014 ARM-to-loan ratios is due to the type of homebuyer demand unique in 2004. During that time, many under-qualified homebuyers were anxious to purchase property in the frenzied real estate market. However, these homebuyers lacked sufficient income to make monthly payments on a 30-year FRM.

Because they did not qualify for FRMs, many homebuyers opted for high-risk ARMs. They expected — based on what they had experienced at the time — the value of their collateral to only increase over the next few years, allowing them to either refinance or resell the property before their ARMs reset based on projections, not forecasts.

However, the value of a California homebuyer's collateral did not increase over the next five years. Instead it dropped drastically beginning in 2006 when pricing had reduced sales volume for over 12 months, decelerated in 2007 being about a price bottom in early 2009. This prevented homebuyers from escaping the obligations of their ARMs by refinancing after the initial period of the ARM.

The 50% implosion of real estate pricing was not just a shock to the real estate market, but to homebuyers as well. (Wall Street had already sold the mortgages and lost nothing, until they settled mortgage fraud cases with the government.) Homebuyers in turn reacted with greatly reduced favor toward ARMs in the years following the Millennium Boom and bust.

Hybrid ARMs remained the most popular type of ARM in 2014, with the 5/1 ARM leading the market, followed by the 7/1, 3/1 and 10/1 ARMs.

However, the vast majority of homebuyers still prefer FRMs to ARMs.

Under Reg Z guidelines, lenders must disclose that homebuyers are not guaranteed the ability to refinance to a lower rate after their mortgage adjusts. Additionally, lenders are required to plainly state the maximum interest rate possible on the mortgage — a kind of "worst case" rate previously buried deep in the rarely read mortgage jargon and formulas of prior ARM documents.

Disclosures required and other regulations

Disclosures lenders are now required to provide to ARM homebuyers include:

- the Consumer Handbook on Adjustable Rate Mortgages;
- notice that the mortgage terms are subject to change, including:
  - the interest rate; and
  - the mortgage payments;
- information regarding the index to which the mortgage is tied;
- an explanation of how the interest rate and payments are calculated;
- an explanation of how the ARM index is adjusted;
- a recommendation to the homebuyer to request additional information about the current margin value and current interest rate;
- notice that the current interest rate is discounted;
- a recommendation to the homebuyer to ask the amount of the rate discount;
- the frequency of interest rate and payment adjustments;
- any payment caps provided by the mortgage terms;
- the possibility of negative amortization;
- the possibility of interest rate carryover;
- either:
  - a historical example of an ARM, which illustrates the effect of interest rate changes on the homebuyer's payments and mortgage balance. This example must be based on a $10,000 mortgage amount and the past 15 years' index values. A description of negative amortization, interest rate carryover, interest rate discounts and payment caps must be integrated into this example; or
  - the maximum interest rate and payment for a $10,000 ARM under the current mortgage terms. This must also disclose the fact that the homebuyer's payments may increase or decrease significantly;

- instructions for calculating mortgage payments;
- notice of the mortgage's demand provision;
- a description of notices of adjustments, and the schedule for these notices; and
- a notice that the homebuyer may access disclosure forms for the lender's other ARM programs.[10]

These avuncular-styled regulations are among the most user-friendly and socially effective amendments to the Truth in Lending Act (TILA). Throughout the past history of our government, Congress demanded the government refrain from this brand of hand-holding consumer protection from lenders. But the parameters set for the playing field for consumer mortgages has been made level for lenders and consumers for the first time in U.S. history. Lenders, expectedly, are unhappy with the changes designed to prevent another social disruption like the 2007 financial crisis and the Great Recession of 2008.

Changes from Fannie Mae

Fannie Mae has tightened standards on the mortgages they purchase, requiring higher credit scores and more documentation of income for ARMs.

Changes to ARM transactions included:

- an increase in the minimum FICO score from 620 to 640;
- the maximum loan-to-value ratio (LTV) for one-unit, principal residence, purchase and limited cash-out refinances became 90% for both desktop underwriting (DU) and manually underwritten mortgages (reduced from 95% and 97%, respectively); and
- the majority of ARM transactions were required to have maximum LTVs of 10 percentage points less than previously, not falling below 60%.

The buyer's total debt obligation, including front-end and back-end **DTI** maximum was revised to 36%, unless the mortgage meets credit score and reserve requirements (found unchanged in Fannie's Eligibility Matrix), then it may be as high as 45%.

10 12 CFR §1026.19

Chapter 20 Summary

Up until the early 1980s, the fixed rate mortgage (FRM) was just about the only type of mortgage available to homebuyers. Then, Congress and regulatory agencies adopted regulations allowing savings-and-loans (S&Ls) to offer adjustable rate mortgage (ARMs).

The face of the ARM has changed over the years, most markedly during the Millennium Boom. During this time, otherwise unqualified homebuyers were able to afford mortgages. Currently, ARM use is relatively low, but climbing. However, in the next few years, any homebuyers who take out ARMs will be at the mercy of the rising interest rates of the next few decades.

All ARMs contain four items:

- an introductory interest rate;
- an index;
- a margin; and
- an adjustment interval.

Some ARMs have other features which will impact how the interest rate or payments adjust. These features include:

- an initial interest rate cap;
- periodic interest rate caps;
- a lifetime interest rate cap;
- periodic payment caps;
- conversion features; and
- prepayment penalties.

Prepayment penalties are usually limited to the prepayments made in the first few years of a mortgage (incidentally, the same period of time in which interest is paid to the lender). When analyzing whether a homebuyer should refinance or allow an ARM to adjust, the prepayment penalty needs to be considered.

A plethora of ARMs exist, each with different terms. Common types of ARMs, or ARMs popular during the Millennium Boom include:

- hybrid ARMs;
- option ARMs;
- conversion ARMs; and
- interest-only ARMs.

The mortgage industry and rule makers have also acknowledged the need for regulation of ARMs. The Truth in Lending Act (TILA) and its Regulation Z require that all features of an ARM mortgage, including the existence of a carryover feature, be disclosed to a homebuyer at the time of the homebuyer's mortgage application. Fannie Mae has also tightened standards on the notes they purchase, requiring higher credit scores and more documentation of income for ARMs.

Chapter 20 Key Terms

adjustable rate mortgage (ARM)	**pg. 202**
conversion adjustable rate mortgage (ARM)	**pg. 209**
fully indexed rate	**pg. 206**
hybrid adjustable rate mortgage (ARM)	**pg. 212**
index	**pg. 206**
initial interest rate cap	**pg. 208**
interest-only adjustable rate mortgage (ARM)	**pg. 212**
introductory interest rate	**pg. 206**
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option adjustable rate mortgage (ARM)	**pg. 213**
payment cap	**pg. 209**
periodic interest rate cap	**pg. 208**
prepayment penalty	**pg. 210**

Chapter 21

FHA-insured mortgages

Learning Objectives

After reading this chapter, you will be able to:

- understand the Federal Housing Administration (FHA)'s purpose as the government's guarantor of mortgages;
- explain the minimum down payment and loan-to-value ratio (LTV) for FHA-insured mortgages;
- anticipate basic underwriting standards for the FHA's single family residence programs;
- counsel a seller on the risks when a buyer acquires their home subject to an FHA-insured mortgage; and
- advise on investor FHA prohibitions.

Key Terms

back-end debt-to-income ratio (DTI)

front-end debt-to-income ratio (DTI)

loan-to-value ratio (LTV)

mortgage insurance premium (MIP)

The creation of the FHA

The **Federal Housing Administration (FHA)** was created as part of the National Housing Act of 1934. Before the FHA's creation, only 40% of American households were homeowners. Most mortgages were three- to five-year mortgages requiring down payments of 50% of the purchase price. Thus, only the older and wealthier were able to purchase a home.

The FHA's guarantee shifted the lender's risk of loss on foreclosure to the government. The guarantee was structured to allow the repayment of home mortgages to be spread out over longer periods. In turn, homebuyers had greater access to housing funds with lower monthly payments and sellers were better able to relocate.

The FHA established two mortgage insurance programs:

- one for one-to-four-unit *single-family residences (SFRs)*; and
- one for multi-family housing units.

The FHA became part of the U.S. Department of Housing and Urban Development (HUD) in 1965.

By allowing down payments as little as 3.5% of the purchase price, the FHA gives many homebuyers who have not yet accumulated the typical 20% down payment the opportunity to own their home.[1]

The 203b program

mortgage insurance premium (MIP)
Default insurance premiums required on a Federal Housing Administration (FHA)-insured mortgage, paid both up-front and annually.

loan-to-value ratio (LTV)
A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property's fair market value (FMV).

The most commonly used FHA insurance program is the owner-occupied, one-to-four unit home **Section 203(b)** program.

For the privilege of making a **small down payment**, the FHA charges the homebuyer:

- an up-front **mortgage insurance premium (MIP)** of 1.75% of the mortgage amount on closing; and
- an annual *MIP* of 0.85% of the mortgage amount on a 30-year FRM with an **loan-to-value ratio (LTV)** greater than 95%, effectively increasing the annual cost of borrowing as an addition to interest.[2]

Homebuyers obtaining a Section 203(b) mortgage need to occupy the property as their **principal residence**.[3]

The public policy rationale behind the Section 203(b) program is based on the proposition that individuals who become homeowners have proven in their later years to be less of a financial burden on the government than the burden imposed by life-time renters.

No consideration is given for inducing tenants to take on the considerable risks of homeownership. These risks include the debt burden accompanying an **FHA-insured mortgage** and reduced job mobility during economic downturns and before full recovery, the mortgaged home becoming a prison for lack of ability to rid themselves of debt and move about for jobs.

HUD's QM

Since mortgages made under Section 203(b) are consumer mortgages, the **Truth in Lending Act (TILA)** and Regulation Z (Reg Z) ability-to-repay (ATR) requirements apply.

In order to meet the qualified mortgage (QM) definition for FHA insurance, mortgages need:

1 24 Code of Federal Regulations §203.20
2 HUD Handbook 4000.1 Appendix 1.0
3 12 United States Code §1709(g)

Summary of available HUD/ FHA programs

***Section 203(b)**: The most commonly used Federal Housing Administration (FHA) program. Under this section, the FHA insures mortgages made by direct endorsement (DE) lenders to creditworthy homebuyers who will use the property purchased as their principal residence. The maximum mortgage amount depends on the type of residential property and price ranges in the county where the property is located. [24 Code of Federal Regulations §§203 et seq.]*

***Section 203(h)**: This program provides FHA-insured mortgages to victims of a major disaster who have lost their homes and are rebuilding or buying another home. To qualify, the homebuyer needs to have lost their home in a presidentially designated disaster area. [24 CFR §§203 et seq.]*

***Section 203(k)**: Under this program, the FHA insures mortgages to finance the rehabilitation of existing homes, the rehabilitation and refinancing of a home or the simultaneous rehabilitation and purchase of a home. For example, rehabilitation includes repairs, installing solar energy systems or expanding dwellings. The maximum mortgage amount is the same as under Section 203(b). [24 CFR §§203 et seq.]*

***Section 234**: Similar to Section 203(b), this program insures mortgages for the purchase of condominiums. The maximum mortgage limit for an area established by Section 203(b) applies to the purchase of condominiums. Investor-buyers who intend to sell individual units may obtain a mortgage insured under this section. [24 CFR §§234 et seq.]*

***Section 245**: Homebuyers who anticipate a substantial increase in income may be insured for a graduated payment mortgage (GPM). This allows a homebuyer to make small monthly payments initially but increase the size of the payments from year to year. Large down payments are required to prevent the mortgage amount from exceeding loan-to-value ratio (LTV) limits. [24 CFR §203.45]*

***Section 251**: Under the FHA-insured adjustable rate mortgage (ARM) program, the interest rate and monthly payments vary over the life of the mortgage. The initial rate and payment are negotiable between the homebuyer and lender. [24 CFR §203.49]*

***Section 255**: The FHA allows homeowners who are 62 years of age or older to convert the equity in their homes into a monthly income. This enables homeowners with sizable equity but small income to turn their equity into spendable dollars without selling the property. [24 CFR §§206 et seq.]*

***Title 1**: Property improvement mortgages are available to homeowners for the repair or improvement of their home, apartment building or commercial building. Mortgages can also be obtained to finance construction of commercial buildings. [24 CFR §§201 et seq.]*

***Energy-efficient mortgages (EEMs)**: These FHA-insured mortgages assist homebuyers in financing the cost of adding energy-efficient improvements to new or existing housing as part of their purchase or refinance mortgage. [24 CFR 203.18(i); see Chapter 22]*

- periodic payments, without risky features such as interest-only payments or negative amortization;
- a mortgage term of 30 years or less;
- up-front points and fees limited to 3%, with adjustments to facilitate smaller mortgages (with exceptions for certain HUD programs); and
- FHA insurance.

HUD recognizes both a safe harbor qualified mortgage, and a rebuttable presumption qualified mortgage. [See Chapter 10]

HUD's safe harbor qualified mortgage definition covers mortgages with annual percentage rates (APRs) equal to or less than the average prime offer rate (APOR) + 115 basis points + the annual MIP.

HUD's rebuttable presumption qualified mortgage definition applies to mortgages with APRs greater than the APOR + 115 basis points + the annual MIP.

FHA mortgage limits by area and LTVs

The maximum FHA-insured mortgage available to assist a homebuyer in the purchase of one-to-four unit residential property is determined by:

- the type of residential property; and
- the county in which the property is located.

A list of counties and their specific mortgage ceilings is available from FHA or an FHA DE lender, or online from HUD at *http://www.hud.gov*.

The FHA also limits the mortgage amount it will insure based on a percentage of the appraised value of the property — the LTV.

The LTV limit on an FHA-insurable mortgage is capped at 96.5%. Thus, the minimum down payment is 3.5%.[4]

Additionally, even after including homebuyer-paid closing costs in the LTV calculations, the insurable mortgage amount cannot exceed the ceiling of 96.5% of the property's appraised value.

To determine the mortgage amount the FHA will insure, multiply the appropriate LTV by the *lesser* of the property's:

- sales price; or
- the appraised value of the property.[5]

Closing costs may not be used to help meet the 3.5% minimum down payment requirement. Also, closing costs paid by the buyer or seller are not deducted from or added to the sales price before setting the maximum mortgage amount.[6]

Buyer's closing costs include:

- the lender's origination fee;
- appraisal fees;
- credit report charges;
- home inspection fees;
- recording fees;
- survey fees; and
- the cost of title insurance.

4 HUD Handbook 4000.1 Chapter II.A.2.b
5 HUD Handbook 4000.1 Chapter II.A.2.a
6 HUD Handbook 4000.1 Chapter II.A.4.d.i

The lender's origination fee included in the closing costs is limited to 1% of the mortgage amount, any competitive discount points and the 1.75% upfront MIP being separately analyzed.

Either the homebuyer or seller can pay the homebuyer's closing costs, called *non-recurring closing costs*. The lender may also advance closing costs on behalf of the homebuyer.

However, discount points or upfront MIPs are not part of the homebuyer's closing costs; they are classified as prepaid interest, the cost of money over time. When the seller agrees to pay the homebuyer's mortgage discount points and MIPs, these amounts are then considered *financing concessions*.

Any closing costs or other financing concession paid by the lender or seller in excess of 6% of the property's sales price are considered an *inducement to purchase* and results in a dollar-for-dollar deduction of the excess from the sales price before applying the appropriate LTV.[7]

The LTV initially sets the mortgage amount. However, the mortgage amount cannot exceed the cap of 96.5% of the appraised property value.

For example, a homebuyer pays $100,000 for an SFR with an appraised value of $100,000. The homebuyer needs to pay the minimum down payment of $3,500 (3.5%) from their own funds (or permissible sources). Thus, the homebuyer's cost basis for calculating the mortgage amount is $100,000. The LTV of 96.5% is then applied to the $100,000 cost basis the homebuyer will have in the property, resulting in a $96,500 maximum mortgage (before pre-paid MIP).

In a seller's market with too many buyers rapidly driving up prices, the price a buyer might agree to pay occasionally exceeds the appraised value of the property. Thus, the gap is widened between the FHA-insurable mortgage limit and the purchase price. The buyer/homebuyer then has the right to close the transaction and qualify for the FHA-insured mortgage. To close, the buyer needs to increase the down payment amount to cover the **higher-than-appraised price** if they are still willing and able to pay for the property.

Minimum credit score and creditworthiness

Homebuyers shopping for FHA-insured mortgages must have a minimum credit score of 500. Those who have a score of 580 or higher are eligible for the maximum financing benefits available.

The minimum credit score requirements are applicable to all single family programs except:

- Section 223(e);
- Section 238;
- Section 247;
- Section 248;

7 HUD Handbook 4000.1 Chapter II.A.4.d.iii.G

- Section 255, home equity conversion mortgages (HECMs) [See Chapter 25];
- Title I; and
- HOPE for Homeowners.[8]

However, the minimums required by the FHA are much lower than those required by the underwriting standards of most lenders. Many lenders set a minimum credit score of 640-660 for FHA-insured mortgages they will fund.

Automated vs. manual underwriting

The FHA uses an automated system called the FHA Technology Open to Approved Lenders (TOTAL) Scorecard system. The TOTAL Scorecard works in conjunction with automated underwriting (AU) systems, like Freddie Mac's Loan Prospector (LP) or Fannie Mae's Desktop Underwriter (DU).

Application information is entered into the AU system. The AU system runs the overall eligibility for the mortgage, and the FHA TOTAL Scorecard runs eligibility for FHA insurance.

Note that unlike the AU systems, FHA TOTAL Scorecard does not underwrite applications — it merely assesses eligibility for FHA insurance. No application is to be denied solely based on a risk assessment given by the FHA TOTAL Scorecard system.

All mortgage applications for FHA-insured mortgages are required to go through the TOTAL Scorecard system. Two exceptions exist: homebuyers with insufficient or non-traditional credit scores, and FHA streamline refinances are not required to first be run through the TOTAL Scorecard system.

FHA TOTAL Scorecard may assign a mortgage with any of the following statuses:

- Accept — here, the mortgage is eligible for FHA insurance when the data entered is accurate and complete, and the mortgage package meets FHA requirements;
- Accept/Ineligible — here, the homebuyer meets credit and capacity requirements for the TOTAL Scorecard system, but does not meet FHA program eligibility requirements, e.g., the mortgage amount exceeds FHA statutory limits; or
- Refer — here, the mortgage is manually underwritten to determine eligibility.

Applications manually underwritten include:

- applications where all homebuyers have insufficient or nontraditional credit;
- applications given a Refer score recommendation from FHA's TOTAL Scorecard;

8 HUD Handbook 4000.1 Chapter II.A.2.b.j

Acceptable sources of the cash down payment and seller concessions

Acceptable sources of the cash down payment made by the homebuyer include:

Savings and checking accounts*: Lenders must verify the account balance is consistent with the homebuyer's typical recent balance and no large increase occurred just prior to the mortgage application.*

Gift funds*: The donor of the gift must have a clearly defined interest in the homebuyer and must be approved by the lender. Relatives or employer unions typically are acceptable donors. Gift funds from the seller or broker are considered an inducement to buy and require a reduction in the sale price.*

Collateralized mortgages*: Any money borrowed to meet the down payment requirement must be fully secured by the homebuyer's marketable assets (i.e., cash value of stocks, bonds, or insurance policies), which do not include the home being financed. Cash advances on a credit card, for example, are not acceptable sources for down payment funds.*

Broker fee*: When the homebuyer is also a real estate agent involved in the sales transaction, their fee may be part of the down payment.*

Exchange of equities*: The homebuyer can trade personal property they own to the seller as the down payment. The homebuyer must produce evidence of value and ownership before the exchange will be approved.*

Sale of personal property*: Proceeds from the sale of the homebuyer's personal property can be part of the down payment when the homebuyer provides reliable estimates of the value of the property sold.*

Undeposited cash*: Cash is an acceptable source of down payment funds when the homebuyer can explain and verify the accumulation of the funds.*

Earnest money deposit*: The earnest money deposit is verified and documented by the lender when the amount is more than 2% of the sales price or is high based on the homebuyer's history of savings.*

Investments*: Up to 60% of the value of assets such as IRAs, 401(k)s, Keogh accounts and thrift savings plans may be included in the underwriting analysis.*

Stocks and bonds*: The value of any stocks or bonds may be counted using the most recent statement.*

Savings bonds*: Government-issued bonds may be counted at the original purchase price unless redemption value and eligibility are confirmed.*

Sweat equity*: Labor or materials the homebuyer provides before closing on the property may be considered the equivalent of a cash investment.*

Rent credit*: Any combined rental payments exceeding the appraiser's estimate of fair market rent may be considered the equivalent of a homebuyer's cash investment.*

The Federal Housing Administration (FHA) currently allows sellers to pay up to 6% of the lesser of the property's sales price or appraised value towards the homebuyer's:

- *permanent and temporary interest rate buydowns;*
- *payments of mortgage interest on fixed rate mortgages (FRMs);*
- *mortgage payment protection insurance; and*
- *payment of the up-front mortgage insurance premium (up-front MIP). [HUD Handbook 4000.1 Chapter II.A.4.d.j.G; 4000.1 Chapter II.A.5.c.iii.G]*

- applications given an Accept from FHA's TOTAL Scorecard, but are downgraded to a Refer by an underwriter; and
- applications where the homebuyer has a credit score below 620 and a back-end debt-to-income ratio (DTI) of more than 43%.[9]

Different qualification standards apply for manually underwritten mortgages. They are denoted where discussed.

Reserves and debt

FHA programs do not require minimum cash reserves. However, for mortgage applications manually underwritten the homebuyers is to have cash reserves of at least one month's mortgage payment for one-to-two unit properties, and at least three months' cash reserves for three-to-four unit properties.[10]

front-end debt-to-income ratio (DTI)
The percentage of monthly gross income that goes towards paying mortgage debt.

back-end debt-to-income ratio (DTI)
The percentage of monthly gross income that goes towards paying non-mortgage debt.

A homebuyer needs to meet the following debt-to-income ratios to be eligible for FHA-insured financing:

- their *mortgage payment* does not exceed 31% of their gross effective income, called the **front-end DTI** or *mortgage payment ratio*; and
- their *total fixed payments* do not exceed 43% of their gross effective income, called the **back-end DTI** or *fixed payment ratio*.[11]

These maximum DTIs may only be exceeded when significant compensating factors exist. Compensating factors include:

- a demonstrated ability during the past 12-24 months to pay housing expenses greater or equal to the proposed monthly payment;
- a down payment of 10% or more;
- a demonstrated ability to accumulate savings;
- a history of conservative credit use;
- a credit history reflecting an ability to devote a greater portion of income to housing expenses;
- compensation other than income, including food stamps or other public benefits;
- the proposed housing payment represents only a minimal increase in the homebuyer's housing expenses;
- substantial cash reserves;
- substantial non-taxable income;
- demonstrates potential for increased earnings due to job training or education; and
- the home is being purchased because the primary wage-earner is relocating and the secondary wage-earner has an established employment history, is expected to return to work and has reasonable employment prospects in the new area.[12]

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9 HUD Handbook 4000.1 Chapter II.A.5
10 HUD Handbook 4000.1 Chapter II.A.5.c.j.C
11 HUD Handbook 4000.1 Chapter II.A.5.d.viii
12 HUD Handbook 4000.1 Chapter II.A.5.d.ix

However, for manually underwritten mortgages, homebuyers with credit scores between 500 and 580, and homebuyers with non-traditional or insufficient credit may not exceed these maximum ratios, regardless of compensating factors.[13]

For manually underwritten mortgages, DTIs can be pushed higher if the homebuyer has good credit, or additional compensating factors exist.[14]

Income requirements

A homebuyer's *gross effective income* consists of:

- their salary and wages;
- social security;
- alimony;
- child support; and
- government assistance.

The maximum *mortgage payment ratio* of 31% of the gross effective income determines the maximum amount of principal, interest, taxes and insurance the homebuyer is able to pay on the mortgage.

Lenders use the *fixed payment ratio* of 43% of the gross effective income to determine whether a homebuyer can afford to incur the long-term debt of an FHA-insured mortgage in addition to all other long-term payments they must make.[15]

When computing the fixed-payment ratio, the lender adds the homebuyer's total mortgage payment to all the homebuyer's recurring obligations (debts extending ten months or more), such as all installment loans, alimony and child support payments, to ascertain the homebuyer's total monthly fixed payments.[16]

Since **predetermined ratios** may not indicate a particular homebuyer's likelihood for default, lenders may be flexible when applying the qualification ratios.

Liability for the FHA losses

Owners may sell their property subject to an existing FHA-insured mortgage which the buyer takes over as the new owner of the encumbered property. Here, the seller is released from personal liability for the mortgage, when:

- they request a release from personal liability;
- the prospective buyer of the property is creditworthy;
- the prospective buyer formally assumes the mortgage; and
- the lender releases the seller from personal liability by use of an FHA-approved form.[17]

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13 HUD Handbook 4000.1 Chapter II.A.5.d.viii
14 HUD Handbook 4000.1 Chapter II.A.5.d.viii
15 HUD Handbook 4000.1 Chapter II.A.5.d.viii
16 HUD Handbook 4000.1 Chapter II.A.4.b.iv.A; 4000.1 Chapter II.A.5.a.iv.A.1
17 HUD Form 92210; 24 CFR §203.510(a); HUD Handbook 4000.1 Chapter III.A.3.b

Mortgage documentation

A Federal Housing Administration (FHA)-approved direct endorsement (DE) lender processing a mortgage application submitted by a homebuyer requests or generates the following list of documents:

- *FHA Loan Underwriting and Transmittal Summary [Form HUD-92900-LT];*
- *mortgage note, including any secondary mortgage;*
- *authoritative copy of the executed security instrument [Fannie Mae Form 1003; Freddie Mac Form 65];*
- *closing disclosure and settlement certification;*
- *Uniform Residential Loan Application (URLA) signed and dated by all buyers and the lender [See **RPI** Form 202 (Form HUD-1003); see Chapter 15];*
- *Addendum to the URLA [Form HUD-92900-A]*
- *Residential Mortgage Credit Report (RMCR) for each buyer;*
- *Credit Alert Verification Reporting System report or verifying documentation from the credit agency;*
- *verification of deposit (VOD) and most recent bank statement [See **RPI** Form 211];*
- *income verification in the form of federal income tax returns (individual and business) for the past two years for self-employed homebuyers [See **RPI** Form 215 and 215-1];*
- *Social Security number evidence for each buyer;*
- *Residential Appraisal Report – Detached Single Family Unit or PUD [See **RPI** Form 200 (Form HUD-1004; 92051)];*
- *Wood Destroying Insect Inspection Report [National Pest Management Association (NPMA) Form 33]*
- *purchase agreement, any additional agreements, and the seller's Condition of Property Disclosure – Transfer Disclosure Statement (TDS) [See **RPI** Form 152 and 304];*

When the conditions for release from personal liability are satisfied, but the seller does not **request a release**, they remain liable to the FHA for any default occurring within five years after the sale.[18]

However, if five years pass from the time the property is resold, the seller is released from personal liability if:

- the buyer assumes the mortgage with the lender;
- the mortgage is not in default at the end of the five-year period; and
- the seller requests the release of liability from the lender.[19]

Lenders will inform buyers when the FHA-insured mortgage is originated of the procedure for obtaining the release from personal liability on their resale of the property.[20]

18 12 USC §1709(r)
19 24 CFR §203.510(b)
20 24 CFR §203.510(c)

- *verification of employment and most recent pay stub [See **RPI** Form 210 and 210-1];*
- *verification of payment history of rent payments or mortgages [See **RPI** Form 212 and 212-1];*
- *Lead-Based Paint Disclosure signed by the buyer;*
- *when special program documents are required, all specialized program documents;*
- *when applicable, the Mortgagee's Assurance of Completion [Form HUD-92300];*
- *when a new construction, the required new construction exhibits;*
- *when an individual water or sewer system is to be used, the local health authority's approval for individual water and sewer systems;*
- *when a gift is shown on form HUD-92900-LT, a gift letter;*
- *when a secondary mortgage is present, a copy of the subordinate note; and*
- *when the case binder is submitted more than 60 days after the disbursement date, the mortgagee submits a late submission letter. [HUD Handbook 4000.1 Chapter II.A.7.b]*

When the buyer is self-employed, they will also need to submit:

- *individual tax returns, signed and dated, for the most recent two years;*
- *for a corporation, "S" corporation or partnership (LLC), copies of federal business income tax returns for the last two years;*
- *a* profit and loss (P&L) balance sheet; *and*
- *a business credit report for a "C" corporation and "S" corporations. [HUD Handbook 4000.1 Chapter II.A.4.c.x.C]*

Mortgage documentation

cont'd

Due on a call

Mortgages insured by the FHA contain a due-on-sale clause. The provision allows the lender to call the mortgage due and immediately payable when the property is sold in violation of assumption requirements.

However, the lender of a Section 203(b) mortgage cannot impose restrictions on the resale of the property or automatically call the mortgage due-on-sale.

To avoid defaults by future owners when a homeowner with a Section 203(b) mortgage sells the home, the lender is allowed to approve the sale if:

- one of the new owners is creditworthy;
- the seller retains an ownership interest; or
- the transfer is by a will.

When an FHA-insured property is sold to an unapproved buyer, such as an investor, the lender first needs to request permission from the FHA to call the balance of the mortgage due-on-sale. The FHA has not called any mortgages under the due-on-sale clause since the policy was initiated in 1985.[21]

21 24 CFR §203.512(d)

An investor will not be approved as a buyer of property which is subject to a Section 203(b) mortgage since the property would be a rental and not the investor's principal residence. However, in spite of the FHA's no-investor policy, once an investor purchases a property subject to a Section 203(b)-insured mortgage, the FHA only requires the investor to make payments as scheduled.

After an FHA-insured mortgage is foreclosed and the lender acquires the property, the property is conveyed to the FHA. The FHA pays the lender the amount of the remaining original principal on the mortgage at the time of foreclosure. When a bidder other than the lender acquires the property at the foreclosure sale, the FHA pays the lender the amount of the unpaid principal balance, minus any amounts the lender receives from the bidder.[22]

Before accepting a conveyance from the lender, the FHA requires the lender to confirm the property is in a marketable condition and has not suffered any waste. The FHA then sells the property to recoup the amount it paid to the lender.

Unlike conventional mortgages with private mortgage insurance (PMI), a homebuyer who takes out an FHA-insured mortgage is personally liable to the FHA or any loss the FHA suffers. The FHA can obtain a money judgment against the homebuyer for the difference between the amount the FHA paid the lender and the price received from the sale of the property.

State anti-deficiency mortgage laws do not apply to FHA-insured mortgages.[23]

Investor prohibitions and fee avoidance

An investor and their real estate agent discuss the investor's intent to add more SFRs to the pool of rentals they have owned for some time. The investor has no further ability to qualify for conventional mortgage financing to buy properties. The investor is interested in low-tier priced homes recently financed with maximum LTV fixed-rate mortgages insured by the FHA.

Specifically, the investor wants to use their cash reserves to upgrade the properties in lieu of a down payment on the purchase price.

The investor's agent explains that the trust deed used for FHA-insured mortgages has a *due-on-sale clause*. To prevent investors from acquiring SFRs with FHA-insured financing, the **due-on-sale** provision allows HUD (not the lender or FHA) to call mortgages taken over by investors.

The reason for discouraging investors from taking over mortgages is HUD's need to reduce the number of defaults on FHA mortgages. Historically, investor-owners default more frequently than owner-occupants of SFRs.

However, the investor is made aware that before the lender can *call* an FHA-insured mortgage on the sale of the SFR property, the lender must first obtain HUD's approval.[24]

22 24 CFR §203.401

23 24 CFR §203.369

24 HUD Handbook 4000.1 Chapter III.A.3.b.iv-v

Despite the U.S. Department of Housing and Urban Development (HUD)'s general no-investor policy, the Federal Housing Administration (FHA) insures mortgages made to investors for these projects:

Section 207 — *Mobile home parks: This program finances construction of mobile home parks consisting of five or more spaces. The park must be located in a HUD-approved location where market conditions show a need for this type of housing. [24 Code Federal Regulations §§200(A); 207]*

Section 221(d)(4) — *Multifamily rental housing: This program finances construction containing at least five units and all must be rented at reasonable prices. [24 CFR §221.751 et seq.]*

Section 231 — *Housing for the elderly: Section 231 programs finance the construction or rehabilitation of housing consisting of at least eight units, all of which must be suited to the elderly or handicapped. Convalescent homes are not included in this section. [HUD Handbook 4570.1]*

Section 231 — *Nursing homes: This program provides financing used to construct or renovate care facilities which accommodate 20 or more patients who require skilled nursing care. Major equipment needed to operate the facilities can be included in the mortgage. [HUD Handbook 4600.1 Chapter 2-1]*

Section 8 — *Low-income rental assistance: Under the Section 8 program, HUD makes up the difference between what a low-income tenant can afford to pay and the approved rent forth unit. HUD rental assistance subsidies can be obtained for existing housing occupied by tenants whose income is less than 50% of the median income for the area. In addition to rental assistance to property owners, HUD also provides rental vouchers and rental certificates to tenants. [HUD Handbook 4350.1]*

FHA programs for investors

In practice, HUD does not grant the right to call unless a default already exists. Thus, lenders are limited to using the due-on clause as a device to pressure an investor to assume the mortgage, typically accomplished by contacting the seller prior to the close of escrow. The sole objective of lenders is *revenue*, not preservation of the security from potential investor waste for recovery of the debt; a demand and receipt of an assumption fee of one-half point or more on the sale while ignoring HUD's late-'80s no-investor rule.

Sales closed subject to an FHA mortgage

When agreeing to purchase property encumbered by an FHA-insured mortgage, rental investors need the seller to obtain a beneficiary statement from the lender. This is accomplished through escrow as part of the closing activity to confirm the seller's representation of the mortgage terms.

The homebuyer then closes escrow, taking over the mortgage by either:

- cashing out the seller's equity; or
- combining cash and a note carried back by the seller to pay for the seller's equity.

Sellers need to be informed of their **risk of loss** when permitting a buyer to take title subject-to their FHA-insured mortgage.

The risk for a seller of a property encumbered by an FHA-insured mortgage is their **personal liability** for any loss the FHA may incur due to a deficiency in the property value at the time of a default by the buyer.[25]

Thus, the seller, on a transfer of title subject to an FHA-insured mortgage, needs to consider entering into an *assumption agreement* with the buyer and securing the agreement by a performance trust deed. [See **RPI** Form 432 and 451]

Then, when the buyer does not perform on the **assumption agreement** by making payments on the mortgage, the seller may call all amounts due by the terms of the assumption agreement. Then when it is not paid or a resolution otherwise agreed to, they may foreclose under the trust deed if they choose to protect their interests.

25 **Carter** v. **Derwinski** (9th Cir. 1993) 987 F2d 611

Chapter 21 Summary

By allowing down payments as little as 3.5% of the purchase price, the Federal Housing Administration (FHA) gives many homebuyers who have not yet accumulated the typical 20% down payment the opportunity to own their home.

Since mortgages made under Section 203(b) are consumer mortgages, the Truth in Lending Act (TILA) and Regulation Z (Reg Z) ability-to-repay (ATR) requirements apply.

Homebuyers shopping for FHA-insured mortgages must have a minimum credit score of 500. Those who have a score of 580 or higher are eligible for the maximum financing benefits available.

The FHA uses an automated system called the FHA Technology Open to Approved Lenders (TOTAL) Scorecard system. The TOTAL Scorecard works in conjunction with automated underwriting (AU) systems, like Freddie Mac's Loan Prospector (LP) or Fannie Mae's Desktop Underwriter (DU).

FHA programs do not require minimum cash reserves. However, for mortgage applications manually underwritten the homebuyers is to have cash reserves of at least one month's mortgage payment for one-to-two unit properties, and at least three months' cash reserves for three-to-four unit properties.

A homebuyer needs to meet the following debt-to-income ratios (DTIs) to be eligible for FHA-insured financing:

- their mortgage payment does not exceed 31% of their gross effective income, called the mortgage payment ratio, also called the front-end DTI; and
- their total fixed payments do not exceed 43% of their gross effective income, called the fixed payment ratio, also called the back-end DTI.

Mortgages insured by the FHA contain a due-on-sale clause. The provision allows the lender to call the mortgage due and immediately payable when the property is sold in violation of assumption requirements.

Chapter 21 Key Terms

Notes:

Chapter 22

FHA Energy-Efficient Mortgages

Learning Objectives

After reading this chapter, you will be able to:

- advise buyers on the use of a Federal Housing Administration (FHA)-insured Energy-Efficient Mortgage to finance energy-efficient improvements; and
- describe the home energy rating report.

Key Term

Energy-Efficient Mortgage

Reduced utilities allow for higher mortgage amounts

The Federal Housing Administration's (FHA's) **Energy-Efficient Mortgage (EEM)** program aims to provide homebuyers and owners with a way to finance energy-efficient improvements.

The underlying concept of the EEM program is to reduce utility expenses and allow homebuyers to make payments on a larger mortgage amount, increased to cover the cost of the energy-efficient improvements. The FHA insures the EEMs, either as added amounts to the purchase or refinance of the mortgage. So, in addition to the base FHA maximum mortgage amount limit, the cost of the energy-efficient improvements can be added to the mortgage amount for an EEM.[1]

Energy-Efficient Mortgage (EEM)
A Federal Housing Administration (FHA) mortgage which finances energy-efficient improvements.

1 HUD Mortgagee Letter 2009-18

EEM requirements

An EEM may be used in connection with either an FHA-insured purchase or refinance mortgage (including streamline refinances), under the:

- "standard" 203(b) program for one-to-four unit residential properties;
- 203(k) rehabilitation program; or
- 203(h) program for mortgages made to victims of presidentially declared disasters.[2] [See Chapter 21]

EEM property requirements

While there are no homebuyer requirements, there are property requirements. Eligible property types include new and existing:

- one-to-four unit new construction properties;
- one-to-four unit residential properties for the 203(b) and 203(k) programs;
- one-unit condominiums; and
- manufactured housing.[3]

Properties are only eligible when the total cost of the improvements is less than the total dollar value of the energy that will be saved during the improvements' useful life. The cost and estimates of the energy savings are to be provided by a home energy rater. The energy rater's report is prepared on completion of a physical inspection of an existing property or a review of the plans and specifications of a home to be built. The resulting home energy rating report is to be provided to the homebuyer (whether owner, or buyer) and the lender.[4]

The assessment is required to be conducted by a qualified energy rater, assessor or auditor trained and certified as a:

- Building Performance Institute Building Analyst Professional;
- Building Performance Institute Home Energy Professional Energy Auditor;
- Residential Energy Services Network Home Energy Rater; or
- energy rater, assessor or auditor who meets local or state jurisdictional requirements for conducting residential energy audits or assessments, including training, certification, licensure and insurance requirements.[5]

The set of improvements agreed to by the homebuyer based on the energy rater's report is called the **energy package**.

The home energy rating report

An example of what the home energy rating report on the energy package may include are:

- the address of the property;
- the name of the homebuyer;
- the FHA Case number;

2 HUD Handbook 4000.1 Chapter II.A.8.c.ii
3 HUD Handbook 4000.1 Chapter II.A.8.c.ii
4 HUD Handbook 4000.1 Chapter II.A.8.c.iv
5 HUD Handbook 4000.1 Chapter II.A.8.c.iv.A

- the name of lender (when applicable);
- the type of property;
- whether the property is new construction or an existing property;
- the date of the physical inspection of the existing property or, for new construction, the date of the plan review;
- a description of the current energy features of the property or proposed features if new construction, to include:
    - a description of the insulation R values in ceilings, walls, and floors;
    - infiltration levels and barriers (caulking, weather-stripping and sealing);
    - a description of the windows (storm windows, double pane, triple pane, etc.) and doors; and
    - a description of the heating (including water heating) and cooling systems;
- a description of the energy package;
- the estimated cost of the energy package, the useful life and the costs of any maintenance over the useful life of the improvements;
- for existing property, the estimated present annual utility cost before the installation of the energy package;
- for new construction, the estimated annual utility costs of a reference house built to 2000 International Energy Conservation Code (IECC);
- the estimated expected annual utility costs after the installation of the energy package;
- the estimated annual savings in utility costs after the installation of the energy package, including the present value of the savings; and
- the names and signatures of the person(s) who inspected the property and of the person(s) who prepared the report, and the date the report was prepared.

This list is based on prior requirements from the U.S. Department of Housing and Urban Development (HUD), but may vary depending on the lender and the applicable state rules regarding home energy reports.

EEM underwriting

As previously mentioned, the EEM is an "add-on" to existing FHA-insured mortgages. Thus, the homebuyer starts by applying for, say, a 203(b) purchase mortgage. The 203(b) mortgage is initially underwritten as if the energy package did not exist.[6]

Exceptions exists for:

- new construction; and
- existing properties built or retrofitted to 2000 IECC.

6 HUD Handbook 4000.1 Chapter II.A.8.vii

For these properties, homebuyers with traditional credit scores of 580 or higher can "stretch" the allowable debt-to-income ratios (DTIs) to 33% front-end/45% back-end (for the standard 203(b) program, it is 31% front-end/43% back-end).

Additionally, on new construction, the homebuyer's qualifying ratios are to be calculated on the sales price MINUS the cost of the energy package. The builder has already included the cost of the improvements in the sales price — unless the builder has arranged for the buyer to lease the energy-efficient equipment, such as solar panels to keep the price from appearing high.

Editor's note — Additionally, all the new stretch limits and requirements apply to EEMs made in connection with a manually underwritten mortgage.[7]

For example, the sales price of a newly constructed property is $200,000. The energy package costs $6,000. The homebuyer will be making a 3.5% down payment of $7,000. For purposes of calculating the homebuyer's qualifying ratios, both the energy package cost ($6,000) and the down payment ($7,000) will be subtracted. Thus, the homebuyer's qualifying ratios will be based on a $187,000 mortgage amount. Further, the homebuyer's maximum allowable DTI can be stretched to 33/45.[8]

Once the lender has determined the homebuyer and the property qualify for the FHA-insured mortgage, the lender will use the home energy rating report and an EEM worksheet to determine the energy package that may be added to the mortgage amount.

The EEM amount

The total dollar amount of energy-efficient improvements which are eligible for financing is the lesser of:

- the dollar amount of cost-effective energy-efficient improvements, plus the cost of reports and inspections; and
- the lesser of 5% of:
    - the value of the property;
    - 115% of the median area price of a single family dwelling; or
    - 150% of the conforming Freddie Mac limit.[9]

To extend our prior example, the costs for the energy package are $6,000. The reports and inspections cost another $200, for a total of $6,200.

The property value (we'll align it with the sales price) is $200,000, 115% of the median area price is $220,000, and 150% of the conforming Freddie Mac limit is $726,525. Thus, 5% of the lesser of those amounts ($200,000 value) is $10,000.

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7 HUD Mortgagee Letter 2014-02

8 HUD Handbook 4000.1 Chapter II.A.5.viii

9 HUD Mortgagee Letter 2009-18

In our scenario, assuming the homebuyer's DTI allows it, the $6,200 is the amount of the EEM.

Any appraisal completed on the property is not required to reflect the value of the energy package.[10]

EEM escrow requirements

On new construction, no extra escrow account is needed for the energy package funds since the improvements already exist. In this case, the EEM gives the homebuyer extra purchasing power to pay for the new construction and its energy-efficient improvements.

On existing properties, the lender places the funds for the energy-efficient improvements in an escrow account at mortgage closing. The money is released to the homebuyer after an inspection verifies the improvements have been installed and energy savings are achieved. Any funds remaining after the construction period are then applied to the mortgage principal — no cash back.

When the energy package is part of a Section 203(k) rehabilitation mortgage, the escrowed amounts are included in the rehabilitation escrow account.

When an additional escrow account is set up for funding, the lender is responsible for filling out form HUD 92300, Mortgage Assurance of Completion, to indicate the escrow account has been established. [11]

For mortgages on existing properties, except for 203(k), the lender is responsible for administering, or arranging for administration of the escrow account when the energy-efficient improvements are not completed by closing.[12]

Installation, inspection and notification

On new construction, the energy package has already been included in the cost of the house, and therefore no installations need be completed.

On existing construction, the energy package is to be installed within 90 days of the mortgage closing. 180 days is allowed for Section 203(k) rehabilitation mortgages. When the work is not completed within the required timelines, the EEM funds are to be applied to the mortgage principal. The homebuyer may not be paid for labor or cash out the EEM funds.[13]

The final inspection to ensure all energy-efficient improvements have been made may be completed by the lender, the HERs rater or an FHA fee inspector. The homebuyer may be charged for this final inspection.

The lender is responsible for informing the FHA the energy package has been completed, and that escrow has cleared.

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10 HUD Handbook 4000.1 Chapter II.A.8.viii

11 HUD Mortgagee Letter 2005-21

12 HUD Handbook 4000.1 Chapter II.A.8.x

13 HUD Mortgagee Letter 2005-21

EEM availability

FHA lenders who already have a direct endorsement from HUD do not need any additional qualifications to offer EEM mortgages. However, despite this program having been around for almost 20 years, it's still difficult to find lenders who offer the program. Why?

On existing properties, the lender has additional responsibilities in connection with the escrow account on these types of mortgages. Since these mortgages are so seldom used, the initial foray into offering them may simply present too much of a barrier. Leasing programs have been successfully marketed to the near exclusion of ownership of the energy equipment and EEM financing.

Still, as both buyers and sellers become more aware of owning, not leasing, and that mortgage financing is available at less cost than leasing the component, this program may come to the fore and finally see its day in the sun.

Chapter 22 Summary

Homebuyers and homeowners may finance energy-efficient improvements under the Federal Housing Administration (FHA)'s Energy-Efficient Mortgage (EEM) program. With reduced utility charges, buyers and owners may make higher monthly mortgage payment to fund the cost of the energy-efficient property improvements.

Properties are only eligible when the total cost of the improvements is less than the total dollar value of the energy that will be saved during the improvements' useful life.

On new construction, the EEM gives the homebuyer extra purchasing power to pay for the new construction and its energy-efficient improvements.

FHA lenders who already have a direct endorsement from the Department of Housing and Urban Development (HUD) do not need any additional qualifications to offer EEM mortgages.

Chapter 22 Key Term

Energy-Efficient Mortgage..pg. 235

Chapter 23

VA mortgages for veteran homebuyers

Learning Objectives

After reading this chapter, you will be able to:

- identify eligibility requirements for U.S. Department of Veterans Affairs (VA)-guaranteed mortgages;
- determine general underwriting standards for VA-guaranteed mortgages;
- identify eligibility requirements for the VA interest rate reduction refinance (IRRRL) program; and
- compare the benefits of Federal Housing Administration (FHA)-insured mortgages with VA-guaranteed mortgages.

Key Terms

guaranty entitlement

Interest Rate Reduction Refinance Loan (IRRRL)

novation agreement

residual income

U.S. Department of Veterans Affairs (VA) automatic

VA mortgage availability

A former member of the armed services — a *veteran* — is interested in purchasing a home. The veteran's income and credit rating are sufficient to qualify them for a home mortgage. However, the veteran has not accumulated enough money for the down payment required by conventional lenders and issuers of *private mortgage insurance (PMI)*.

May the veteran buy a home now, even though their savings are insufficient for a typical down payment?

Yes! The **U.S. Department of Veterans Affairs (VA) mortgage** guarantee program is specially designed to assist qualified veterans to buy a home with **zero down payment**.

To be eligible for the VA-guaranteed mortgage program, the **veteran homebuyer** needs to have:

- served at least 90 days on active duty during World War II, the Korean Conflict, the Vietnam era, or the Persian Gulf War;
- been discharged or released from active duty for a service-connected disability after September 15, 1940; or
- served on active duty for more than 180 days, after July 25, 1947.[1]

Reservists who have completed a total of six years in the Selected Reserves or National Guard are also eligible if:

- they are a member of an active unit, attended required weekend drills and two-week active duty for training; AND
- were discharged with an honorable discharge;
- were placed on the retired list;
- were transferred to the Standby Reserve or an element of the Ready Reserve other than the Selected Reserve after service characterized as honorable service; or
- continue to serve in the Selected Reserves.[2]

Individuals who completed less than six years may be eligible if discharged for a service-connected disability.

Others eligible for the VA mortgage guaranty program include:

- the surviving spouses of veterans who died from service-related injuries; and
- spouses of service members who are listed as missing in action or have been prisoners of war for more than 90 days.[3]

An honorable discharge certificate is the veteran's certificate of eligibility for the program. A veteran without a discharge certificate, or whose discharge was other than honorable, may apply to the Secretary of the VA for a certificate of eligibility.[4]

Mortgage purposes

Mortgages guaranteed by the VA are limited to mortgages which fund the financing of the **veteran's residence**, including:

- the purchase or construction of residential improvements consisting of one-to-four units;
- the purchase of a farm with an existing residence;
- the construction of a residence on a farm owned by the veteran;
- the purchase of a single family residence (SFR) unit in a condominium project;

1 38 United States Code §3702(a)(2)
2 38 USC §3701(b)(5)
3 38 USC §3701(b)
4 38 USC §3702(c)

- the purchase of a manufactured home which is permanently affixed to a lot, or which is to be affixed to a lot owned by the veteran;
- the additional improvements to an existing residence;
- the installation of energy-efficient improvements on an existing residence; or
- the refinance of an existing VA mortgage.[5]

The VA will only guarantee mortgages which are a first trust deed lien on the property, except for **home improvement mortgages** which may be a second trust deed lien.[6]

Further, VA-guaranteed mortgages are only made on property to be occupied by the veteran or their spouse as their **principal residence**, or for veterans currently on active duty.[7]

The lender's VA mortgage guaranty

A VA-guaranteed mortgage is originated and funded by an institutional lender or mortgage banker. The VA merely guarantees payment of a portion of the mortgage if the veteran defaults and the lender suffers a loss on the mortgage.

The **amount guaranteed** by the VA varies according to the amount of the mortgage as follows:

- for a mortgage of $45,000 or less, 50% of the mortgage;
- for a mortgage over $45,000 and up to $56,250, $22,500;
- for a mortgage over $56,250 and up to $144,000, 40% of the mortgage, limited to $36,000; and
- for mortgages exceeding $144,000, the lesser of 25% of the mortgage amount and 25% of the applicable Freddie Mac conforming mortgage limit for an SFR.[8]

The VA-guaranteed portion of the mortgage varies over the life of the mortgage based on the outstanding mortgage amount.

For example, a veteran borrows $250,000. In 2019, the Freddie Mac mortgage limit is $484,350. Thus, on origination, the VA-guaranteed repayment is 25% of the mortgage amount, or $62,500. Over time, the veteran makes mortgage payments and the outstanding mortgage balance decreases. Years later, the mortgage balance is $200,000. The VA guaranty now is only $50,000, being 25% of the $200,000 remaining balance.[9]

guaranty entitlement
The portion of a veteran's mortgage guaranteed by the U.S. Department of Veterans Affairs (VA).

Guaranty limited to entitlement

The portion of a mortgage guaranteed by the VA is the amount of the **guaranty entitlement** the veteran homebuyer is eligible to receive from the VA.

5 38 USC §3710(a)
6 38 USC §3703(d)(3)
7 38 USC §3704(c)
8 38 USC §3703(a)(1)(A)
9 38 USC §3703(b)

The maximum dollar amount of entitlement per veteran applies to all VA-guaranteed mortgages made to the same veteran.

For example, a veteran borrows $10,000 on a VA-guaranteed mortgage. The VA guarantees 50% of the mortgage, or $5,000. The veteran still has $31,000 of guaranty entitlement left which they may apply toward future VA-guaranteed mortgages of less than $144,000.

The maximum guaranty entitlement available to each veteran has increased several times since the inception of the VA mortgage guaranty program. With each increase, a veteran who previously obtained a VA-guaranteed mortgage receives an additional guaranty entitlement.

Additionally, if two or more individuals (such as spouses) are each eligible veterans, they may combine their guaranty entitlements to qualify for a larger mortgage on one-to-four unit residential property. However, the property needs to be the *principal residence* of both veterans.[10]

Reinstatement of eligibility

Even though a veteran may have used their maximum guaranty entitlement to obtain a VA-guaranteed mortgage, they may obtain another VA-guaranteed mortgage in the future.

However, before another mortgage is guaranteed by the VA for the maximum entitlement, the veteran's guaranty entitlement needs to be restored through a process called **reinstatement of eligibility**.

Reinstatement of eligibility occurs when the veteran disposes of the property and:

- the previously guaranteed mortgage is paid in full;
- the VA is reimbursed for amounts it paid to a lender for losses on a guaranteed mortgage originated by the veteran; or
- another veteran assumes the VA-guaranteed mortgage and replaces the guaranty entitlement with their own entitlement.[11]

Consider a veteran who bought a house in the early 1970s, and used their maximum guaranty entitlement of $12,500. The maximum guaranty entitlement now available has increased since the early 1970s to $36,000. Thus, the veteran has $23,500 left in entitlement eligibility they may use for future home mortgages of less than $144,000.

If the veteran's eligibility has been fully reinstated by the veteran paying off the mortgage, the veteran has the full entitlement available to them — up to the lesser of 25% of the mortgage amount and 25% of the applicable Freddie Mac conforming mortgage limit for a SFR, for a mortgage amount exceeding $144,000.

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10 38 Code of Federal Regulations §36.4308(b)

11 38 USC §3702(b)

VA automatics and income and credit requirements

Financial institutions subject to governmental supervision and mortgage bankers in compliance with VA lender guidelines are allowed to certify mortgages conforming to VA regulations, called **VA automatics**.

These lenders are allowed to issue *certificates of reasonable value (CRVs)* which set the maximum mortgage amount and the value of the real estate securing the mortgage, collect fees and deposits and certify the real estate meets the VA's requirements. Use of a VA automatic lender greatly speeds up the process of obtaining a VA-guaranteed mortgage.

U.S. Department of Veterans Affairs (VA) automatic
A lender authorized to certify a mortgage conforms to U.S. Department of Veterans Affairs (VA) regulations.

The VA has set credit history standards and income criteria veterans meet to qualify for a VA-guaranteed mortgage.

In determining a veteran's ability to pay — **creditworthiness** — the VA uses two income criteria:

- *debt-to-income ratio (DTI)*; and
- *residual income,* defined as the income remaining to cover family living expenses (e.g. food, gasoline) after subtracting monthly shelter expense.[12]

To qualify for a VA-guaranteed mortgage, the veteran who does not possess compensating factors needs to meet the income guidelines of:

- a DTI of less than 41%;[13]
- **residual income** greater than the guidelines, which vary based on region and family size; and
- the VA's minimum requirements for estimated living expenses — for active duty veterans receiving the benefits of living near a base, the minimum residual income requirement is reduced by 5%.[14]

The DTI is determined by comparing the veteran's total monthly obligations for housing expenses and any long-term debt to their gross monthly income.

residual income
On a U.S. Department of Veterans Affairs (VA)-guaranteed mortgage, an analysis of a veteran's monthly debt obligations from their gross income to ensure the veteran is able to meet minimum living expenses.

Residual income is an entirely different analysis of gross income from conventional mortgage lending. It is determined by subtracting the veteran's monthly obligations for estimated income taxes, shelter and other debts from their gross monthly income. The purpose of a residual income review is to ensure the veteran is able to meet minimum living expenses set by the VA residual income guidelines.[15]

Compensating factors

Positive compensating factors possessed by the veteran are considered if their residual income is below VA guidelines or their DTI is above 41%. **Positive compensating factors** include:

- significant residual income;
- conservative use of consumer credit;
- long-term employment;

12 VA Pamphlet 26-7 Chapter 4.9.e
13 VA Pamphlet 26-7 Chapter 4.10.b
14 VA Pamphlet 26-7 Chapter 4.9.e
15 VA Pamphlet 26-7 Chapter 4.9.e

- significant liquid assets;
- a large down payment;
- little to no increase in living expenses due to the purchase;
- military benefits; and
- tax benefits of homeownership. [See **RPI** Form 320-4][16]

Veterans who fail to meet one of the credit requirements are not automatically prohibited from obtaining a VA-guaranteed mortgage. The VA does not limit its creditworthiness evaluation to the published guidelines. Special circumstances may exist which cause the VA to approve a mortgage to a veteran who does not otherwise qualify.[17]

For instance, a veteran may use their VA entitlement to purchase income-producing property consisting of two-to-four residential units if the veteran occupies one of the units as their principal residence.

If income from the rental units is used as a source of revenue to carry payments on the VA-guaranteed mortgage, the veteran needs to demonstrate to the VA that they possess the management skills needed to be a successful landlord.

Also, a cash reserve needs to exist to cover the payments on the mortgage for up to six months *without* any rental income.

The VA mortgage guaranty program was established to encourage lenders to make home mortgages to veterans. However, the VA mortgage guaranty program provides no assurance that all veterans will qualify for a mortgage.

Mortgages eligible for guaranty

The three basic categories of mortgages which qualify for a VA mortgage guaranty are:

- fixed rate mortgages (FRMs);
- adjustable rate mortgages (ARMs); and
- graduated payment mortgages (GPMs).

The VA imposes separate restrictions on each type of mortgage offered. For **FRMs**, the VA requires:

- a term of no more than 30 years and 32 days;
- full amortization if the mortgage term exceeds five years; and
- an interest rate mutually agreed to by both the lender and the veteran homebuyer.[18]

For an **ARM** to be eligible for a VA guaranty, the mortgage adjustment provisions needs to:

- correspond to a specified national interest rate;
- provide for the monthly payments to be adjusted annually on the anniversary of the mortgage's closing;

16 VA Pamphlet 26-7 Chapter 4.10.d
17 38 USC §3710(g)(5)
18 38 USC §3703(c), (d)

- limit interest rate adjustments up or down to one percent per year; and
- establish a life-of-mortgage interest rate cap not to exceed the initial (teaser) interest rate on origination by more than five percentage points.[19]

Further, the VA requires the lender to fully explain the features of the ARM to the veteran homebuyer. Disclosures include a hypothetical payment schedule showing the maximum potential payment increases for the first five years of the mortgage term.[20]

GPMs are also eligible to be VA-guaranteed mortgages, provided:

- the period of deferred interest, called *negative amortization*, does not exceed five years;
- the total amount of outstanding principal and interest owed on the mortgage will never exceed the value of the property at the time of origination;
- the monthly payments are increased annually on the mortgage's anniversary date;
- the increase in monthly payments is limited to 7.5% annually; and
- the payments made after the five-year deferred interest period are approximately equal and are sufficient to fully amortize the mortgage over the term remaining on the mortgage.[21]

A GPM will allow a veteran homebuyer to qualify for a larger mortgage than available under a fixed rate mortgage.

Special VA mortgage regulations

The lender's processing of a VA-guaranteed mortgage application is accompanied by procedures and requirements regarding:

- appraisals;
- property standards;
- structural warranties; and
- mortgage funding fees.

Like all mortgage insurers, the VA requires an **appraisal** of the real estate securing the VA-guaranteed mortgage. The appraisal is prepared and submitted by an appraiser who meets the VA's criteria. Generally, the VA will approve an appraiser who has at least five years of appraisal experience.[22]

The VA, on receipt of a copy of the appraisal, determines and sets what it believes to be a reasonable value of the property. The VA prepares and sends a *CRV* to the lender. VA automatic lenders may issue a CRV without sending the appraisal to the VA.[23]

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19 38 USC §3707(b)
20 38 USC §3707(d)
21 38 CFR §36.4310(e)
22 38 CFR §36.4342
23 38 USC §3731

The veteran may agree to pay a purchase price which exceeds the reasonable value set by the VA. However, the VA will only guaranty financing based on the findings of the CRV. The excess in the actual purchase price over the CRV is paid by the veteran or financed separately.

Conversely, the veteran will *not* be required to make a down payment if the CRV is greater than the agreed to purchase price, since the VA lender will finance an amount equal to the CRV.[24]

Property standards

The property which will secure the VA-guaranteed mortgage needs to meet minimum VA eligibility **property standards**.

Property securing a home construction mortgage, or a home constructed within one year before recording the veteran's guaranteed mortgage, needs to meet minimum property requirements for planning, construction and general acceptability prescribed by the VA.[25]

Further, a residence constructed after the enactment of the energy efficiency standards in 1992 needs to comply with the VA standards to qualify for a guaranty.[26]

For construction mortgages, the builder, seller or another person designated by the VA needs to **warrant the construction** will conform to the specifications submitted to the VA for valuation of the property. The construction warranty also protects the veteran homebuyer if the condition of the improvements is misrepresented.[27]

Mortgage fees

The VA is paid a **mortgage funding fee** when the VA issues a guaranty. The amount of the funding fee depends on the amount of down payment made by the veteran, the type of military service performed by the veteran and the purpose of the mortgage.

The funding fee, sometimes called a *guaranty fee*, may be added to the mortgage balance. However, all other closing costs are paid as out-of-pocket expenses of the veteran homebuyer, or paid by the seller.[28]

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24 38 USC §3710(b)(5)
25 38 USC §3704(a)
26 38 USC §3704(f)
27 38 USC §3705(a)
28 38 CFR §36.4313

For a veteran or reservist using their VA entitlement on a purchase-assist or construction mortgage, the funding fees are:

VA purchase-assist or construction loan funding fees

Type of Veteran	Downpayment	Percentage for first time use	Percentage for subsequent use
Regular Military	None	2.15%	3.30%
	5% or more	1.50%	1.50%
	10% or more	1.25%	1.25%
Reserves/ National Guard	None	2.40%	3.30%
	5% or more	1.75%	1.75%
	10% or more	1.50%	1.50%

Source: U.S. Department of Veterans Affairs

For cash-out refinances, the following funding fees are charged:

VA Cash-out refinance funding fees

Type of Veteran	Percentage for first time use	Percentage for subsequent use
Regular Military	2.15%	3.3%*
Reserves/ National Guard	2.40%	3.3%*

Source: U.S. Department of Veterans Affairs

A fee of only 0.5% is charged on a no-cash-out **refinance** which pays off an existing mortgage (VA-guaranteed or conventional) when the refinancing is sought to reduce the interest rate on an existing mortgage.[29]

If the mortgage assists in the purchase of a **manufactured home**, the funding fee is limited to 1% of the mortgage for all veteran homebuyers.[30]

A fee of 0.5% applies to mortgage assumptions.

Veterans who receive compensation from the VA for a service-connected disability are exempt from paying a funding fee. Also, a surviving spouse of a veteran who died while on active duty from a service-connected incident is exempt from paying a funding fee.[31]

These fees are in place through September 30, 2028.

29 38 USC §3729(b); VA Pamphlet 26-7 Chapter 8.8.h
30 38 USC §3729(b)(2)(G)
31 38 USC §3729(c)

Manufactured homes

The VA applies somewhat different regulations on mortgages secured by **manufactured homes**. The VA only guarantees 40%, but not more than $20,000, of a mortgage used to purchase a manufactured home.

Any entitlement previously used by the veteran and not reinstated is subtracted from the $20,000 maximum.

The term of a mortgage used to purchase a manufactured home is limited to:

- 15 years and 32 days, for a mortgage to purchase a lot;
- 20 years and 32 days, for a mortgage to purchase a single-wide manufactured home or a single-wide manufactured home and a lot;
- 23 years and 32 days, for a mortgage to purchase a double-wide manufactured home; or
- 25 years and 32 days, for a mortgage to purchase a double-wide manufactured home and a lot.[32]

The manufacturer of the manufactured home warrants the condition of a manufactured home used to secure a VA mortgage.[33]

Direct mortgages to veterans in rural areas

The VA recognizes the difficulty a veteran may encounter in some **rural areas** locating a lender who is willing to cooperate in the origination of a VA-guaranteed mortgage. As a remedy, the VA will fund mortgages directly to veterans to purchase or improve a residence located in a rural area. Mortgages directly funded to veterans by the VA are subject to the same requirements as other VA-guaranteed mortgages, plus additional direct mortgage conditions.[34]

To qualify for a direct mortgage, the veteran needs to first show the VA they are unable to obtain:

- financing at an interest rate which does not exceed the rate authorized by the VA; or
- a mortgage from the Secretary of Agriculture.[35]

The **maximum amount** of a direct mortgage to a veteran is $33,000. Veterans who qualify for the full $36,000 VA-guaranty entitlement may borrow up to the $33,000 maximum through this program.

Veterans whose available guaranty entitlement is less than $36,000 may borrow a mortgage amount which bears the same ratio to $33,000 as the amount of the veteran's remaining guaranty bears to $36,000. This amount is further limited to a maximum of 91.67% of their remaining VA mortgage entitlement.[36]

For example, suppose a veteran interested in a direct mortgage is currently eligible for $18,000 of guaranty entitlement. The veteran compares their

32 38 USC §3712(d)(1)
33 38 USC §3712(i)
34 38 USC §3711(a)
35 38 USC §3711(c)
36 38 CFR §36.4503(a)

CalVet mortgage program

The California Department of Veterans Affairs (CalVet) mortgage program offers variable rate mortgages to qualified veterans for:

- *the purchase of farms, homes, condominiums or mobilehomes; and*
- *the construction of a home. [Calif. Military and Veterans Code §987.53(a), (b)]*

A CalVet mortgage provides a veteran with a variable interest rate which is generally below market interest rates, low monthly payments and flexible credit standards, as compared to conventional financing, or mortgages insured by the Federal Housing Administration (FHA) or guaranteed by the U.S. Department of Veterans Affairs (VA).

Mortgage companies certified by CalVet originate CalVet mortgages directly with veterans. Money for the CalVet mortgage program is raised by the sale of California state general obligation bonds.

CalVet mortgages are available to qualified veterans, whether or not the veteran lived in California at the time the veteran entered active duty. [M & V C §980]

When negotiating the purchase of a home, a veteran seeking a CalVet mortgage submits an application to CalVet or a direct mortgage lender certified by CalVet.

California residents who served and were honorably discharged, or honorably released from active duty during World Wars I and II, the Korean Conflict and the Vietnam War, and citizens on active duty during Desert Storm and Operation Desert Shield or Operation Restore Hope in Somalia, are veterans who may qualify for a CalVet mortgage. [M & V C §980]

An unremarried surviving spouse of a veteran who lived in California for six months prior to entering active military duty may qualify for a CalVet mortgage if the veteran:

- *was killed in the line of duty;*
- *died after discharge from injuries incurred in the line of duty;*
- *is being held as a prisoner of war; or*
- *is designated as missing in action. [M & V C §987.58(b)-(c)]*

Once CalVet determines the veteran is eligible for a mortgage, CalVet needs to approve the farm or home the veteran is purchasing, or plans for any proposed residence to be constructed by the veteran. [M & V C §987.59]

If the veteran qualifies for a CalVet mortgage, and the property and the price the veteran agreed to pay for the property are approved, CalVet intervenes in the sales transaction by becoming the purchaser of the property in lieu of the veteran, an archaic mortgage financing documentation often also used to avoid the appearance of charging interest.

CalVet, in a legally fictitious transaction, "resells" the property to the veteran by entering into a CalVet mortgage agreement with the veteran for the amount advanced by CalVet as purchase-assist financing. [M & V C §987.60]

CalVet holds legal title to the property as security for repayment of the loan. The veteran is the actual owner of the property, with equitable ownership. It is a title arrangement similar to a loan secured by a motor vehicle, or a sale of real estate on a land sales contract, or leasing arrangement with title conveyed to the homebuyer on expiration of the lease without further monies due. [M & V C §987.60(a)(3)(A)]

guaranty entitlement to the $36,000 maximum figure and discovers that their entitlement is 50% of the maximum. Here, they are eligible for a direct mortgage of 50% of $33,000, or $16,500.

Direct mortgages to veterans carry an interest rate of 7.5%. However, if the mortgage is used to fund home improvements, the interest rate is 9%.[37]

37 38 CFR §36.4503(a)

The veteran homebuyer is charged a **funding fee** of $50 or 1% of the mortgage amount, whichever figure is greater. The funding fee is 2% of the mortgage amount if the mortgage requires progress disbursements, as is the case with a construction mortgage.[38]

Closing costs incurred by the veteran homebuyer, including VA fees, insurance, recording fees, taxes, etc., are paid in cash as out-of-pocket expenses of the veteran or seller, not from the proceeds of the direct mortgage.[39]

The term of a direct mortgage may not exceed 25 years and 32 days. However, the VA may extend the term for up to five years if necessary to prevent a default on the mortgage.[40]

A direct mortgage to a veteran is not assumable without the written consent of the VA. If the VA consents, the assuming party is subject to the same assumption fees and costs imposed on the assumption of a VA-guaranteed mortgage.[41]

Assuming a VA mortgage

The VA mortgage assumption policy is entirely different from the Federal Housing Administration (FHA) assumption policy.

A buyer of property secured by a VA-guaranteed mortgage may take over the mortgage if:

- the mortgage is **current**;
- the buyer **assumes** the mortgage; and
- the buyer is **creditworthy**.[42]

For a buyer to assume a VA-guaranteed mortgage, a fee of 0.5% of the mortgage balance is to be paid to the VA by the buyer.[43]

The VA **assumption fee** is to be paid to the lender on closing the sale with the buyer. The lender has 15 days to forward the fee to the VA or the lender faces late charges.[44]

Additionally, the lender charges and retains an assumption fee of the lesser of:

- $300, plus the costs of a credit report; or
- the maximum amount for an assumption fee allowed under state law.[45]

38 38 CFR §36.4504(b)(1)
39 38 CFR §36.4504(b)(3)
40 38 CFR §§36.4505(a), 36.4506
41 38 CFR §36.4508
42 38 USC §§3713(a); 3714(a)(1)
43 38 USC §3729(b)(2)(I)
44 38 CFR §36.4313(e)(2)
45 38 CFR §36.4313(d)(8)

When an assumption application is approved by the lender, the original VA homebuyer is released from further liability to the VA under the mortgage insurance program, including liability for losses caused by the buyer's default in payments.[46]

However, the veteran who is released by the VA is not necessarily released by the lender from further liabilities for the mortgage. For instance, the veteran who **refinances** their home with a VA-guaranteed mortgage has liability to the VA for any deficiency in the property value to cover the mortgage.

The veteran exposed to refinancing liability needs to consider negotiating and entering into a *novation agreement* with the lender in order to be relieved of liability for a potential deficiency. Liability to a lender for a mortgage used to refinance a property is different from the mortgage insurance liability the veteran has with the VA.

A **novation agreement** requires the consent by three parties — the buyer, seller and lender — to release the seller from further liability to the lender when the seller is released from mortgage insurance liability by the VA under a *substitution of liability*.

novation agreement
An agreement entered into by a mortgage holder, buyer and seller to shift responsibility for a mortgage obligation to the buyer by an assumption and release the seller of liability.

If the lender refuses to allow the buyer to assume the mortgage, the VA may review the findings and determine whether the buyer is entitled to assume the mortgage.

If the veteran is unable to make payments on their VA-guaranteed mortgage, but finds a qualified buyer to assume the mortgage, the VA may require the lender to agree to the mortgage assumption since it is in the best interest of the VA.[47]

However, neither the lender nor the VA has to release the seller from liability on the mortgage when the assumption is granted to avoid foreclosure.[48]

If the VA refuses to allow the buyer to assume the mortgage, and the original veteran homebuyer sells the property nonetheless, the lender may call the mortgage and demand payment of the remaining principal and interest without prior approval from the VA.[49]

Also, the lender may call the VA mortgage if the original veteran homebuyer sells their personal residence and fails to notify the lender of the sale.[50]

However, when a lender becomes aware the original veteran homebuyer sold the property secured by a VA-guaranteed mortgage and the lender fails to notify the VA, the lender, not the seller, is liable for any VA losses on the mortgage.[51]

46 38 CFR §36.4326(h)
47 38 USC §3714(a)(4)(B)
48 38 CFR §36.4326(h)(2)
49 38 USC §3714(a)(4)(C)
50 38 USC §3714(b)
51 38 USC §3714(c)

The IRRRL

The VA-guaranteed **Interest Rate Reduction Refinance Loan (IRRRL)** was created to refinance an existing VA-guaranteed home mortgage, at a lower interest rate. It's the VA's version of a rate-and-term refinance.[52]

Interest Rate Reduction Refinance Loan (IRRRL)
A U.S. Department of Veterans Affairs (VA)-guaranteed refinance that lowers the interest rate of an existing VA-guaranteed mortgage.

IRRRLs may not be used to cash out equity. IRRRL proceeds may only be applied towards:

- paying off the existing VA mortgage and paying closing costs; or
- energy-efficient improvements.[53]

An IRRRL may not be used to pay off liens other than the existing VA mortgage.

Additionally, IRRRLs needs to replace the existing VA mortgage as the first lien on the same property. Second lien holders need to subordinate.[54]

IRRRLs can be either:

- FRMs; or
- hybrid ARMs.

Generally, appraisal, credit information and underwriting are not required on an IRRRL, and lenders may close an IRRRL automatically.[55]

However, the IRRRL needs to have a lower interest rate and principal and interest payment than the VA mortgage it is refinancing, unless:

- the IRRRL is refinancing an ARM;
- the term of the IRRRL is shorter than the term of the existing VA mortgage; or
- energy-efficient improvements are included in the IRRRL.[56]

In any of these cases, the veteran's monthly payment may increase. If the PITI payment increases by 20% or more, the lender is to:

- determine the veteran qualifies for the new payment; and
- include a certification that the veteran qualifies for the new monthly payment.[57]

Maximum IRRRL amount and terms

VA Form 26-8923, the **IRRRL Worksheet,** is used to calculate the maximum mortgage amount available on an IRRRL. The maximum mortgage amount is the existing VA mortgage balance, plus:

- late fees and late charges, if the mortgage is past due;
- allowable fees and charges, up to two discount points;
- the costs of any energy efficient improvements; and
- the VA funding fee.[58]

52 VA Pamphlet 26-7 Chapter 6.1.a
53 VA Pamphlet 26-7 Chapter 6.1.f
54 VA Pamphlet 26-7 Chapter 6.1.j
55 VA Pamphlet 26-7 Chapter 6.1.a
56 VA Pamphlet 26-7 Chapter 6.1.c
57 VA Pamphlet 26-7 Chapter 6.1.c
58 VA Pamphlet 26-7 Chapter 6.1.g

IRRRLs do not impact the veteran's use of their entitlement, though the amount of the IRRRL impacts the guaranty on the mortgage.

For example, a veteran's existing VA-guaranteed mortgage was originally made for $110,000 with a guaranty of $27,500, or 25%. The new IRRRL is for $112,000. The guaranty on the new mortgage is $28,000 or 25%, but the veteran's entitlement use remains at $27,500.

Here's another example: a veteran's existing VA-guaranteed mortgage was originally made for $42,000 with a guaranty of $25,000, or almost 60% (the percentage applicable under former law). The new IRRRL is for $40,000. The guaranty on the new mortgage is $20,000 or 50%, but the veteran's entitlement use remains at $25,000.

The maximum mortgage term for an IRRRL is the term of the original VA mortgage, plus 10 years, but not to exceed 30 years and 32 days. For example, if the existing VA mortgage is a 15-year mortgage, the new mortgage can't exceed 25 years.[59]

Refinancing delinquent mortgages

As indicated above, IRRRLs may be used to refinance past-due mortgages. However, if delinquent payments are included, the mortgage amount is to be submitted to the VA for approval, even if the lender has automatic authority to make the VA mortgage.[60]

Before submitting the mortgage to the VA for approval, the veteran needs to provide evidence that:

- the cause of the delinquency has been resolved; and
- the veteran is willing and able to make the proposed mortgage payments.[61]

The following items are to be submitted in order to refinance a delinquent mortgage:

Item	Information
1	The full name of the veteran and all other parties obligated on the prior mortgage and to be obligated on the new mortgage.
2	The VA mortgage number and month and year of origination of the mortgage to be refinanced.
3	The name and address of the lender proposing to make the mortgage.
4	The approximate proposed mortgage amount, interest rate, and term for the new mortgage versus the old mortgage.
5	Discount to be charged, expressed as a percentage of the mortgage and a dollar amount.

59 VA Pamphlet 26-7 Chapter 6.1.i
60 VA Pamphlet 26-7 Chapter 6.1.g
61 VA Pamphlet 26-7 Chapter 6.2.a

6	Statement signed by the veteran acknowledging the effect of the refinancing mortgage on the veteran's mortgage payments and interest rate. • The statement shows the interest rate and monthly payments for the new mortgage versus that for the old mortgage. • The statement also indicates how long it will take to recoup ALL closing costs (both those included in the mortgage and those paid outside of closing).
7	The appropriate certification concerning occupancy signed by the veteran or the spouse of an active duty servicemember. One of the following is signed. "I have previously occupied the property securing this mortgage as my home." ____________________ veteran's signature "While my spouse was on active duty and unable to occupy the property securing this mortgage, I occupied the property securing this mortgage as my home." ____________________ spouse's signature
8	VA Form 26-8923, Interest Rate Reduction Refinancing Mortgage Worksheet.
9	VA Form 26-8937, Verification of VA Benefits (if applicable).
10	Certificate of Eligibility, or, if unavailable, a request for a duplicate certificate VA Form 26-1880, Request for a Certificate of Eligibility.
11	Uniform Residential Mortgage Application (URLA).
12	Explanation of the reason(s) for the mortgage delinquency, including appropriate documentation to verify the cause.
13	Documentation to verify that the cause of the delinquency has been corrected.
14	Credit report (in-file credit report is acceptable).
15	Current pay stub and telephone verification of current employment.
16	VA Form 26-6393, Mortgage Analysis.
17	Documentation of the cost of energy efficiency improvements to be included in the mortgage, if known. See section 3 of chapter 7. For cash reimbursement of the veteran, the improvements are completed within the 90 days immediately preceding the date of the mortgage.

Homebuyer eligibility

Homebuyers on existing VA mortgages are to be the same homebuyers on the IRRRL.[62]

Parties Obligated on Old VA Mortgage		Parties to be Obligated on new IRRRL	Is IRRRL Possible?
1	Unmarried veteran	Veteran and new spouse	Yes
2	Veteran and spouse	Divorced veteran alone	Yes
3	Veteran and spouse	Veteran and different spouse	Yes
4	Veteran alone	Different veteran who has substituted entitlement	Yes
5	Veteran and spouse	Spouse alone (veteran died)	Yes
6	Veteran and nonveteran joint mortgage obligors	Veteran alone	Yes
7	Veteran and spouse	Divorced spouse alone	No
8	Unmarried veteran	Spouse alone (veteran died)	No
9	Veteran and spouse	Different spouse alone (veteran died)	No
10	Veteran and nonveteran joint mortgage obligors	Nonveteran alone	No

The VA does not require credit/income documentation or re-underwriting of IRRRLs when the borrower is not the original homebuyer. However, lenders may check payment history, or obtain statements regarding the new borrower's ability to repay the mortgage.[63]

The veteran, or surviving co-homebuyer spouse needs to own the property, but they are not required to occupy the property as their principal residence. Thus, the IRRRL can refinance a prior home which is now an investment or second home.[64]

Veteran's certification required for IRRRL

For all IRRRLs, the veteran needs to sign a statement which acknowledges the effect the refinancing will have on the veteran's mortgage payments and interest rate.

The statement is to be on the lender's letterhead, and include:

- the interest rate and monthly payments on the existing VA-guaranteed mortgage;
- the interest rate and monthly payments on the proposed IRRRL;
- a statement indicating how long it will take to recoup closing costs paid inside and outside of closing in relation to monthly payment savings; and

62 VA Pamphlet 26-7 Chapter 6.1.k
63 VA Pamphlet 26-7 Chapter 6.1.l
64 VA Pamphlet 26-7 Chapter 6.1.m

FHA vs. VA

A prospective homebuyer meets with their mortgage loan originator (MLO) agent to discuss purchase-assist financing options. Since the homebuyer has little knowledge of their mortgage options, the MLO begins by asking the homebuyer questions about their finances and other circumstances to ascertain what type of mortgage is best for the homebuyer.

The MLO asks the homebuyer several questions to obtain pertinent information for mortgage placement. The following information is determined:

- *the homebuyer served in active duty for more than 180 days in the regular military;*
- *the homebuyer is a first-time homebuyer, and thus has no mortgage debt;*
- *the homebuyer's current rental payments are about $1,900 per month;*
- *the homebuyer has been employed at their current job for five years;*
- *the geographic area for the property the homebuyer is interested in purchasing;*
- *the homebuyer's gross monthly income, averaged over the last two years, is $7,750;*
- *the homebuyer makes a $300 monthly auto payment, and has made these payments on time;*
- *the homebuyer now keeps a balance of less than $100 on both of their credit cards, but had one 30-day late payment for two years prior to the application due to a past financial difficulty;*
- *the homebuyer only wants a 30-year fixed rate mortgage (FRM), and does not want to review adjustable rate mortgage (ARM) options;*
- *the homebuyer wants to put as little down as possible to keep more money in their emergency household reserves;*
- *the homebuyer has a 640 credit score;*
- *the homebuyer has no other financial debts (e.g. student loans, alimony, child support, etc.); and*
- *the homebuyer has savings of $30,000.*

Based on the information received, the MLO discusses possible mortgage options with the homebuyer. Since the homebuyer has limited savings, the MLO informs them after closing costs and reserve requirements, the homebuyer will only be able to make a small down payment. Therefore, their options are limited to taking out:

- *an FHA mortgage with a minimum 3.5% down payment;*
- *a conventional mortgage with a minimum 3% down payment, as allowed by Fannie Mae and Freddie Mac; or*
- *a U.S. Department of Veterans Affairs (VA)-guaranteed mortgage with no minimum down payment.*

The MLO begins their calculations to give the homebuyer options.

The MLO first determines the homebuyer's maximum debt-to-income ratio (DTI). The MLO uses the FHA standard for total DTI is 43% of the homebuyer's $7,750 gross effective income.

Thus, the maximum total monthly expenditure allowed for all debts is approximately $3,333. The maximum monthly housing expenditure would be capped at 31% of the gross effective income, which is around $2,402.

Based on the homebuyer's preference for a 30-year (FRM), the MLO determines the homebuyer's up-front mortgage insurance premium (MIP) is 1.75% and their annual MIP is 0.85% of the base mortgage amount for an FHA-insured mortgage.

The MLO uses a 1.5% estimate to determine taxes and insurance on the property, and a 3.75% interest rate based on interest rates available from the lenders the MLO does business with on a no points, no fees FHA-insured mortgage.

FHA vs. VA cont'd

The MLO then calculates the homebuyer's maximum purchase price at $370,000. With a 3.5% down payment of $12,950, the base mortgage amount is $357,050. After financing the up-front MIP of $6,249 ($357,050 base mortgage amount x 1.75% UFMIP), the final FHA mortgage amount is $363,299. The resulting payment is around $2,398, just below the 31% housing DTI.

With the maximum payment of $2,402, the $300 car payment, and their minimum $40 monthly credit card payments, the homebuyer's total monthly debt would be $2,742 at a 35% total DTI.

Under the FHA-insured mortgage, the homebuyer down payment of 3.5%, or $12,950, plus the estimated closing costs of approximately 4%, or $14,800, will leave the homebuyer with a $2,250 cushion in their savings.

The MLO then completes a similar analysis for the VA-guaranteed mortgage. The maximum total DTI guideline for a VA-guaranteed mortgage is 41% of the homebuyer's income, which is $3,178. However, since VA-guaranteed mortgages give qualified homebuyers the ability to purchase a home with no down payment and no mortgage insurance, the homebuyer's purchasing power has increased.

On a VA-guaranteed 30-year fixed rate mortgage with a 3.75% interest rate, and no discount or origination fees, the homebuyer has a maximum VA mortgage purchase price of $400,000. However, the VA funding fee is usually financed (but can be paid in cash at closing). Since the homebuyer chooses to finance the funding fee, the monthly mortgage payment is roughly the same as the comparable FHA-insured mortgage: $2,397.

The MLO then checks to make sure the homebuyer still qualifies under the second prong of the VA income qualification standard: residual income, defined as the income remaining to cover family living expenses (e.g. food, gasoline) after subtracting monthly shelter expense. [VA Pamphlet 26-7 Chapter 4.9.e]

The homebuyer lives in the West, and is unmarried, without children. Thus, the veteran needs to have a residual income of at least $491.

Since the homebuyer's gross income is $7,750, their total monthly debt, including estimated federal and state taxes, will leave them around $3,000 in residual income.

Based on the MLO's review of the homebuyer's files and their discussion with the homebuyer, the MLO believes there are no additional expenses to significantly reduce this residual amount and cause the homebuyer to no longer qualify.

Under the VA-guaranteed mortgage, the homebuyer will have to pay a VA funding fee of 2.15%, or $8,600 ($400,000 mortgage amount x 2.15%), which the homebuyer chooses to finance, including it in the monthly mortgage payment. Just like the FHA-insured mortgage, the veteran will also have to pay closing costs of roughly 4%, or $16,000. This leaves the veteran a total cushion of $14,000 in savings.

The MLO knows the total payment is reduced if the homebuyer determines they will purchase a home for less than the $400,000, or if the homebuyer negotiates with the seller to pay some of the closing costs, options any buyer's agent needs to consider when preparing a purchase offer.

The MLO surveys the options available from three lenders the MLO regularly does business with, in accordance with the rules prohibiting steering. They come up with several different options for their homebuyer, and present them, along with their logic in the analysis for an FHA-insured mortgage vs. a VA-guaranteed mortgage.

It is best for the homebuyer to submit mortgage applications to at least two lenders to ensure they receive the best mortgage terms. Just like consumers shop for the best deal on a car, shopping around for a mortgage yields the best and most competitive mortgage terms available. Further, without a backup application concurrently processed by another lender, the buyer is left with no opportunity to reject any lender changes.

Our homebuyer reviews the neighborhood in which they are shopping and finds a home with a list price of $400,000.

The homebuyer thus chooses the VA-guaranteed mortgage, since at a $400,000 purchase price, they are able to afford more property at the same monthly payment. With the FHA-insured mortgage, the homebuyer would have only qualified for $370,000, far below their eventual purchase price.

- if the monthly payment increases more than 20%, the certification that the veteran qualifies for the new monthly payment.[65]

For example, if a veteran's monthly payment decrease by $50, but the veteran pays $5,000 in closing costs, the recoup period is 100 months — $5,000 divided by $50.

Lenders are to report all mortgages to the VA within 60 days of closing.[66]

65 VA Pamphlet 26-7 Chapter 6.1.d
66 VA Pamphlet 26-7 Chapter 6.1.q

Chapter 23 Summary

The U.S. Department of Veterans Affairs (VA) mortgage guarantee program is specially designed to assist qualified veterans to buy a home with zero down payment.

Mortgages guaranteed by the VA are limited to mortgages which finance property to be occupied by the veteran or their spouse as their principal residence, or for veterans currently on active duty.

A VA-guaranteed mortgage is originated and funded by an institutional lender or mortgage banker. The VA guarantees payment of a portion of the mortgage if the veteran defaults and the lender suffers a loss on the mortgage. The amount guaranteed by the VA varies according to the mortgage amount. Further, the VA-guaranteed portion of the mortgage varies over the life of the mortgage based on the outstanding mortgage amount.

The maximum dollar amount of entitlement per veteran applies to all VA-guaranteed mortgages made to the same veteran.

Even though a veteran may have used their maximum guaranty entitlement to obtain a VA-guaranteed mortgage, they may obtain another VA-guaranteed mortgage in the future.

Financial institutions subject to governmental supervision and mortgage bankers in compliance with VA lender guidelines are allowed to certify mortgages conforming to VA regulations. The VA has set credit history standards and income criteria veterans meet to qualify for a VA-guaranteed mortgage. However, positive compensating factors possessed by the veteran are considered if their residual income is below VA guidelines or their debt-to-income ratio is above 41%.

The three basic categories of mortgages which qualify for a VA mortgage guaranty are:

- fixed rate mortgages (FRMs);
- adjustable rate mortgages (ARMs); and

- graduated payment mortgages (GPMs).

The VA imposes separate restrictions on each type of mortgage offered.

Like all mortgage insurers, the VA requires an appraisal of the real estate securing the VA-guaranteed mortgage. The appraisal is prepared and submitted by an appraiser who meets the VA's criteria.

The property which will secure the VA-guaranteed mortgage needs to meet minimum VA eligibility property standards.

The VA is paid a mortgage funding fee when the VA issues a guaranty. The amount of the funding fee depends on the amount of down payment made by the veteran, the type of military service performed by the veteran and the purpose of the mortgage.

The VA applies somewhat different regulations on mortgages secured by manufactured homes.

The VA will fund mortgages directly to veterans to purchase or improve a residence located in a rural area. Mortgages directly funded to veterans by the VA are subject to the same requirements as other VA-guaranteed mortgages, plus additional direct mortgage conditions.

A buyer of property secured by a VA-guaranteed mortgage may take over the mortgage if:

- the mortgage is current;
- the buyer assumes the mortgage; and
- the buyer is creditworthy.

The VA-guaranteed Interest Rate Reduction Refinance Loan (IRRRL) was created to refinance an existing VA-guaranteed home mortgage, at a lower interest rate. It's the VA's version of a rate-and-term refinance.

Chapter 23 Key Terms

Notes:

Chapter 24

Home equity lines of credit

Learning Objectives

After reading this chapter, you will be able to:

- identify a home equity line of credit (HELOC);
- review the features and functions of a HELOC;
- understand the proper timing of HELOC disclosures;
- discuss the triggers for the change or termination of a HELOC;
- advise on the tax ramifications of a HELOC; and
- understand the impact HELOCs have on the real estate market.

Key Terms

draw period
end of draw (EOD) period
freeze
home equity line of credit (HELOC)

Drawing equity out

A homeowner with equity in their home may arrange for access to funds they can draw on as needed, up to a set amount, called a *line of credit*. The right to draw money is evidenced by a mortgage encumbering a one-to-four unit residential property, called a **home equity line of credit (HELOC).**

home equity line of credit (HELOC)
A mortgage giving a homeowner access to draw on their home's equity.

The right to withdrawn funds from time to time with a HELOC is in contrast to the lump-sum funding of a purchase-assist mortgage to acquire property.

HELOCs take a junior position to purchase-assist mortgages or refinances.[1]

Like a consumer mortgage, a mortgage broker arranging a HELOC is subject to Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act)

1 12 Code of Federal Regulations §§1026.40 et seq.

registration, licensing and endorsement requirements. However, unlike consumer mortgages HELOCs are not subject to ability-to-repay (ATR) or qualified mortgage (QM) standards for underwriting.[2]

HELOC features

To arrange a HELOC, the lender approves the homeowner for a line of credit amount based on a percentage of the home's equity. Equity is calculated as the property value minus the balance owed on any existing mortgage.

The line of credit amount is the total dollar amount the homeowner may withdraw. The principal debt owed on a HELOC is the total amount withdrawn by the homeowner and not yet repaid.

Additionally, the annual percentage rate (APR) on a HELOC is the note interest rate. No other charges or fees are used to calculate the APR.[3]

Consider a home which appraises for $200,000. The lender approves the homeowner for a 75% loan-to-value ratio (LTV) draw ($150,000). However, the homeowner owes $50,000 on their first mortgage. Thus, $150,000 – $50,000 equals a potential line of credit of $100,000.

draw period
The time period during which the homeowner may draw on the funds in a home equity line of credit (HELOC).

end of draw (EOD) period
The time period following the draw period during which the home equity line of credit (HELOC) resets and the homeowner begins making monthly payments of principal and interest.

The lender and the homeowner decide on a **draw period** during which the homeowner can draw up to the maximum approved amount, similar to the revolving balance on a credit card, the ATM effect for home equity. The typical draw period is ten years.

During the draw period, HELOC payments are limited to interest. HELOC payments may be made with HELOC funds.

Once the draw period has passed, the HELOC reaches the **end of draw (EOD)** or **amortization period**. At this point, the HELOC resets and the homeowner owes monthly payments of principal in addition to interest (or in some cases, a final balloon payment). No more funds may be withdrawn after the HELOC resets.

For example, consider a HELOC with:

- a debt balance of $100,000;
- a variable interest rate, currently 7%, which adjusts based on an agreed-to **index rate**;
- a ten-year *draw period*, in which the homeowner makes interest only payments; and
- a ten-year *amortization period* with monthly payments of **principal and interest (PI).**

During the ten-year draw period, the homeowner makes monthly, interest-only payments of $583. Then after ten years the HELOC resets, with a new monthly *PI* payment of $1,160 at the 7% interest rate. This rate — and the payment — will adjust (upwards) as the index rate increases.

2 Calif. Business and Professions Code §10166.02(a); 12 CFR §1026.43(a)(1)
3 12 CFR §1026.40(d)(6)

HELOC disclosures

HELOC-specific disclosures are handed to HELOC applicants. If the HELOC application is taken in person by the lender, the disclosures are delivered by the lender at the time of application.

If the application is taken in person by an mortgage loan originator (MLO) who is arranging the HELOC on behalf of the lender, the MLO is responsible for handing the homeowner the "What You Should Know About Home Equity Lines of Credit" brochure on receipt of the application.[4]

When the lender takes an application by phone, mail or through an intermediary MLO agent, the disclosures need to be placed in the mail no later than three business days after taking the information for the application.[5]

Disclosure content

The HELOC disclosures need to be grouped together, but separated from other disclosures provided to the homeowner.[6]

The disclosures needed to physically precede other HELOC disclosures include:

- a statement that the homeowner is advised to retain a copy of the HELOC disclosures;
- a timeline for the homeowner to submit an application to receive the terms disclosed;
- identification of any terms subject to change prior to the opening of the HELOC;
- a statement that the homeowner will receive a refund of all fees paid in connection with the application if the disclosed terms change prior to the opening of the HELOC and they opt out of opening the HELOC;
- a statement that the homeowner's dwelling will be security for the HELOC and a default in the HELOC may result in the loss of the dwelling;
- a statement informing the homeowner that the lender may:
    - terminate the HELOC and require payment of the outstanding balance in a single payment and impose fees upon termination;
    - prohibit additional extensions of credit under the HELOC, called a **freeze**; or
    - reduce the credit limit; and
- a list of conditions under which the lender may terminate, freeze or reduce the credit limit.[7]

freeze
A prohibition against additional extensions of credit under a home equity line of credit (HELOC).

Disclosures which follow the above disclosures include:

- the payment terms of the HELOC, including:
    - the length of the draw and repayment periods; and

4 12 CFR §1026.40(c)
5 12 CFR §1026.40(b); 12 CFR §1026.40(c)
6 12 CFR §1026.40(a)
7 12 CFR §1026.40(a)(2); 12 CFR §1026.40(d)(1)-(4)(ii)

  - an explanation and example of the minimum periodic payment's effect on the HELOC principal;
- when interest begins to accrue and how it is calculated;
- the length of any grace period;
- an example of the minimum periodic payment's effect on the HELOC principal;
- an APR, based on APRs available in the preceding 12 months;
- a statement that the APR does not include costs other than interest;
- an itemization of the fees the lender charges to open, use or maintain the HELOC, and when the fees are payable;
- a good faith estimate of fees charged by others and a statement that the homeowner may receive a good faith itemization of charges upon request;
- a notification that negative amortization may occur;
- a disclosure of the maximum number of credit extensions allowable within a given time period, minimum outstanding balance and minimum draw requirements;
- a statement advising the homeowner to consult a tax professional regarding potential deductibility of the interest and fees associated with the HELOC;
- the homeowner's rights regarding billing errors; and
- the "What You Should Know About Home Equity Lines of Credit" brochure published by the Consumer Financial Protection Bureau (CFPB).[8]

Adjustable rate disclosures

On HELOCs with adjustable interest rates, the disclosures also include:

- a disclosure that the interest rate may change;
- a statement that the APR is the same as the interest rate;
- the index used when making rate adjustments;
- an explanation of how the APR is determined, including how the index is adjusted;
- a statement advising the homeowner to ask about current index, margin, discounts, premiums and APR values;
- a disclosure that the initial APR is not based on the index and margin used to make later adjustments to the interest rate;
- the period of time the initial APR is in effect;
- the frequency of changes in the APR;
- the events which trigger a rate increase;
- limitations on rate increases;
- the effect of rate increases; and

8 12 CFR §1026.6(a); 12 CFR §1026.40(d)(5)-(e)

- an explanation and example of the minimum periodic payment's effect on the HELOC principal.[9]

The lender may not charge nonrefundable fees in connection with the application until three business days have passed after the homeowner receives the HELOC disclosures.[10]

Homeowners have the option to cancel a HELOC within three business days after a HELOC account is opened when the HELOC is secured by their principal residence.[11]

Changing terms on a HELOC

Once a HELOC mortgage has been recorded, the terms for draws and repayments may change only if:

- the change is explicitly included in the terms of the HELOC agreement, such as an interest rate adjustment for an adjustable HELOC;
- the lender indicated in the initial HELOC agreement that it may prohibit additional extensions of credit or reduce the credit limit after reaching the maximum interest rate;
- the HELOC agreement indicates that the terms will change upon specific events such as the homeowner's loss of employment;
- the index used under the original HELOC agreement is no longer available;
- the homeowner agrees in writing to the change;
- the change will benefit the homeowner;
- the change will be technical or insignificant, such as a change in number rounding practices;
- the value of the dwelling declines below its original appraised value;
- the lender believes the homeowner will be unable to repay the HELOC due to a change in the homeowner's financial circumstances;
- the homeowner is in default on a material obligation under the HELOC, as agreed to by the lender and homeowner;
- the lender is no longer able to offer the interest rate in the mortgage agreement due to new government laws prohibiting usury;
- the lender's security interest in the property is less than 120% of the credit line; or
- the lender is notified by a regulatory agency that further extensions of funds are unsafe and unsound.[12]

If a change is triggered, the lender is to deliver to the homeowner a written notice of the change 15 days or more before the change.[13]

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9 12 CFR §1026.40(d)(12)
10 12 CFR §1026.40(h)
11 12 CFR §1026.15
12 12 CFR §1026.40(f)(3)
13 12 CFR §1026.9(c)(1)

However, for a freeze or reduction in the line of credit, the written notice is to be mailed or delivered to the homeowner within three business days after the freeze or reduction. The notice needs to include the reason for the freeze or reduction.[14]

A homeowner may rebut the circumstances leading to a freeze or reduction in line of credit.

Premature termination

A lender may not **terminate** the HELOC and require full payment of the outstanding balance before the end of the HELOC term unless:

- the homeowner misrepresented facts in connection with the application for the HELOC;
- the homeowner fails to make timely payments under the terms of the HELOC; or
- the homeowner impairs the dwelling securing the mortgage, such as by failing to pay property taxes.[15]

Recourse/ nonrecourse

HELOCs funding a home's remodel are **nonrecourse debt.** Thus, the lender is unable to pursue the homeowner for additional money when the proceeds from the foreclosure sale of the home do not cover the amount due.[16]

However, HELOCs used to fund any other purpose are considered recourse debt. With liability attached, the lender may choose to judicially foreclose to pursue the homeowner for the additional funds.

Deducting interest paid on a HELOC

Interest paid on a HELOC secured by a principal residence or second home may be deducted as interest on mortgages which fund acquisition or improvements up to a combined principal amount of $375,000 ($750,000 for married couples filing jointly).

To qualify as a home improvement mortgage for interest deductions, the new improvements need to substantially:

- add to the property's market value;
- prolong the property's useful life; or
- adapt the property to residential use.

Mortgage funds spent on repairing and maintaining property to keep it in good condition do not qualify as funding for substantial improvements.[17]

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14 12 CFR §1026.9(c)(1)(iii)

15 12 CFR §1026.40(f)(2)

16 Calif. Code of Civil Procedure §580b

17 26 United States Code §163; Temporary Revenue Regulations §1.163-8T

The danger of HELOC overuse

Obtaining a HELOC allows a homeowner to liquidate the equity in their property without selling it. Thus, the use of HELOCs increases when home prices are increasing.

However, too many homeowners taking out HELOCs at the same time contributes to a destructive housing climate, a condition controlled primarily by lenders. During the Millennium Boom, HELOCs seemed to mortgage lenders like an ideal product for many homeowners. Home values continually rose, with no acknowledged end in sight.

Many homeowners who took out HELOCs during the Millennium Boom made only interest payments on their HELOCs. When home values plummeted, many homeowners were left with nothing but negative equity and a silently looming payment shock on their HELOCs.

These cycles repeat themselves, mirroring the constant rise and fall of real estate prices during normal business recessions.

Homeowners who are unable to make up the payment difference will find themselves selling the property or defaulting and on their way to **foreclosure**, or a short sale.

Chapter 24 Summary

A homeowner with equity in their home may arrange for access to funds they can draw on as needed, up to a set amount, called a line of credit. The right to draw money is evidenced by a mortgage encumbering a one-to-four unit residential property, called a home equity line of credit (HELOC). HELOCs take a junior position to purchase-assist mortgages or refinances.

The line of credit amount is the total dollar amount the homeowner may withdraw. The principal debt owed on a HELOC is the total amount withdrawn by the homeowner and not yet repaid.

HELOC-specific disclosures are handed to HELOC applicants. The HELOC disclosures need to be grouped together, but separated from other disclosures provided to the homeowner.

Once a HELOC mortgage has been recorded, the terms for draws and repayments may change only under certain circumstances. If a change is triggered, the lender is to deliver to the homeowner a written notice of the change 15 days or more before the change.

Interest paid on a HELOC secured by a principal residence or second home may be tax deductible.

Chapter 24 Key Terms

Chapter 25

Reverse mortgages

Learning Objectives

After reading this chapter, you will be able to:

- appreciate the current demographics driving reverse mortgage demand in the United States, and forecasts for demand in the future;
- understand the basic functions of a Federal Housing Administration (FHA)-insured home equity conversion mortgage (HECM);
- apply the qualifications and rules for originating a HECM; and
- advise on the events triggering repayment of a HECM.

Key Terms

eligible non-borrowing spouse

home equity conversion mortgage (HECM) program

life expectancy set-aside

line of credit payment

lump sum option

mandatory obligation

maximum claim amount

principal limit

property charges

reverse mortgage

tenure payment

term payment

The Baby Boomer effect

The massive Baby Boomer generation, defined by the U.S. Census Bureau as the generation born between 1946 and 1964, is well on its way to retirement.

Citizens aged 65-75 are more likely to own their home than any other age group. The vast majority of retirees will continue to pursue some form of traditional homeownership as they have come to abhor renting.

The decision to retire is often swiftly followed by a series of lifestyle changes. One of the most significant changes is the downward change in the retiree's flow of income.

As Baby Boomers begin to retire in earnest, some will **sell** their homes and relocate to be closer to family and warmer climates. Others will **remain** in their existing homes and seek to tap the equity which they have built up in stored wealth over years of ownership and mortgage payments.

The reverse mortgage programs currently available in the market can assist in both circumstances. A strong potential exists for reverse mortgage demand to grow in the near future, to meet the needs of the retiring Baby Boomers for additional income and continued occupancy of their residence. Property tax incentives play a role in increasing the likelihood of staying put and taking out a reverse mortgage for income.

HECM basics

reverse mortgage
A mortgage which allows senior homeowners to use their home equity as a stream of income.

A **reverse mortgage** is a mortgage which allows senior homeowners to use wealth buried in their home's equity as the basis for a stream of income, a contrast to their past expenditures of mortgage payments.[1]

In a traditional mortgage, a homeowner makes payments to the lender each month. In a reverse mortgage, the lender makes payments to the homeowner according to a payment schedule chosen by the homeowner.

In a traditional mortgage, the principal balance of the mortgage is the amount of money initially received which the homeowner will repay in monthly installments to the lender. In a reverse mortgage, the mortgage balance at any point in time is the amount of monthly advances of money the lender has disbursed. The mortgage principal increases as the lender makes disbursements while the debt buildup is not yet due to be repaid.

home equity conversion mortgage (HECM) program
The Federal Housing Administration (FHA)'s reverse mortgage program.

Since the reverse mortgage is pulling equity out of a relatively illiquid asset (the home), reverse mortgages are only available to a homeowner who has paid down all, or most, of the principal balance on their existing mortgage.

The majority of reverse mortgages originated are insured under the Federal Housing Administration's **home equity conversion mortgage (HECM) program**.

Age eligibility and younger spouses

HECMs are only available to homeowners 62 years of age or older — the elderly and those generally retired from a lifetime working jobs. This minimum age rule applies to all homeowners and co-borrowers on the mortgage.[2]

When the homeowner's spouse is not eligible to be a HECM homeowner, they have no right to receive funds from the HECM. However, upon the homeowner's death, the spouse may defer repayment of the HECM and retain the right to remain in the property if they meet the requirements to be an **eligible non-borrowing spouse**.

1 Calif. Civil Code §1923
2 24 Code of Federal Regulations §206.33

To be considered an *eligible non-borrowing spouse*, they need to:

- remain the spouse of the homeowner for the homeowner's remaining lifetime after obtaining the HECM;
- be identified and certified as the spouse in the HECM mortgage documents; and
- have occupied, and continue to occupy, the real estate securing the HECM as their principal residence.[3]

eligible non-borrowing spouse
A non-borrowing spouse eligible to defer repayment of a home equity conversion mortgage (HECM) and remain on the property after the borrower's death.

After origination, married homeowners and their non-borrowing spouses provide annual certifications of their marriage status, and acknowledge their rights, or lack of rights, to defer repayment of the HECM upon the homeowner's death.

Financial assessment

Owners need to undergo **financial assessment** requirements before the lender may deem them eligible for a HECM. A HECM default is triggered by the homeowner's failure to make payments on property taxes, homeowners insurance or property upkeep. To avoid these failures and a HECM default, the financial assessment focuses heavily on the owner's ability to make these payments.

The **financial assessment** includes:

- a credit history analysis;
- a cash flow/residual income analysis;
- documentation and verification of credit, income, assets and **property charges**;
- evaluation of extenuating circumstances and compensating factors;
- evaluation of the results of the financial assessment;
- determining when a mandatory set-aside is required for *property charges*; and
- completing a HECM Financial Assessment Worksheet.[4]

property charges
On a home equity conversion mortgage (HECM), a collective term for property taxes, insurance, ground rents, fees and special assessments.

Property charges collectively refer to:

- property taxes;
- hazard insurance;
- flood insurance;
- ground rents;
- planned unit development (PUD) fees;
- homeowners' association (HOA) fees; and
- any other special assessment bonds levied by state or federal governments.[5]

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3 HUD Mortgagee Letter 2014-07
4 HUD Mortgagee Letter 2014-21
5 HUD Mortgagee Letter 2014-21

A tri-merged credit report is required for all homeowners, and for eligible non-borrowing spouses. A full credit analysis is now required to determine whether the homeowner has a satisfactory credit history on all revolving and installment debts. A satisfactory credit history also includes:

- no property tax arrearages in the last 24 months prior to the date of the initial HECM application; and
- homeowners insurance is in place for a minimum of 90 days prior to the date of the HECM application.[6]

Unlike a traditional mortgage, the mortgage loan originator (MLO) or lender may not charge for a credit report before closing.

Qualifying income ratios are not calculated for HECMs. Rather, the income and asset review assesses whether the HECM will allow the owner to continue to pay their living expenses, and the taxes and insurance required to avoid a HECM default.

When the lender determines the homeowner is unlikely or unable to pay the property charges on their own, the lender requires a set-aside of HECM funds to pay the property charges, called a **life expectancy set-aside** — a reduction in the amount of advances to the homeowner.

life expectancy set-aside
A lender-mandated portion of a home equity conversion mortgage (HECM) set aside for the payment of property charges.

When the *life expectancy set-aside* is depleted, the homeowner is responsible for making the payments. When the homeowner does not make the payments, the lender is required to make payments on behalf of the homeowner, and add the expenditure to the principal balance of the HECM.[7]

Note that the life-expectancy set-aside is not the same as an impound account in a traditional mortgage. The property charges are set aside from the principal limit available to the homeowner, and when advanced, are added to the homeowner's outstanding mortgage balance. The lender is prohibited from holding the payment in a separate interest-bearing account in trust for the homeowner.[8]

Ineligible homeowners

An owner with delinquent or defaulted federal debts — income taxes — is not eligible for a HECM when the government debt is not satisfied at closing.[9]

Further, an owner who is suspended from any other federal lending program is not eligible for a HECM, unless they are able to prove:

- the homeowner's former spouse, and not the homeowner, was responsible for mortgage payments and defaulted on the payments after a divorce;
- the homeowner's bankruptcy was caused by the death of the principal wage earner or an employment layoff; or
- the homeowner sold the property to a buyer who assumed, and later defaulted on the original mortgage.[10]

6 HUD Mortgagee Letter 2014-22; HECM Financial Assessment and Property Charge Guide
7 HUD Mortgagee Letter 2014-21
8 24 CFR §206.205(e)
9 HUD Handbook 4235.1 Rev-1 Chapters 4-3 and 4-8.B
10 HUD Handbook 4235.1 Rev-1 Chapter 4-3.C

Housing counseling

Before the HECM may be funded, the homeowner completes HECM housing counseling.

Before housing counseling takes place, the lender hands the owner a disclosure in no less than 16-point type which advises the owner:

- of the impact of taking out a reverse mortgage; and
- against using the proceeds of the reverse mortgage to purchase annuities or other related financial products.[11]

To fulfill the counseling requirement, the lender hands the homeowner a list of at least ten U.S. Department of Housing and Urban Development (HUD)-approved housing counselors. The lender may not *steer* the homeowner to a certain counselor or mandate a lender representative be present during the counseling.[12]

The lender or housing counselor presents the owner with a reverse mortgage worksheet listing topics to be discussed during the counseling.[13]

Further, the housing counselor may not be directly or indirectly associated with or compensated by:

- an MLO or lender originating the mortgage;
- the servicer of the mortgage;
- a lender funding the mortgage; or
- the sale of annuities, investments, long-term care insurance or any other type of financial or insurance project.[14]

The housing counseling certificate and the reverse mortgage worksheet signed by the homeowner and the housing counselor are delivered to the lender. The lender waits seven days after the date of housing counseling before accepting a HECM application from an owner.[15]

Principal residence certification

The real estate securing a HECM needs to be the principal residence of each owner of the home. When one or more of the homeowners is in a health care institution at the time of the mortgage, the property is still eligible when at least one of the other homeowners lives in the property as their principal residence.[16]

The homeowner makes an *annual certification* that at least one homeowner is still occupying the property as the principal residence. When the homeowner dies, the eligible non-borrowing spouse makes the annual principal residence certification.[17]

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11 CC §1923.5(a)
12 CC §1923.2(j); 12 USC §1715z-20(e)(1); 24 CFR §206.41(a)
13 CC §1923.5(b)
14 12 United States Code §1715z-20(d)(2)(B)
15 CC §1923.5(a), CC §1923.2(k)
16 24 CFR §206.39
17 24 CFR §206.211; HUD Mortgagee Letters 2014-07 and 2015-02

Property eligibility requirements

One-to-four unit single family residences or condominium in a HUD-approved condominium project are eligible for HECM financing.[18]

Title to the property must be held in:

- fee simple;
- on a renewable leasehold for not less than 99 years; or
- under a lease having a remaining period of at least 50 years beyond the date of the 100th birthday of the younger homeowner.[19]

Standard flood insurance and lead-based paint requirements apply.[20]

Properties which do not meet HUD's property standards are repaired to ensure the property will be adequate security for the HECM. Repairs may take place after closing using funds set aside from the HECM funds available to the homeowner.[21]

Required disclosures

Within three business days after the lender receives a homeowner's HECM mortgage application, the lender hands the homeowner a good faith estimate and, for an adjustable rate HECMs, the adjustable rate mortgage (ARM) disclosure required under the Truth in Lending Act (TILA) and Regulation Z (Reg Z).[22]

Editor's note — Reverse mortgage homeowners do not receive the integrated consumer mortgage disclosures. [See Chapter 27]

At least ten days prior to mortgage closing, the lender delivers a statement to the homeowner which:

- informs the homeowner that the homeowner's liability under the mortgage is limited;
- explains the homeowner's rights, obligations and remedies with respect to temporary absences from the home, late payments, and payment default by the lender; and
- states all conditions requiring payoff of the mortgage debt.[23]

Additionally, the lender hands the following disclosures to the homeowners at least three business days before closing:

- a notice stating the homeowner is not obligated to complete the reverse mortgage transaction merely because they have received the disclosures required by this section or signed an application for a reverse mortgage;
- a disclosure of the total annual mortgage costs, known as the *Total Annual Loan Cost* (*TALC) disclosure*;
- an itemization of mortgage terms, charges, the age of the youngest homeowner and the appraised property value;

18 24 CFR §206.45(b); 24 CFR §206.51
19 24 CFR §206.45(a)
20 24 CFR §206.45(c)-(d)
21 24 CFR §206.47(a), 24 CFR §206.19(d)(2), 24 CFR §206.31(b); HUD Handbook 4235.1 Rev-1 Chapter 3-3.A.2
22 12 CFR §1024.7; 12 CFR §1026.19
23 12 USC §1715z-20(e)(2)

- an explanation of the table of total annual mortgage cost rates set out in the model form found in Reg Z, Appendix K;
- a full disclosure of all costs charged to the homeowner, including costs of estate planning, financial advice and other nonmandatory services related to the mortgage; and
- a notice of right to rescind.[24]

Limits and mortgage amount

To understand how a HECM works, it's necessary to understand some key terms.

First, the **maximum claim amount** is the lesser of the home's appraised value and the maximum mortgage amount set by the FHA for the real estate's location. The maximum claim amount sets the ceiling for how much the homeowner or their heirs are responsible for repaying once the HECM becomes due.

maximum claim amount
The ceiling amount for how much the homeowner is responsible for repaying once a home equity conversion mortgage (HECM) becomes due.

The **principal limit** is the maximum mortgage amount available to the homeowner. It is determined by considering the:

- maximum claim amount;
- the interest rate;
- the payment option chosen by the homeowner;
- the age of the homeowner(s), or the eligible non-borrowing spouse; and
- the homeowner's financial ability to pay property taxes, insurance and maintain the property.

principal limit
The maximum mortgage amount available to the homeowner on a home equity conversion mortgage (HECM).

Generally, the greater the age of the oldest homeowner, the higher the principal limit.

Initially, the principal limit is always less than the maximum claim amount. The difference between the maximum claim amount and the principal limit is an amount set aside for the interest which accrues on the funds used by the homeowner.

The principal limit is the amount of funds for:

- payments to the homeowner;
- closing costs;
- mortgage insurance premiums; and
- set-asides to service payments or repairs.

When the total amount withdrawn from the principal limit equals the principal limit of the HECM, the homeowner will receive no further payments. However, they may remain in the property as long as they pay their taxes and insurance, and maintain the property.

24 12 CFR §1026.31(a), 12 CFR §1026.31(c)(2), 12 CFR §1026.33(a)-(b), 24 CFR §206.43(a), 12 USC §1715z-20(d)(2)(C), 12 CFR§1026.15

mandatory obligation
The costs associated with originating and closing a home equity conversion mortgage (HECM).

The **mandatory obligation** is comprised of costs associated with the originating and closing the HECM. The *mandatory obligation* reduces the total amount the homeowner is able to withdraw from the HECM, and is comprised of the:

- initial mortgage insurance premium (MIP);
- mortgage origination fee;
- HECM counseling fee;
- recording fees;
- credit report fees;
- survey fees;
- title examination fees;
- title insurance fees;
- appraisal fees;
- repair set-asides;
- repair administration fee;
- delinquent federal debt;
- amounts used to pay off any existing liens on the property;
- customary fees and charges for warranties, inspections, surveys or engineer certifications;
- funds to pay contractors making repairs required prior to closing;
- actual insurance premiums charged for property tax and flood and hazard insurance payments scheduled for payment within the initial 12-month disbursement period under a *life expectancy set-aside*;
- property tax, flood and hazard insurance payments required to be paid at closing;
- total amount of property charges to be made during the initial 12-month disbursement period, for adjustable rate HECMs; and
- other charges authorized by HUD.[25]

Allowable fees

At closing, the lender is limited to charging the following fees in connection with the origination of a HECM:

- a lender origination fee, with a floor of $2,500 and a ceiling of $6,000[26];
- recording fees and recording taxes, or other charges incident to recording the insured mortgage;
- credit report fees;
- survey and inspection fees, when required by the lender or the homeowner;
- title examination fees;
- the lender's title insurance premium;

25 HUD Mortgagee Letter 2014-21
26 HUD Mortgagee Letter 2008-34

- fees paid to an appraiser for the initial appraisal of the property; and
- the repair administration fee paid to the lender, when repairs are required to bring the property up to HUD's minimum property standards.[27]

When an independent MLO assists the homeowner, the MLO's fee is included in the lender origination fee, subject to its limits. Additionally, the MLO may only be paid when they are employed by the homeowner and no financial arrangements exists between the MLO and the lender.[28]

HECM mortgage insurance premiums

HECMs require the payment of non-refundable MIPs.[29]

As with all FHA-insured mortgages, the HECM requires:

- an **up-front MIP**; and
- an **annual MIP**.

The *up-front MIP* is 2.00% of the maximum claim amount. The HECM program charges an *annual MIP* of 0.50%.[30]

Payments

HECM homeowners may choose from the following payment options:

- a fixed-rate **lump sum option**;
- an adjustable rate **term payment**;
- an adjustable rate **tenure payment**;
- an adjustable rate **line of credit payment**; or
- a **modified tenure payment**; or
- a **modified term payment**.[31]

lump sum option
A home equity conversion mortgage (HECM) payment option in which the homeowner receives one payment after closing.

term payment
A home equity conversion mortgage (HECM) payment option in which the homeowner receives equal monthly payments for a fixed period of time.

Regardless of the payment option chosen, the maximum amount the homeowner may receive during the first 12 months after closing is the greater of:

- 60% of the principal limit; or
- the homeowner's mandatory obligation, plus 10% of the principal limit.[32]

The homeowner is able to draw an additional 10% of the amount of the principal limit during the initial 12-month disbursement period when the homeowner's mandatory obligation is greater than 50% of the principal limit.[33]

27 24 CFR §206.31(a)
28 24 CFR §206.31(a)(1)
29 24 CFR §206.103, 24 CFR §206.116
30 HUD Mortgagee Letter 2014-21
31 HUD Mortgagee Letter 2014-21
32 HUD Mortgagee Letter 2014-21
33 HUD Mortgagee Letter 2014-21

Disbursement types

tenure payment
A home equity conversion mortgage (HECM) payment option in which the homeowner receives equal monthly payments until they die or sell the property.

line of credit payment
A home equity conversion mortgage (HECM) payment option in which the homeowner may choose when and how much money to withdraw from their line of credit until they reach their principal limit.

A homeowner who chooses the *fixed rate lump sum payment* receives one payment after closing. The mortgage lender makes no further payments to the homeowner.

A homeowner who receives *term payments* receives equal monthly payments for a fixed period of time. The fixed time period is set by the homeowner.[34]

With *tenure payments*, the homeowner receives money from the lender in equal monthly payments until the homeowner dies or sells the property.[35]

A homeowner who receives the reverse mortgage money through a *line of credit payment* may choose when and how much money to withdraw from their line of credit until they reach their principal limit, the ATM arrangement.[36]

Under a *modified tenure payment,* the homeowner receives equal monthly payments from the lender until the death of the homeowner or the sale of the property. The homeowner also has the freedom to withdraw money from the reverse mortgage as with a line of credit.[37]

Under a *modified term payment*, the homeowner receives equal monthly payments and may also take money out through their line of credit, for a set period of time.[38]

As long as the mortgage balance is less than the principal limit, a homeowner with an adjustable rate HECM may change from one adjustable rate payment option to another.[39]

The lender cannot compel the homeowner to use the HECM proceeds or require a homeowner to draw a certain amount at any time.[40]

HECM refinances

In addition to the traditional HECM which allows a homeowner to tap into their home equity, HECMs may be used to refinance existing HECMs.[41]

Within three business days of receiving a HECM refinance application, the lender needs to provide the owner with an **anti-churning disclosure**.[42]

The *anti-churning disclosure* contains the lender's best estimate of:

- the homeowner's total cost of the refinancing; and
- the increase in the homeowner's principal limit as measured by the estimated initial principal limit on the mortgage to be insured minus the current principal limit on the HECM being refinanced.[43]

34 12 USC §1715z-20(d)(9)(B); 24 CFR §206.19(a)
35 12 USC §1715z-20(d)(9)(D); 24 CFR §206.19(b)
36 12 USC §1715z-20(d)(9)(A); 24 CFR §206.19(c)
37 12 USC §1715z-20(d)(9)(E)
38 12 USC §1715z-20(d)(9)(C)
39 24 CFR §206.26(a); 24 CFR §206.26(c)
40 24 CFR §206.25(g); HUD Mortgagee Letter 2014-10
41 24 CFR §206.53(a)
42 24 CFR §206.53(d)(2)
43 24 CFR §206.53(d)(1)

Disbursement limit examples

Example 1: Mandatory obligations of 60% or less of the principal limit

Principal limit: *$100,000*
Mandatory obligations: *$40,000*
Repair set-aside: *$0*
60% of the principal limit: *$60,000*
Initial disbursement limit amount: *$60,000, includes $40,000 in mandatory obligations and $20,000 to homeowner*

The homeowner can draw the $20,000 exceeding mandatory obligations and any set-aside at mortgage closing or during the first 12-month disbursement period.

Example 2: Mandatory obligations in excess of 60% of the principal limit

Principal limit: *$100,000*
Mandatory obligations: *$65,000*
Repair set-aside: *$0*
10% of principal limit: *$10,000*
60% of the principal limit: *$60,000*
Initial disbursement limit amount: *$75,000, includes $65,000 in mandatory obligations and $10,000 to homeowner*

The homeowner can draw the $10,000 exceeding mandatory obligations and any set-aside at mortgage closing or during the first 12-month disbursement period.

Example 3: Mandatory obligations of 60% or less of the principal limit

Principal limit: *$200,000*
Mandatory obligations: *$17,000*
Repair set-aside: *$33,000*
60% of the principal limit: *$120,000*
Initial disbursement limit amount: *$120,000, includes $17,000 in mandatory obligations, $33,000 set-aside and $70,000 to homeowner*

The homeowner can draw the $70,000 exceeding mandatory obligations and any set-aside at mortgage closing or during the first 12-month disbursement period.

Example 4: Mandatory obligations in excess of 60% of the principal limit

Principal limit: *$200,000*
Mandatory obligations: *$140,000*
Repair set-aside: *$13,000*
10% of the principal limit: *$20,000*
60% of the principal limit: *$120,000*
Initial disbursement limit amount: *$160,000, includes $140,000 mandatory obligations, $13,000 repair set-aside and $7,000 to homeowner*

The homeowner can draw the $7,000 exceeding mandatory obligations and the set-aside at mortgage closing or during the first 12-month disbursement period.

The total cost of refinancing is the sum of:

- all allowable charges and fees on a HECM;
- the up-front MIP; and
- set-asides.

However, the up-front MIP is calculated differently on a HECM refinance than on a traditional HECM.

For HECM refinances, the initial mortgage insurance premium is the difference between:

- the maximum claim amount for the new HECM multiplied by the new initial mortgage insurance premium; and
- the maximum claim amount for the existing HECM being refinanced, multiplied by the old up-front MIP.[44]

For example:

New HECM MIP: $480,000 x 0.50% = $2,400

Old HECM MIP: $400,000 x 0.01% = $40

Calculation: $2,400 - $40

Initial MIP Amount Owed to HUD on HECM refinance: $2,360

Homeowners refinancing a HECM may waive their right to HECM counseling if:

- the homeowner has received the anti-churning disclosure;
- the increase in the homeowner's principal limit disclosed in the anti-churning disclosure is at least five times greater than the total cost of refinancing; and
- it has been five or fewer years since the closing on the initial HECM.[45]

The HECM purchase program allows seniors to purchase a new principal residence with HECM proceeds.

Purchase HECM

The purchase HECM needs to meet all the requirements as a traditional HECM. In addition:

- HECM homeowners are required to occupy the property as their principal residence within 60 days of the closing of the HECM; and
- no other liens are allowed against the property.

For purchase HECMs, the maximum claim amount is the lesser of:

- the appraised value;
- the sales price; and
- the FHA mortgage limit for a single family residence.

44 24 CFR §206.53(c); HUD Mortgagee Letter 2014-21

45 24 CFR §206.53(e)

For purchase HECMs, the mandatory obligation includes:

- fees and charges for preparing the real estate purchase contracts; and
- the amount of principal advanced towards the purchase price of the subject property.[46]

The homeowner pays the difference between the principal limit of the HECM purchase mortgage and the purchase price of the new principal residence, called the homeowner's **monetary investment**.

The proceeds of the sale of an existing principal residence, and any other assets, may be used towards this *monetary investment*. The monetary investment cannot come from seller concessions, sweat equity, trade equity or rent credits. The source of all funds must be verified.

The up-front mortgage insurance premium required for the HECM purchase program is 2%.

The mortgage counseling required for the HECM purchase program includes information specific to the HECM purchase program, in addition to existing reverse mortgage counseling requirements.[47]

Periodic statements

The reverse mortgage lender provides the homeowner with an annual statement of mortgage activity which summarizes:

- the total principal amount which has been paid to the homeowner during the year;
- the mortgage insurance premium paid to HUD and charged to the homeowner;
- the total amount of deferred interest added to the mortgage balance;
- the total mortgage balance;
- the current principal limit; and
- an accounting of all property charge payments during the year.

The statement is provided to the homeowner:

- no later than January 31 for each preceding year until the mortgage is paid in full by the homeowner;
- every time the homeowner receives a line of credit payment; and
- each time the lender recalculates monthly payments.[48]

For adjustable rate HECMs, at least 25 calendar days before the interest rate is set to adjust, the lender notifies the homeowner of:

- the current index rate;
- the date of the publication of the index; and
- the new interest rate.[49]

46 HUD Mortgagee Letter 2014-21
47 HUD Mortgagee Letters 2008-33 and 2009-11
48 24 CFR §206.203
49 24 CFR §206.21(d)

Homeowner HECM obligations

A reverse mortgage doesn't require a homeowner to make regular monthly payments, but a homeowner does have other obligations to fulfill. To remain in good standing on a reverse mortgage, the homeowner or surviving eligible non-borrowing spouse needs to:

- live in the home as their principal residence;
- maintain hazard insurance on the property in an amount acceptable to HUD and the lender;
- keep the property free of liens, unless such liens are subordinate to the reverse mortgage;
- keep the property in good repair; and
- pay property taxes, hazard insurance, ground rents and assessments in a timely manner.[50]

The homeowner's failure to meet all of these requirements constitutes a default on the HECM.

Repayment of the HECM

Repayment of the HECM is triggered when:

- the homeowner dies without a surviving eligible non-borrowing spouse;
- the homeowner or their surviving eligible non-borrowing spouse moves permanently from the home;
- the homeowner transfers title to the home;
- the homeowner fails to pay their property taxes or homeowners insurance; or
- the homeowner fails to maintain the property.[51]

Once repayment is triggered, the homeowner or their heirs have 30 days to:

- pay the mortgage balance in full, including any accrued interest and mortgage insurance premiums;
- sell the property for at least 95% of the appraised value, with the net proceeds to go towards the mortgage balance; or
- provide the lender with a deed-in-lieu of foreclosure.[52]

Default in payment of property charges

Within 30 days of the first missed property charge payment, the lender is to notify HUD of the default and provide the homeowner (or surviving eligible non-borrowing spouse) with a notice informing the homeowner of:

- their 30-day period to pay any property charges in arrears;
- the homeowner's ability to seek free counseling from a HUD-approved counselor regarding the homeowner's alternatives to comply with the terms of the mortgage; and
- a list of loss mitigation options available to the homeowner, including at a minimum:

50 24 CFR §206.27(b)-(c)

51 24 CFR §206.27(c); HUD Handbook 4330.1 Rev-5 Chapter 13-30.B; HUD Mortgagee Letters 2014-07 and 2015-10

52 24 CFR §206.125(a)(2); HUD Mortgagee Letters 2014-07 and 2015-10

- establishing a repayment plan;
- pursuing a refinance of the HECM to a new HECM when sufficient equity exists to pay off the existing mortgage and bring the property charges current; and
- meeting any other loss mitigation steps as prescribed by HUD.

A lender may refuse reinstatement by the homeowner when:

- the lender has accepted reinstatement of the mortgage within the past two years immediately preceding the current notification to the homeowner that the HECM is due and payable;
- reinstatement will preclude foreclosure when the mortgage becomes due and payable at a later date; or
- reinstatement will adversely affect the priority of the mortgage lien.[53]

HECMs are nonrecourse debts. The sale or foreclosure of the property is the only recourse the lender has to collect on the debt. A lender is barred from going after the personal assets of the homeowner or their heirs to satisfy the amounts due on the HECM.[54]

53 24 CFR §206.125(a)(3); HUD Mortgagee Letter 2015-02
54 12 USC §1715z-20(d)(7); HUD Handbook 4235.1 Rev-1 Chapter 1-3.C

Chapter 25 Summary

A reverse mortgage is a mortgage which allows senior homeowners to use wealth buried in their home's equity as the basis for a stream of income, a contrast to their past expenditures of mortgage payments.

The majority of reverse mortgages originated are insured under the Federal Housing Administration (FHA)'s home equity conversion mortgage (HECM) program.

HECMs are only available to homeowners 62 years of age or older.

Owners need to undergo financial assessment requirements before the lender may deem them eligible for a HECM. The real estate securing a HECM needs to be the principal residence of each owner of the home. Additionally, before the HECM may be funded, the homeowner completes HECM housing counseling.

In addition to the traditional HECM which allows a homeowner to tap into their home equity, HECMs may be used to refinance existing HECMs. A HECM purchase program allows seniors to purchase a new principal residence with HECM proceeds.

Repayment of the HECM is triggered when:

- the homeowner dies without a surviving eligible non-borrowing spouse;
- the homeowner or their surviving eligible non-borrowing spouse moves permanently from the home;
- the homeowner transfers title to the home;
- the homeowner fails to pay their property taxes or homeowners insurance; or
- the homeowner fails to maintain the property.

Chapter 25 Key Terms

Chapter 26

High-cost and higher-priced consumer mortgages

Learning Objectives

After reading this chapter, you will be able to:

- apply the tests you use to designate a consumer mortgage as a Section 32 high-cost mortgage;
- determine the terms restricted on a Section 32 mortgage;
- understand the disclosure requirements for Section 32 mortgages;
- identify which consumer mortgages are Section 35 higher-priced mortgages;
- determine the prepayment penalty restrictions and impound and appraisal requirements for Section 35 mortgages; and
- recognize which consumer mortgages are California high-cost mortgages.

Key Terms

closed-end mortgage
open-end mortgage
Section 32 mortgage
Section 35 mortgage

HOEPA

To protect homebuyers and homeowners from potentially predatory mortgage features, such as balloon payments and prepayment penalties, the Truth in Lending Act (TILA) was amended in 1994 by the *Home Ownership and Equity Protection Act (HOEPA)*.

High-cost consumer mortgages were specifically addressed by HOEPA. Regulations limiting use of these high-cost consumer mortgages are found in Section 1026.32 of Title 12 of the Code of Federal Regulations. Thus, these high-cost consumer mortgages are known as **Section 32 mortgages**.

Section 32 mortgage
A consumer mortgage subject to additional disclosures and restrictions due to its high points and fees or an annual percentage rate (APR) or prepayment penalty duration which exceeds thresholds set by the federal Truth in Lending Act (TILA).

Restrictions on *Section 32 mortgage* terms, the additional disclosure burden and heavy penalties for violations are intended to make high-cost mortgages unattractive to lenders and mortgage loan originators (MLOs). However, knowing what constitutes a Section 32 mortgage is part of how MLOs and lenders either make these mortgages or avoid them.

Section 32 mortgage designation

closed-end mortgage
A mortgage in which the funds are disbursed once and paid off over time.

open-end mortgage
A mortgage which gives the borrower the ability to withdraw funds in a line of credit.

Section 32 mortgage designation may apply to any consumer mortgage secured by a one-to-four unit residential which, additionally, is or will become the homeowner's or homebuyer's principal residence, except:

- reverse mortgages;
- construction loans financing the initial construction of a new principal residence;
- loans originated and financed by a Housing Finance Agency; and
- U.S. Department of Agriculture (USAD) Rural Development §502 direct loans.[1]

Both **closed-end mortgages** and **open-end mortgages** are covered by HOEPA.

A *closed-end mortgage* is a mortgage the funding of which is disbursed once, and paid off over time. A 30-year fixed rate mortgage (FRM) is an example of a closed-end mortgages.

In contrast, an *open-end mortgage* is a mortgage which gives the homebuyer or homeowner the ability to withdraw mortgage funds in a line of credit, similar to how a credit card functions. Interest is charged on amounts withdrawn. A home equity line of credit (HELOC) is an example of an open-end mortgage.

Whether a mortgage subject to Section 32 designation (i.e., a consumer mortgage secured by the homeowner or homebuyer's principal residence) is a Section 32 mortgage is determined based on any one of three so-called coverage tests:

- the **annual percentage rate (APR) coverage test**;
- the **points and fees coverage test**; and
- the **prepayment penalty coverage test**.

When a consumer mortgage exceeds even one of the thresholds, it is a Section 32 mortgage.[2]

The APR coverage test

A consumer mortgage is subject to Section 32 requirements when the APR on the total loan amount exceeds the *average prime offer rate (APOR)* for a comparable mortgage transaction on the same date, by more than:

- 6.5 percentage points for first lien transactions;
- 8.5 percentage points for first lien transactions when the residence is personal property and the mortgage amount is less than $50,000; or

1 12 Code of Federal Regulations §1026.32(a)

2 12 CFR §1026.32(a)(1)

- 8.5 percentage points for junior lien transactions.[3]

APOR tables are published by the Federal Financial Institutions Examination Council (FFIEC). A tool to determine rate spread can be found at *https://ffiec.cfpb.gov/tools/rate-spread*.

Editor's note — For the following examples, assume that other factors (points and fees and prepayments) do not alone make the loan a Section 32 mortgage.

Consider a first-lien of $250,000 with an APR of 11%, a consumer mortgage secured by a single family residence used as the homeowner's or homebuyer's principal residence. The APOR for a comparable transaction is 4%. Is this transaction a Section 32 mortgage?

Yes! Since the consumer mortgage is a first-lien secured by real estate occupied as the homeowner's or homebuyer's principal residence, the 6.5 percentage point threshold applies. The percentage point difference between the APR and the APOR is 7%. Thus, the mortgage is a Section 32 mortgage without further coverage testing.

Now consider a second-lien of $10,000 secured by consumer mortgage on a principal residence. The APR on the mortgage is 10%. The APOR for a comparable transaction is 4%. Is this transaction a Section 32 consumer mortgage?

No! Since the transaction involves a junior lien, the 8.5 percentage point threshold applies. The difference between the APR and the APOR is only 6%. Thus, this consumer mortgage is not a Section 32 mortgage.

The points and fees coverage test

A Section 32 mortgage exists when the points and fees payable by the homebuyer or homeowner-occupant at or before closing exceed:

- 5% of the total loan amount for a mortgage of $21,549 or more (in 2019); or
- the lesser of 8% or $1,077 for a loan of less than $21,549 (in 2019).

These figures are adjusted annually for inflation.[4]

For closed-end mortgages — the classic purchase-assist home mortgage — the following fees are excluded from the points and fees coverage test:

- mortgage insurance premiums;[5]
- up to **two bona fide discount points** paid by the homebuyer or homeowner when the interest rate before the discount is one percentage point or less below the APOR;

3 12 CFR §1026.32(a)(1)(i)
4 12 CFR §1026.32(a)(1)(ii)
5 12 CFR §1026.32(b)(1)(i)(B)-(C)

- up to **one bona fide discount point** paid by the homebuyer or homeowner when the interest rate exceeds the APOR by one to two percentage points;[6] and
- MLO compensation paid by the MLO's employer which has already been included in the finance charge.[7] [See Chapter 27]

The prepayment coverage test

A consumer mortgage is designated a Section 32 mortgage when the prepayment penalty:

- is charged more than 36 months after the origination on a closed-end mortgage or open-end mortgage; or
- exceeds in amount 2% of the prepaid principal.[8]

Section 32 mortgage requirements

In addition to meeting the ability-to-repay (ATR) requirements for all consumer mortgages, a lender or MLO originating a Section 32 mortgage:

- ensures the homebuyer or homeowner completes pre-mortgage counseling;[9]
- makes Section 32 disclosures, in addition to the integrated disclosures called for by TILA;[10] and
- limits transaction terms, fees and practices as regulated.[11]

Pre-mortgage counseling

Before making a Section 32 mortgage, a counselor approved by the U.S. Department of Housing and Urban Development (HUD) needs to certify to the lender that the homebuyer or homeowner has received mortgage counseling about Section 32 mortgages. The counselor may not be an employee or otherwise affiliated with the lender. Further, the lender may not steer the homebuyer or homeowner towards a specific counselor or counseling agency.[12]

Before counseling takes place, the counselor verifies the homebuyer or homeowner has received the lender's Loan Estimate form or home equity line of credit (HELOC) disclosures.[13] [See **RPI** Form 204-5]

The counseling certificate contains:

- the name of the homebuyer or homeowner who obtained counseling;
- the date of the counseling;
- the name and address of the counselor;

6 12 CFR §1026.32(b)(1)(i)(F)
7 12 CFR §1026.32(b)(1)(ii)
8 12 CFR §1026.32(a)(1)(iii)
9 12 CFR §1026.34(a)(5)
10 12 CFR §1026.32(c)
11 12 CFR §1026.32(d)
12 12 CFR §1026.34(a)(5)(i); 12 CFR §1026.34(a)(5)(iii); 12 CFR §1026.34(a)(5)(v)
13 12 CFR §1026.34(a)(5)(iv)(F)

- a statement the homebuyer or homeowner received counseling on the advisability of a Section 32 mortgage, based on the terms provided in the Loan Estimate or HELOC disclosures; and
- a statement the counselor verified the homebuyer or homeowner's receipt of the Section 32 disclosures.[14]

Note: some disclosures are delivered within three days after the lender's receipt of a mortgage application, and others are delivered within three days before the loan is originated. Guidance from the Consumer Financial Protection Bureau (CFPB) suggests counseling be completed in two stages:

- once after the homebuyer or homeowner receives the Loan Estimate form or HELOC disclosure; and
- again after all required disclosures have been provided to the homebuyer or homeowner.

Section 32 disclosures

In addition to the Loan Estimate and Closing Disclosures (or equivalent disclosures required on HELOCs) required on all consumer mortgages, a separate written Section 32 disclosure is required on Section 32 mortgages.

The lender needs to deliver the Section 32 disclosure to the homebuyer or homeowner at least three business days before closing.[15]

The Section 32 disclosure contains:

- the following statement: "You are not required to complete this agreement merely because you have received these disclosures or have signed a loan application. If you obtain this loan, the lender will have a mortgage on your home. You could lose your home, and any money you have put into it, if you do not meet your obligations under the loan.";
- the APR based on the total loan amount financed and the total points and fees;
- the amount of the periodic payments and any final/balloon payment when a balloon payment is allowed;
- on variable rate transactions, a statement disclosing that the interest rate and monthly payment may increase, the amount of the maximum possible monthly payment and interest rate;
- on a closed-end mortgage, the amount borrowed;
- on an open-end mortgage, the credit limit as the amount borrowed;
- charges for optional mortgage protection life insurance coverage;
- an example of repayment under a fully funded Section 32 mortgage;
- when the mortgage contains a balloon feature, a disclosure of that fact and an example stating the amount of the balloon payment; and
- statements clarifying the examples.[16] [See **RPI** Form 223]

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14 12 CFR §1026.34(a)(5)(iv)

15 12 CFR §1026.31(c)(1)

16 12 CFR §1026.32(c)(3)(ii); 12 CFR §1026.32(c)(5)(ii)

When the terms of the mortgage change enough to make the prior disclosures inaccurate, a new Section 32 disclosure must be provided to the homebuyer or homeowner. Redisclosure with an accurate Section 32 disclosure restarts the three-business-day waiting period before closing.[17]

Section 32 prohibited mortgage features

The following mortgage repayment provisions are restricted or prohibited on a Section 32 mortgage:

- balloon payments, except in very limited circumstances;[18]
- negative amortization;[19]
- using the mortgage funds to make more than two periodic payments at closing;[20]
- an increased interest rate on default;[21]
- less favorable rebate calculation when the loan is called due to a default;[22] and
- prepayment penalties.[23]

Additionally, a **due-on** clause is prohibited on Section 32 mortgages unless:

- the homebuyer or homeowner has committed fraud or material misrepresentation in connection with the loan;
- the homebuyer or homeowner fails to repay the loan as agreed; or
- the homebuyer or homeowner's actions or negligence adversely impact the value of the property securing the loan — waste.[24]

Disclosure on sale or assignment

A lender who **sells or assigns** a Section 32 mortgage prepares and delivers the following statement to the purchaser or assignee of the mortgage:

"Notice: This is a mortgage subject to special rules under the Federal Truth in Lending Act. Purchasers or assignees of this mortgage could be liable for claims and defenses with respect to the mortgage that the borrower could assert against the creditor."

This notice must be prominent, such as a stamp on the face of the note itself.[25]

Refinance

A lender who makes a Section 32 mortgage to a homebuyer or homeowner may not refinance that mortgage into another Section 32 mortgage within one year of originating. However, the lender may refinance the mortgage when the homebuyer or homeowner needs to meet a bona fide financial emergency.[26]

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17 12 CFR §1026.31(c)(1)(i)
18 12 CFR §1026.32(d)(1)
19 12 CFR §1026.32(d)(2)
20 12 CFR §1026.32(d)(3)
21 Official Interpretation of 12 CFR §1026.32(d)(4)
22 12 CFR §1026.32(d)(5)
23 12 CFR §1026.32(d)(6)
24 12 CFR §1026.32(d)(8)
25 12 CFR §1026.34(a)(2); Official Interpretation of 12 CFR §1026.34(a)(2)-2
26 12 CFR §1026.34(a)(3)

Violations

A lender has 60 days from their first discovery of a violation of Section 32 requirements to notify the homebuyer or homeowner and make the mortgage Section 32 compliant, provided the homebuyer or homeowner has not first brought an action against the lender for the violation.[27]

A homeowner is barred from bringing an action for a TILA violation after three years from the date of the violation, the statute of limitations for TILA.[28]

Section 35 designation

In 2008, HOEPA was amended to add a separate TILA disclosure for **higher-priced mortgage loans (HPMLs)**, also known as **Section 35 mortgages**.

A Section 32 high-cost mortgage and a *Section 35 mortgage* have similar guidelines for designation, but they are not interchangeable and have different lending restrictions and disclosure requirements.

> **Section 35 mortgage**
> A closed-end consumer mortgage secured by a principal residence and subject to mandatory impounds, appraisal requirements and restrictions due to an annual percentage rate (APR) which exceeds thresholds set by the federal Truth in Lending Act (TILA).

A Section 35 mortgage is a fully funded **closed-end mortgage** funding a consumer purpose and secured by the homebuyer or homeowner's one-to-four unit principal residence on which the APR exceeds the APOR for a comparable transaction by more than:

- 1.5% for mortgages secured by a first lien with a Freddie Mac conforming mortgage amount;
- 2.5% for mortgages secured by a first lien with a mortgage amount exceeding Freddie Mac's conforming mortgage limit (i.e., jumbo mortgages); and
- 3.5% for mortgages secured by a junior lien.[29]

Section 35 mortgages have mandatory impound requirements, special appraisal requirements and restrictions on prepayment penalties, fees and other mortgage terms.[30]

Restricted terms and prohibited actions

A Section 35 mortgage may not include a negative amortization feature.[31]

In addition, prepayment penalties, when allowed, are restricted to:

- 2% of the prepaid principal balance during the first 12 months following mortgage closing; and
- 1% of the prepaid principal balance during the second 12 months following mortgage closing.[32]

No prepayment penalty is allowed after two years from the date the mortgage is originated. Further, the prepayment penalty is not allowed when:

- the source of the prepayment is a refinance; or
- the principal and interest payments are able to change during the first four years following origination of the mortgage.[33]

27 15 United States Code §1640(b)-(c)
28 15 USC §1640(e)
29 Calif. Financial Code §4995; 12 CFR §1026.35(a)(1)
30 12 CFR §1026.35(b)(1)
31 Fin C §4995.2(g)
32 Fin C §4995.1
33 12 CFR §1026.35(e)(2)(ii)

MLOs may not charge more fees for a Section 35 mortgage with a prepayment penalty than one without a prepayment penalty.[34]

Further, the MLO's pay may not vary based on who is paying their fee — the lender, homebuyer or homeowner or a third-party participant.[35]

Impound account required

Lenders that make Section 35 higher-priced mortgages need to establish an **impound account** for the homebuyer or homeowner before originating the mortgage. An *impound account* allows the homeowner to deposit funds with the lender for payment of property taxes, insurance premiums and any other periodic payment associated with the property or mortgage.[36]

For **Section 35 higher-priced consumer mortgages**, impound accounts are mandatory unless:

- the mortgage is secured by shares in a cooperative;
- the mortgage is a construction loan;
- the mortgage is temporary or bridge financing;
- the mortgage is a reverse mortgage;[37] or
- the lender is a defined small lender.[38] [See Chapter 10]

A lender when establishing a mandatory impound account for a Section 35 mortgage needs to disclose the following information to the homebuyer or homeowner at least three business days before originating the mortgage:

- the fact an impound account will be established upon origination;
- the amount required as a deposit at closing to fund the impound account;
- the amount of the first year's estimated taxes and insurance premiums to be deposited in the impound account;
- the estimated amount of the monthly impound account payment to the lender; and
- a statement informing the homebuyer or homeowner that when they choose to terminate the impound account, the homebuyer or homeowner will be responsible for making all payments on taxes and insurance premiums.[39]

Impound accounts may be cancelled on the earlier of:

- the termination of the debt, e.g., repayment, refinancing, rescission or foreclosure; or
- the homebuyer or homeowner's request, no sooner than five years after mortgage closing.[40]

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34 Fin C §4995.2(e)
35 Fin C §4995.2(e)(2)
36 12 CFR §1026.35(b)(1)
37 12 CFR §1026.35(b)(2)(i)
38 12 CFR §1026.35(b)(2)(iii)
39 15 USC §1639d(h)
40 12 CFR §1026.35(b)(3)(i)

However, a mandatory Section 35 impound account may not be cancelled while:

- the mortgage payments are delinquent; or
- the **loan-to-value ratio (LTV)**, based on the original value of the property at mortgage closing, is 80% or higher.[41]

Section 35 appraisal rules

Appraisals for Section 35 mortgages are to be prepared by a licensed appraiser based on a physical interior inspection of the property.[42]

Special appraisal rules are required for Section 35 mortgages. The following mortgages are exempt from Section 35 appraisal requirements:

- qualified mortgages;[43]
- mortgages of less than $26,700 during 2019, adjusted annually for inflation;[44]
- mortgages secured by a manufactured home, mobile home, boat or trailer;[45]
- mortgages used to finance the initial construction of a dwelling;[46]
- bridge loans with maturities of 12 months or less, when used in connection with the acquisition of the homebuyer or homeowner's principal residence;[47]
- reverse mortgages;[48] and
- certain streamline refinances by the existing lender.[49]

Double appraisals on a flip

Two appraisals are required when the Section 35 mortgage funds the purchase of property on a flip of the property by the seller and:

- the seller acquired the property 90 or fewer days prior to entering into a purchase agreement with a buyer, and the purchase price exceeds the original purchase price by more than 10%;[50] or
- the seller acquired the property 91 to 180 days prior to entering into a purchase agreement with a buyer, and the purchase price exceeds the original purchase price by more than 20%.[51]

The second appraisal is to be completed by a **different appraiser** than the appraiser who completed the original appraisal.[52]

41 12 CFR §1026.35(b)(3)(ii)
42 12 CFR §1026.35(c)(3)(i)
43 12 CFR §1026.35(c)(2)(i); 12 CFR §1026.43(e)
44 12 CFR §1026.35(c)(2)(ii); Official Interpretation of 12 CFR §1026.35(c)(2)(ii)-1
45 12 CFR §1026.35(c)(2)(iii), 12 CFR §1026.35(c)(2)(viii)
46 12 CFR §1026.35(c)(2)(iv)
47 12 CFR §1026.35(c)(2)(v)
48 12 CFR §1026.35(c)(2)(vi)
49 12 CFR §1026.35(c)(2)(vii)
50 12 CFR §1026.35(c)(4)(i)(A)
51 12 CFR §1026.35(c)(4)(i)(B)
52 12 CFR §1026.35(c)(4)(ii)

The second appraisal needs to include an analysis of the difference in sale prices, changes in market conditions and improvements to the property between the date the seller acquired it and the current sales date.[53]

The fee due for the second appraisal cannot be charged to the homebuyer or homeowner.[54]

The second appraisal is not required on loans that finance a consumer acquisition of property:

- from a local, state or federal government agency;
- from a person who acquired title to the property through the exercise of the right to collect on a defaulted mortgage, resulting in foreclosure, deed-in-lieu of foreclosure or other judicial or nonjudicial procedure;
- from a non-profit entity which acquired the property through foreclosure or deed-in-lieu of foreclosure;
- from a person who inherited the property due to a death;
- from a person who received the property as the result of a divorce;
- from an employer or relocation agency in connection with a relocation;
- from a servicemember who was deployed or received a permanent change of station order after purchasing the property;
- located in a federal disaster area; or
- located in a rural county.[55]

Appraisal disclosure

The lender is to deliver or place in the mail a written disclosure about the Section 35 appraisal requirements within three business days of:

- receiving an application for a Section 35 mortgage; or
- determining the loan associated with an existing application is a Section 35 mortgage.

The disclosure is to state:

"We may order an appraisal to determine the property's value and charge you for this appraisal. We will give you a copy of any appraisal, even if your loan does not close. You can pay for an additional appraisal for your own use at your own cost."[56]

Providing appraisal reports

A free copy of each Section 35-mandated appraisal report is provided by the lender to the homebuyer or homeowner:

- at least three days before mortgage closing; or
- if the mortgage doesn't close, no later than 30 days after the lender determines the mortgage will not close.[57]

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53 12 CFR §1026.35(c)(4)(iv)
54 12 CFR §1026.35(c)(4)(v)
55 12 CFR §1026.35(c)(4)(vii)
56 12 CFR §1026.35(c)(5)
57 12 CFR §1026.35(c)(6)(i)-(ii); 12 CFR §1026.35(c)(6)(iv)

Violations

Any attempt to evade Section 35 requirements by restructuring the mortgage as several transactions is a violation of Section 35.[58]

A Department of Real Estate (DRE) licensee may not advise a client to default on an existing mortgage in order to refinance with a Section 35 mortgage.[59]

Further, steering a homebuyer or homeowner who qualifies for a non-higher priced mortgage into a Section 35 mortgage is prohibited.[60]

An MLO has 90 days from the date of discovering a violation to notify the homebuyer or homeowner and cure the violation, or amend the terms of the mortgage so it is no longer a Section 35 mortgage.

However, when the homebuyer or homeowner has already initiated an action against the MLO for a Section 35 mortgage, the MLO has 120 days after the homebuyer or homeowner's complaint or discovery of the violation to cure the violation or amend the terms of the mortgage so it is no longer a Section 35 mortgage.[61]

A lender who willfully violates the second appraisal requirements for Section 35 mortgages is liable to the homebuyer or homeowner for $2,000 under federal law.[62]

Further, an MLO, broker or lender who violates any part of Section 35 is in violation of DRE licensing law, and subject to disciplinary action. Willful violators are subject to a fine of up to $10,000 per violation.[63]

California's high-cost mortgage

California also recognizes a high-cost mortgage designation, with its own state-specific disclosure requirements and prohibitions.

A **California high-cost mortgage** is a mortgage which funds a personal use and encumbers a homeowner or homebuyer's one-to-four unit principal residence, and which has a mortgage amount at or below the Fannie Mae conforming mortgage limits with:

- an APR eight percentage points higher than the yield on a comparable treasury security; or
- total points and fees more than 6% of the mortgage amount.[64]

When a mortgage is a *California high-cost mortgage* and a federal Section 32 mortgage or Section 35 mortgage, both sets of rules apply. Where the rules overlap, the most restrictive terms apply.

58 Fin C §4995.2(a)
59 Fin C §4995.2(f)
60 Fin C §4995.2(d)
61 Fin C §4995.2(h)
62 15 USC §1639h(e)
63 Fin C §4995
64 Fin C §4970(b)

Prepayment penalties are allowed on a California high-cost mortgage when the MLO:

- also offers the homebuyer or homeowner a mortgage without a prepayment penalty;
- discloses in writing at least three days before origination the terms of the prepayment penalty;
- the maximum prepayment penalty is limited to six months' advance interest on prepayments of more than 20% of the original principal;
- the prepayment penalty does not apply more than three years after origination;[65] and
- the prepayment penalty does not apply in the event of a default.[66]

Other prohibitions include:

- an MLO who originates a California high-cost mortgage may not originate another mortgage with a prepayment penalty for the same homebuyer or homeowner;[67]
- an interest rate increase on the mortgage in the event of a default;[68]
- negative amortization;[69]
- use of the mortgage funds to pay a home improvement contractor;
- recommending default on an existing mortgage to obtain a California high-cost mortgage;
- use of the mortgage funds to consolidate debt, or in any way which does not benefit the homebuyer or homeowner;
- steering the homebuyer or homeowner to a riskier or more expensive mortgage than the homebuyer or homeowner qualifies for; and
- an MLO is prohibited from selling the homebuyer or homeowner insurance or other financial product within 30 days of originating a California high-cost mortgage.[70]

California also requires the lender to provide the homebuyer or homeowner with a California high-cost mortgage disclosure at least three business days before signing mortgage documents. The homebuyer or homeowner is to provide a signed acknowledgement of receipt of the disclosure.[71]

Both the lender and the MLO may be held liable for a violation of California high-cost mortgage rules. A DRE-licensed MLO is subject to disciplinary action from DRE, and a penalty of $2,500 for each violation. The penalty for a willful violation is $25,000 per violation. [72]

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65 Fin C §4973(a)(1)
66 Fin C §4973(a)(2)
67 Fin C §4973(a)(2)(E)
68 Fin C §4973(e)
69 Fin C §4973(c)
70 Fin C §§4973, 4979.7
71 Fin C §4973(k)
72 Fin C §§4974(b), 4977

Chapter 26 Summary

High-cost consumer mortgages are known as Section 32 mortgages.

Section 32 mortgage designation may apply to any consumer mortgage secured by a one-to-four unit residential principal residence except reverse mortgages, construction loans financing the initial construction of a new principal residence, loans originated and financed by a Housing Finance Agency and U.S. Department of Agriculture (USDA) Rural Development §502 direct loans.

To determine whether a mortgage is a Section 32 mortgage, three different coverage tests apply, based on:

- the annual percentage rate (APR) coverage test;
- the points and fees coverage test; and
- the prepayment penalty coverage test.

A Section 32 mortgage designation requires the lender or mortgage loan originator (MLO) to:

- ensure the homebuyer or homeowner completes pre-mortgage counseling;
- make Section 32 disclosures, in addition to the integrated disclosures required by the Truth in Lending Act (TILA); and
- restrict certain transaction terms, fees and practices.

A Section 35 mortgage is a closed-end mortgage secured by a homebuyer or homeowner's one-to-four unit principal residence, with an APR which exceeds the average prime offer rate (APOR) for a comparable transaction by more than:

- 1.5% for mortgages secured by a first lien with a Freddie Mac conforming mortgage amount;
- 2.5% for mortgages secured by a first lien with a mortgage amount exceeding Freddie Mac's conforming mortgage limit (i.e., jumbo mortgages); and
- 3.5% for mortgages secured by a junior lien.

Section 35 mortgages have mandatory impound requirements, special appraisal requirements and restrictions on prepayment penalties, fees and other mortgage terms.

California also recognizes a high-cost mortgage designation, with its own state-specific disclosure requirements and prohibitions.

When a mortgage is a California high-cost mortgage and a federal Section 32 mortgage or Section 35 mortgage, both sets of rules apply. Where the rules overlap, the most restrictive terms apply.

Chapter 26 Key Terms

Chapter 27

Regulation Z disclosures

Learning Objectives

After reading this chapter, you will be able to:

- determine the consumer mortgage processing activities which trigger disclosures required by Regulation Z (Reg Z) under the Truth in Lending Act (TILA);
- identify the purpose, structure and use of the Loan Estimate and Closing Disclosure forms; and
- recognize when the lender may make changes to either disclosure.

Key Terms

changed circumstance	**Regulation Z (Reg Z)**
Closing Disclosure	**Special Information Booklet**
Loan Estimate	**tolerances**
regular financier	**Truth in Lending Act (TILA)**

Integrated consumer mortgage disclosures

In 1968, consumers of credit, which includes **consumer mortgages**, began receiving mandated information in formal disclosures made by lenders about the costs of borrowed funds due to passage of the **Truth in Lending Act (TILA)**. The content of these *TILA* disclosures is established under **Regulation Z (Reg Z)** by authorized government agencies.[1]

Prior to October of 2015, confusions existed for homebuyers and mortgage lenders due to overlapping information provided in consumer mortgage disclosures under TILA and the *Real Estate Settlement Procedures Act (RESPA)*.

1 12 Code of Federal Regulations §1026.1

Truth in Lending Act (TILA)
A federal consumer mortgage law which controls the terms of a consumer mortgage and requires lenders to disclose mortgage rates and charges.

Today, consumer mortgage disclosures required by TILA and RESPA are condensed under Regulation Z at the direction of the Consumer Financial Protection Bureau (CFPB). Collectively, these integrated disclosures are known by the consumer mortgage industry as the *TILA-RESPA integrated disclosures (TRID)*.

Regulation Z (Reg Z)
A federal regulation implementing the Truth in Lending Act (TILA).

Reg Z disclosures include:

- **information booklets** on the consumer mortgage process;[2]
- the **Loan Estimate** form, replacing the old up-front TILA disclosure and the RESPA good faith estimate;[3]
- the **Closing Disclosure**, replacing the old final TILA disclosure and the HUD-1 Settlement Statement;[4]
- the **notice of right to rescind** [See Chapter 28]; and
- the **escrow account cancellation** notice.

Closing Disclosure
A disclosure of the buyer's final settlement charges and mortgage terms handed to the buyer on a standard form within three business days before mortgage closing.

High-cost mortgages, higher-priced mortgages, reverse mortgages and home equity lines of credit (HELOCs) each have their own special Reg Z disclosures. [See Chapters 26, 25 and 24]

Reg Z **mandates disclosures** on consumer mortgage financing only when the funds or credit are:

- from a lender or carryback seller who *regularly funds mortgages* or extends credit on the sale of property;
- used primarily to purchase real estate, personal property or services for personal, family, or household use, called a **consumer purpose**; and
- repayable with *interest*, or, when no interest, payable in five or more installments.[5]

Counting consumer mortgages

A lender is required to make Reg Z disclosures when they are a **regular financier** of consumer-purpose mortgages.

A lender is a *regular financier* when, in the current or prior year, the lender makes more than:

- five **consumer mortgages**;
- one **Section 32 high-cost consumer mortgage**; or
- 25 consumer-purpose loans, including consumer mortgages, consumer-purpose loans secured by other than one-to-to-four unit residential property and unsecured consumer-purpose loans.[6]

regular financier
A lender subject to Truth in Lending Act restrictions by making more than a set threshold of consumer purpose loans or mortgage in a calendar year.

A *consumer mortgage* is a mortgage originated to fund a consumer purpose and secured by a one-to-four unit residential property, regardless of occupancy.[7]

2 12 CFR §1026.19(g), 12 CFR §1026.19(b)(1)
3 12 CFR §1026.37(e)
4 12 CFR §1026.37(f)
5 12 CFR §1026.1(c)(1)
6 12 CFR §1026.2(a)(17)(v)
7 12 CFR §1026.43(a)

The Consumer Financial Protection Bureau

In 2010, Congress passed the ***Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)****. Among other things, this act established a new regulatory agency: the Consumer Financial Protection Bureau (CFPB). The CFPB is responsible for regulating and enforcing consumer protection laws.*

Since its start, the CFPB has implemented the ***ability-to-repay*** *(ATR) and* ***qualified mortgage*** *rules and clarified the rules for the integrated mortgage disclosures.*

Additionally, it:

- *released resources for consumer use, to help them understand the new mortgage rules, including sample letters to use when requesting corrections from servicers, mortgage tips, FAQs and tools to help consumers find housing counselors;*
- *prosecuted several companies for Real Estate Settlement Procedures Act (RESPA) violations;*
- *released a report on mortgage servicing issues and addressed current misdeeds perpetrated by mortgage servicers;*
- *launched a proposal to make changes to the Home Mortgage Disclosure Act (HMDA) as required by the Dodd-Frank Act;*
- *in an interagency effort, released a proposal for minimum requirements for appraisal management companies;*
- *released mortgage pain points, and released guidelines for its mortgage eClosing pilot program;*
- *addressed mortgages brokers attempting to skirt consumer protection rules by adopting a "mini-correspondent" model (hint: it doesn't fool anyone); and*
- *proposed a more open forum for* ***consumer complaints*** *about financial companies.*

Consumers may submit a complaint to the CFPB online, or via telephone, mail, email, fax or referral. The CFPB will then forward the complaint to the lender and the borrower will be issued a tracking number to monitor the progress of their complaint. Once the CFPB has forwarded the complaint, the lender is expected to review the case, contact the borrower if needed, resolve the issue and report its actions to the CFPB.

Consumers are given 30 days to dispute a company's response if it is unsatisfactory. The CFPB's website is also designed to be accessible to the layperson, increasing transparency and empowering consumers to actively participate in the CFPB's efforts to decrease unfriendly lending practices.

The CFPB makes consumer mortgage complaints searchable. Mortgage consumers can readily see which lenders receive complaints, whether the company responded to the complaint, and whether the response was timely.

The CFPB's complaint database is located at http://www.consumerfinance.gov/complaintdatabase/.

Exceeding any one of the mortgage quantity thresholds triggers the lender's need to make Reg Z disclosures on their consumer mortgage originations in the current year, and the subsequent calendar year.[8]

8 12 CFR §1026.2(a)(17)(v), Official Interpretation of 12 CFR §1026.2(a)(17)-1

Consider a mortgage lender who opens for business in December of 2014. In 2014, they make five consumer mortgages. Thus, the lender was not required to make Reg Z disclosures based on its activity in 2014.

In 2015, the lender originates 28 consumer mortgages. Beginning with its sixth consumer mortgage, the lender now needs to provide Reg Z disclosures. Additionally, the lender is required to provide Reg Z disclosures for all consumer-purpose mortgages originated in 2016.

Consumer purpose

Consumer-purpose acquisitions funded by a mortgage include:

- a one-to-four unit residential property, including condominiums, cooperative units, mobile homes and trailers, when used as the homebuyer's principal residence;
- a vacation home or second home for the personal use of the homebuyer;
- personal property for personal use, such as boats, trailers and recreational vehicles;
- services provided a homebuyer on credit (an installment note) for personal use, such as brokerage fees due from a homebuyer to acquire a principal residence or second home, or construction/repair of personal-use property; and
- any other real estate or personal property acquired for personal enjoyment rather than for business, investment or farming.

A **mixed-use consumer mortgage** requires Reg Z disclosures when the primary use (specifically defined by case law as *more than half)* of the mortgage proceeds are used to purchase property or services for personal use.[9]

Information booklets

Special Information Booklet
A required Truth in Lending Act (TILA) disclosure containing information about the consumer mortgage process, mortgage features and costs.

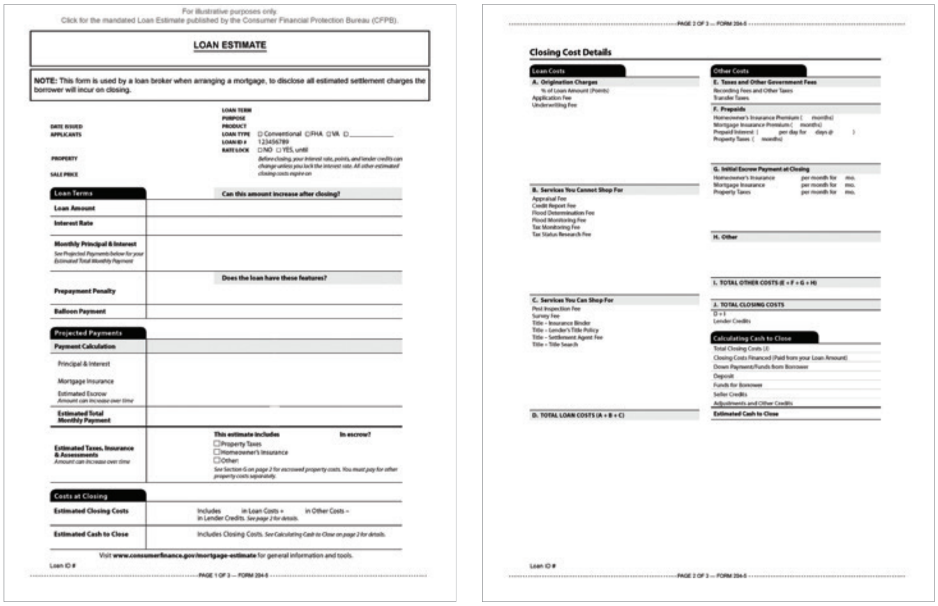
Within three business days after receiving a homebuyer's consumer mortgage application for the purchase of a one-to-four unit, the lender or mortgage loan originator (MLO) who takes the mortgage application delivers a **Special Information Booklet** to the homebuyer-applicant. The Special Information Booklet contains information about the consumer mortgage process, mortgage features and costs.[10]

Further, mortgage lenders need not deliver the *Special Information Booklet* on applications for refinances, second liens or reverse mortgages.[11]

The CFPB released the "Your home loan toolkit" booklet for lenders to provide to homebuyers. Providing the "Your home loan toolkit" fulfills the lender's duty to provide the Special Information Booklet disclosure.

For adjustable rate mortgages, the "Consumer Handbook on Adjustable Rate Mortgage (CHARM)" booklet is provided to the homebuyer or homeowner by the lender.[12]

9 **Bokros v. Associates Finance, Inc.** (1984) 607 F.Supp 869
10 12 CFR §1026.19(g)
11 12 CFR §1026.19(g)(1)(iii)
12 12 CFR §1026.19(b)



For illustrative purposes only.
Click for the mandated Loan Estimate published by the Consumer Financial Protection Bureau (CFPB).

LOAN ESTIMATE

NOTE: This form is used by a loan broker when arranging a mortgage, to disclose all estimated settlement charges the borrower will incur on closing.

DATE ISSUED
APPLICANTS

PROPERTY
SALE PRICE

LOAN TERM
PURPOSE
PRODUCT
LOAN TYPE ☐ Conventional ☐ FHA ☐ VA ☐ ____________
LOAN ID # 123456789
RATE LOCK ☐ NO ☐ YES, until
Before closing, your interest rate, points, and lender credits can change unless you lock the interest rate. All other estimated closing costs expire on

Loan Terms	Can this amount increase after closing?
Loan Amount	
Interest Rate	
Monthly Principal & Interest *See Projected Payments below for your Estimated Total Monthly Payment*	
	Does the loan have these features?
Prepayment Penalty	
Balloon Payment	

Projected Payments	
Payment Calculation	
Principal & Interest	
Mortgage Insurance	
Estimated Escrow *Amount can increase over time*	
Estimated Total Monthly Payment	
Estimated Taxes, Insurance & Assessments *Amount can increase over time*	This estimate includes / In escrow? ☐ Property Taxes ☐ Homeowner's Insurance ☐ Other: *See Section G on page 2 for escrowed property costs. You must pay for other property costs separately.*

Costs at Closing	
Estimated Closing Costs	Includes in Loan Costs + in Other Costs – in Lender Credits. *See page 2 for details.*
Estimated Cash to Close	Includes Closing Costs. *See Calculating Cash to Close on page 2 for details.*

Visit **www.consumerfinance.gov/mortgage-estimate** for general information and tools.

Loan ID #

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Closing Cost Details

Loan Costs

A. Origination Charges
% of Loan Amount (Points)
Application Fee
Underwriting Fee

B. Services You Cannot Shop For
Appraisal Fee
Credit Report Fee
Flood Determination Fee
Flood Monitoring Fee
Tax Monitoring Fee
Tax Status Research Fee

C. Services You Can Shop For
Pest Inspection Fee
Survey Fee
Title – Insurance Binder
Title – Lender's Title Policy
Title – Settlement Agent Fee
Title – Title Search

D. TOTAL LOAN COSTS (A + B + C)

Other Costs

E. Taxes and Other Government Fees
Recording Fees and Other Taxes
Transfer Taxes

F. Prepaids
Homeowner's Insurance Premium (months)
Mortgage Insurance Premium (months)
Prepaid Interest (per day for days @)
Property Taxes (months)

G. Initial Escrow Payment at Closing
Homeowner's Insurance per month for mo.
Mortgage Insurance per month for mo.
Property Taxes per month for mo.

H. Other

I. TOTAL OTHER COSTS (E + F + G + H)

J. TOTAL CLOSING COSTS
D + I
Lender Credits

Calculating Cash to Close
Total Closing Costs (J)
Closing Costs Financed (Paid from your Loan Amount)
Down Payment/Funds from Borrower
Deposit
Funds for Borrower
Seller Credits
Adjustments and Other Credits
Estimated Cash to Close

Loan ID #

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Additional Information About This Loan

LENDER
NMLS/__ LICENSE ID
LOAN OFFICER
NMLS/__ LICENSE ID
EMAIL
PHONE

MORTGAGE BROKER
NMLS/__ LICENSE ID
LOAN OFFICER
NMLS/__ LICENSE ID
EMAIL
PHONE

Comparisons	Use these measures to compare this loan with other loans.
In 5 Years	Total you will have paid in principal, interest, mortgage insurance, and loan costs. Principal you will have paid off.
Annual Percentage Rate (APR)	Your costs over the loan term expressed as a rate. This is not your interest rate.
Total Interest Percentage (TIP)	The total amount of interest that you will pay over the loan term as a percentage of your loan amount.

Other Considerations	
Appraisal	We may order an appraisal to determine the property's value and charge you for this appraisal. We will promptly give you a copy of any appraisal, even if your loan does not close. You can pay for an additional appraisal for your own use at your own cost.
Assumption	If you sell or transfer this property to another person, we ☐ will allow, under certain conditions, this person to assume this loan on the original terms. ☐ will not allow assumption of this loan on the original terms.
Homeowner's Insurance	This loan requires homeowner's insurance on the property, which you may obtain from a company of your choice that we find acceptable.
Late Payment	If your payment is more than days late, we will charge a late fee of
Refinance	Refinancing this loan will depend on your future financial situation, the property value, and market conditions. You may not be able to refinance this loan.
Servicing	We intend ☐ to service your loan. If so, you will make your payments to us. ☐ to transfer servicing of your loan.

Confirm Receipt

By signing, you are only confirming that you have received this form. You do not have to accept this loan because you have signed or received this form.

Applicant Signature Date Co-Applicant Signature Date

Loan ID #

FORM 204-5 12-15 ©2015 RPI — Realty Publications, Inc., P.O. BOX 5707, RIVERSIDE, CA 92517

For a full-size, fillable copy of this or any other form in this book that may be used in your professional practice, go to realtypublications.com/forms

Figure 1

Form 204-5

Loan Estimate

For home equity lines of credit, the "What You Should Know About Home Equity Lines of Credit (HELOCs)" brochure is delivered to homeowners by lenders."[13]

These booklets, and instructions for using these booklets, are available at *http://www.consumerfinance.gov/learnmore/*.

13 12 CFR §1026.19(g)(1)(ii)

The Loan Estimate

Loan Estimate
An estimate of a buyer's settlement charges and mortgage terms handed to the buyer on a standard form within three business days following the lender's receipt of the mortgage application.

Reg Z lenders deliver the Loan Estimate to consumer mortgage applicants as an initial disclosure of the terms, features and costs of the mortgage they are offering. The Loan Estimate is required on all closed-end consumer mortgages.[14] [See Figure 1]

Homebuyers use the Loan Estimate to:

- compare the mortgage terms offered by several lenders while shopping for a mortgage; and
- compare the initial mortgage terms and costs with the lender's final mortgage terms and costs later disclosed on the Closing Disclosure for any changes.[15]

Information disclosed on the Loan Estimate includes:

- identification of the homebuyer, lender and MLO;
- the core features of the consumer mortgage, including its purpose, sale price or property value of the security, mortgage term, type of mortgage product and interest rate;[16]
- the existence and effect of any rate lock;[17]
- the monthly payment, and whether this amount may change after closing;[18]
- the existence and terms of any prepayment penalty;[19]
- the existence and terms of any balloon payment;[20]
- a breakdown of the monthly payment into principal and interest, mortgage insurance payments and impounds for estimated taxes, insurance and assessments;[21]
- total closing costs, including a detailed itemization of costs and differentiation between closing costs the homebuyer may and may not shop for and place elsewhere;[22]
- cash needed to close, including a table showing how the amount is calculated;[23]
- for ARMs, an adjustable interest rate (AIR) table with relevant information about how the interest rate will change;[24]
- a summary of the total payments, annual percentage rate (APR) and the total interest paid over the life of the mortgage as a percentage of the mortgage amount, called the total interest percentage (TIP), to be used when comparison shopping; and
- information about the appraisal, assumption policies, homeowner's insurance, late payments, refinancing and servicing.[25]

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14 12 CFR §1026.37(e)
15 12 CFR §1026.37
16 12 CFR §1026.37(a)
17 12 CFR §1026.37(a)(13)
18 12 CFR §1026.37(b)(1)-(3), (6)
19 12 CFR §1026.37(b)(4)-(5)
20 12 CFR §1026.37(b)(7)
21 12 CFR §1026.37(c)
22 12 CFR §1026.37(f)-(g)
23 12 CFR §1026.37(d), (h)
24 12 CFR §1026.37(j)
25 12 CFR §1026.37(k), (m)

Prohibited activities before disclosure

The only fee a lender may charge and receive before the Loan Estimate is delivered to the homebuyer is a reasonable credit report fee.

Otherwise, the lender may not collect any fees from a homebuyer as an applicant, even in the form of a post-dated check, until after:

- the Loan Estimate has been delivered to the homebuyer; and
- the homebuyer has indicated they will proceed with the consumer mortgage covered by the Loan Estimate.[26]

A homebuyer may indicate their intent to proceed in any manner. However, a written document indicating the homebuyer's intent to proceed allows a lender or MLO to document their compliance with the Reg Z requirements.[27]

Further, the lender is barred from calling for the homebuyer to provide information verifying facts in the mortgage application until the Loan Estimate has been delivered.[28]

Triggering events and delivery

Reg Z lenders provide homebuyers with a Loan Estimate within three business days after a homebuyer submits a consumer mortgage application.[29]

For timely delivery of the Loan Estimate, a business day is any day on which the lender's offices are open to the public, carrying out substantially all of its business functions.[30]

To trigger the lender's preparation and delivery of the Loan Estimate, the consumer mortgage application needs to include:

- the homebuyer's name;
- the homebuyer's income;
- the homebuyer's Social Security number, to obtain a credit report;
- the property address;
- the price or an estimate of the value of the property; and
- the mortgage amount sought.[31]

As soon as all six pieces of information are received, the three-business-day countdown for delivery of the Loan Estimate form begins. A lender may not delay delivery of the Loan Estimate form based on any information other than these six listed items.[32]

The homebuyer is required to acknowledge receipt of the disclosure — not an acceptance of the consumer mortgage — by signing and dating the disclosure.[33]

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26 12 CFR §1026.19(e)(2)(i)
27 12 CFR §1026.19(e)(2)(i)(A)
28 12 CFR §1026.19(e)(2)(iii)
29 12 CFR §1026.19(e)(1)(iii),12 CFR §1026.19(e)(1)(iv)
30 Official Interpretation of 12 CFR §1026.19(e)(1)(iii)-1; 12 CFR §1026.2(a)(6)
31 12 CFR §1026.2(a)(3)
32 Official Interpretation of 12 CFR §1026.2(a)(3)-1
33 12 CFR §1026.37(n)

When an MLO is negotiating the consumer mortgage on behalf of a homebuyer, the MLO may provide the Loan Estimate on behalf of the lender. The lender is bound to the Loan Estimate, and may not issue a "revised" Loan Estimate to correct any errors made by the MLO.[34]

Loan Estimate revisions

changed circumstance
Extraordinary events defined by federal mortgage law which may be the basis for the costs provided in the Loan Estimate.

Lenders may not revise Loan Estimates due to technical errors, miscalculations or underestimations of charges — whether the lender is providing the Loan Estimate, or an MLO is providing it on the lender's behalf.[35]

A Loan Estimate revision may only be given to an applicant when:

- a **changed circumstance**, as defined by Reg Z, affects the homebuyer's eligibility for the terms applied for, or the value of the real estate;
- the homebuyer requests a change to the mortgage terms offered;
- the interest rate was not locked when the Loan Estimate was provided, and locking the interest rate causes the points or lender credits to change;
- the consumer indicates the intent to proceed with the transaction more than ten business days after the Loan Estimate was provided; or
- the consumer mortgage is a new construction mortgage, the settlement is delayed more than 60 calendar days and the original Loan Estimate states the lender may issue a revised disclosure 60 days before closing.[36]

Changed circumstances include:

- an extraordinary event beyond the control of any consumer mortgage participant, e.g., war or natural disaster;
- an unexpected event specific to the homebuyer or mortgage, e.g., the lender provides an estimate of title insurance costs, but the title insurer goes out of business;
- a change or inaccuracy in information provided by the homebuyer and relied upon by the lender when preparing the Loan Estimate form, e.g., the homebuyer indicated their income was $90,000 but underwriting determines the income is only $80,000; and
- new information specific to the homebuyer or mortgage, e.g., a boundary claim is filed against the property, affecting its value.[37]

Revised Loan Estimates are to be delivered by the lender to the homebuyer or placed in the mail no later than three business days after receiving information sufficient to justify a revision.[38]

Tolerances

Outside of bona fide changed circumstances, lenders are bound by the fees and amounts disclosed in Loan Estimates when they finally originate a consumer mortgage, subject to **tolerances**. Amounts disclosed in the Loan

34 12 CFR §1026.19(e)(1)(ii); Official Interpretation of 12 CFR §10269.19(e)(1)(ii)-1-2
35 12 CFR §1026.19(e)3)(iv)
36 12 CFR §1026.19(e)(3)(iv)
37 12 CFR §1026.19(e)(3)(iv)(A)
38 12 CFR §1029.19(e)(4)(i)

Estimate which exceed set tolerances in the closing statement on origination of the consumer mortgage are to be refunded to the homebuyer within 60 days of mortgage closing.[39]

tolerances
Acceptable ranges of deviation for changes to fees and amounts disclosed on a Loan Estimate, set by type of charge.

The fees and amounts disclosed in a Loan Estimate are subject to one of three levels of *tolerances* for charging a greater amount on closing:

- **unrestricted tolerance**;
- **10% cumulative tolerance**; and
- **no tolerance**.

Amounts which fall within the *unrestricted tolerance* level may be additionally changed on closing without restriction. These amounts include:

- prepaid interest;
- property insurance premiums;
- amounts placed into an impound account;
- settlement service charges from providers who are chosen by the homebuyer and who are not on a list of service providers provided by the lender; and
- charges paid to third-party service providers not required by the lender.[40]

Fees in the *10% cumulative tolerance* level may change on closing no more than an aggregate 10% from the amounts disclosed to the homebuyer in the Loan Estimate. These fees include:

- recording fees; and
- third-party settlement service charges provided by a service providers (other than the lender and lender affiliates) chosen by the homebuyer from a list provided by the lender.[41]

For instance, consider a Loan Estimate which discloses $25 in recording fees and $3,000 in third-party settlement service fees, both in the 10% cumulative tolerance level.

At closing, the recording fees increase from the $25 disclosed on the Loan Estimate to $28, a 12% increase. However, all the third-party settlement service fees at closing remain charged in the amounts disclosed in the Loan Estimate. Since the cumulative change is less than 10% of the total fees charged in the 10% cumulative tolerance category, the lender is compliant and not required to refund any charges.

Fees and amounts in the *zero tolerance* level may not change at closing from the terms disclosed in the Loan Estimate. These include:

- fees paid to the lender, MLO or an affiliate of either;[42]

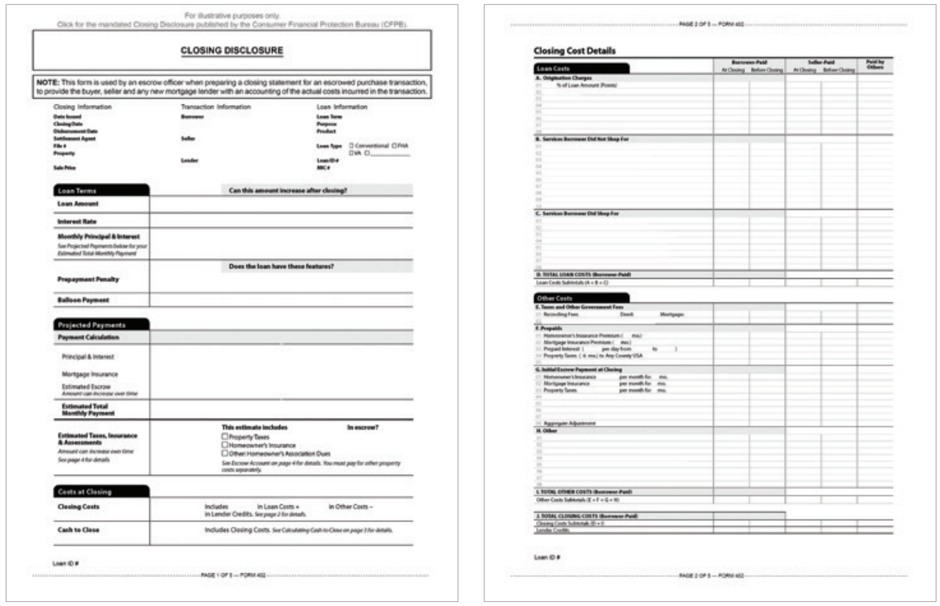
39 12 CFR §1026.19(f)(2)(v)
40 12 CFR §1026.19(e)(3)(iii)
41 12 CFR §1026.19(e)(3)(ii)
42 12 CFR §1026.19(e)(3)(ii)(B)

Figure 2

Form 402

Closing Disclosure

Pages 1-3



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- fees paid to an unaffiliated third party settlement service provider when the creditor did not allow the consumer to shop for the settlement service provider;[43] and
- transfer taxes.[44]

Closing timelines and retention

At least seven business days must pass between delivering or mailing the Loan Estimate (or revised Loan Estimate) and mortgage closing.[45]

The lender or MLO who initially delivered the Loan Estimate form to the homebuyer retains it for three years after closing the mortgage.[46]

43 12 CFR §1026.19(e)(3)(ii)(C)

44 Official Interpretation of 12 CFR §1026.19(e)(3)(i)-1, -4

45 12 CFR §1029.19(e)(1)(iii)(B)

46 12 CFR §1026.25(c); Official Interpretation of 12 CFR §10269.19(e)(1)(ii)-1

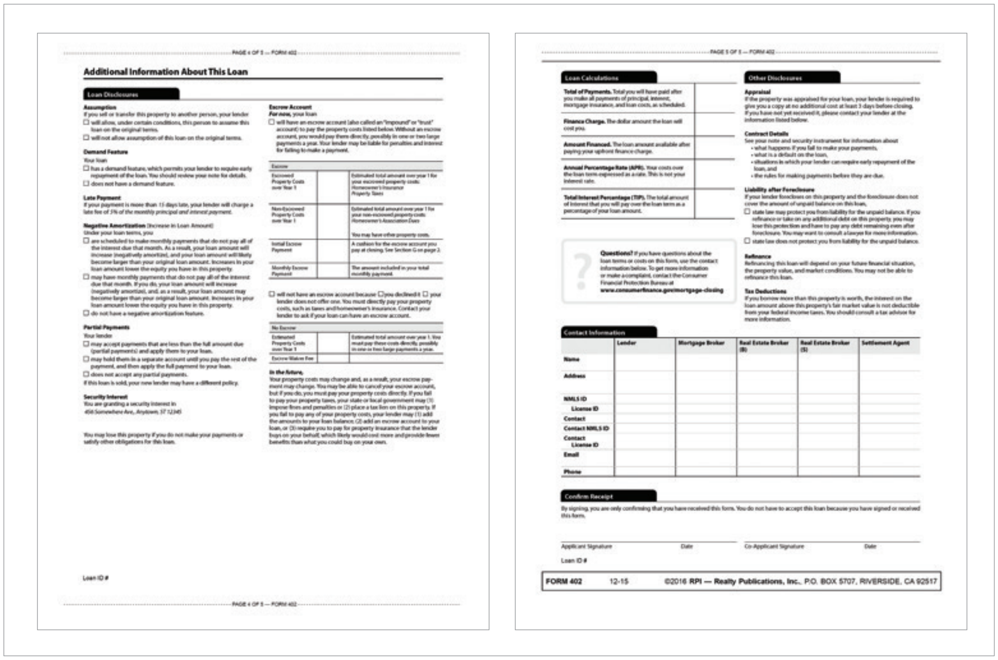

Figure 2

Form 402

Closing Disclosure

Pages 4-5

The Closing Disclosure

The Closing Disclosure provided by a Reg Z lender to a homebuyer contains the actual terms and costs of a consumer mortgage. The Closing Disclosure works in tandem with the Loan Estimate form.[47] [See Figure 2]

A Reg Z lender delivers the Closing Disclosure to a homebuyer no later than three business days before closing.[48]

For the Closing Disclosure, a business day is any calendar day except Sunday and legal public holidays.[49]

The Closing Disclosure is handed to each borrower who has a right to rescind the consumer mortgage.

When the consumer mortgage is not rescindable, the Closing Disclosure is delivered to the primary buyer.[50]

The Closing Disclosure may be handed to the homebuyer by an escrow agent on the lender's behalf. The lender remains responsible for any defects in the Closing Disclosure.[51]

However, the escrow agent is responsible for delivering the Closing Disclosure to the seller when a sale of property is involved. The seller is to receive the Closing Disclosure on the day of closing.[52]

47 12 CFR §1026.19(f)(1)(i)
48 12 CFR §1026.19(f)(1)(ii)
49 12 CFR §1026.2(a)(6); 12 CFR §1026.19(f)(1)(ii)(A)-(iii)
50 12 CFR §1026.17(d)
51 12 CFR §1026.19(f)(1)(v); Official Interpretation of 12 CFR §1026.19(f)(1)(v)-3
52 12 CFR §1026.19(f)(4)(i)-(ii)

Contents of the Closing Disclosure

The first page of the Closing Disclosure is a mirror image of the Loan Estimate. The duplicate appearance allows homebuyers to easily compare the initial estimates listed item by item on the Loan Estimate with the final terms and charges in the Closing Disclosure.

The remaining pages of the Closing Disclosure include:

- closing cost details;
- the calculation of cash required to close;
- summaries of transactions for both the homebuyer and seller;[53]
- disclosures about:
  - assumptions;
  - demand features;
  - late payments;
  - negative amortization;
  - partial payments;
  - the granting of a security interest in the property;
  - impound accounts;[54]
  - consumer mortgage calculations;
  - appraisals;
  - agreement provisions;
  - liability after foreclosure;
  - refinancing;
  - tax deductions; and
- contact information for the lender, MLO and the CFPB.[55]

Corrections to the Closing Disclosure

When terms or costs change after the homebuyer has received the initial Closing Disclosure, the lender delivers a corrected Closing Disclosure.

The three categories of changes which require a corrected Closing Disclosure are:

- changes that occur before closing and require a new three-business-day waiting period before the mortgage is closed;
- changes that occur before closing and do not require a new three-business-day waiting period; and
- changes that occur after closing.[56]

Changes before closing that restart the three-business-day waiting period include:

- changes to the APR;

53 12 CFR §1026.38(i)-(k)
54 12 CFR §1026.38(l)
55 12 CFR §1026.38(o)-(r)
56 12 CFR §1026.19(f)(2)

- changes to the mortgage product; or
- the addition of a prepayment penalty.[57]

All other changes before closing require a new Closing Disclosure, but do not retrigger the three-business-day period before closing.[58]

For changes occurring after closing, the lender needs to deliver a corrected Closing Disclosure to the homebuyer no later than 30 calendar days after the lender is notified of the change. An example of such a change is when the actual recording fee paid by the homebuyer is more than the fee indicated in the Closing Disclosure.[59]

For changes due to non-numerical clerical errors, or to document the correction of an overage charged above the allowable tolerances, the corrected Closing Disclosure is to be provided with 60 calendar days of closing.[60]

A lender is required to keep a copy of the Closing Disclosure on file for five years after closing.[61]

Penalties for Reg Z disclosure violations

A lender who fails to timely deliver correctly prepared Reg Z disclosures to a homebuyer is liable to the homebuyer for:

- *out-of-pocket losses* caused by the incorrect or absent disclosures;
- twice the amount of the *finance charge,* limited to $4,000, on a closed-end consumer mortgage;
- *court costs* and attorney fees; and
- for Section 32 mortgages, all finance charges and fees paid by the homebuyer to the lender.[62]

To recover their money losses and penalties, a homebuyer needs to file an action against the lender within one year of the lender's Reg Z violations.[63]

A lender can avoid penalties by notifying the homebuyer and correcting an error in the Reg Z disclosures within 60 days after the lender discovers the error.

However, when the homebuyer notifies the lender before the lender discovers the error or has previously commenced legal action against the lender, the correction will not shield the lender from liability.[64]

Also, a lender who **knowingly** makes inaccurate disclosures or **willfully** miscalculates the APR may be fined up to $5,000 or sentenced to up to a year in jail, or both.[65]

57 12 CFR §1026.19(f)(2)(ii)
58 12 CFR §1026.19(f)(2)(i); Official Interpretation of 12 CFR §1026.19(f)(2)(i)-1-2
59 12 CFR §1026.19(f)(2)(iii); Official Interpretation of 12 CFR §1026.19(f)(2)(iii)-1
60 12 CFR §1026.19(f)(2)(iv)-(v)
61 12 CFR §1026.25(c)(1)(ii)
62 15 United States Code §1640(a)
63 15 USC §1640(e)
64 15 USC §1640(b)
65 15 USC §1611

Chapter 27 Summary

In 1968, consumers of credit, which includes consumer mortgages, began receiving mandated information in formal disclosures made by lenders about the costs of borrowed funds due to passage of the Truth in Lending Act (TILA). The content of these TILA disclosures is established under Regulation Z (Reg Z).

A lender is required to make Reg Z disclosures when they are a regular financier of consumer-purpose mortgages.

Reg Z disclosures include:

- information booklets on the consumer mortgage process;
- the Loan Estimate form, replacing the old up-front TILA disclosure and the Real Estate Settlement Procedures Act (RESPA) good faith estimate;
- the Closing Disclosure, replacing the old final TILA disclosure and the HUD-1 Settlement Statement; and
- the notice of right to rescind; and
- the escrow account cancellation notice.

Reg Z lenders deliver the Loan Estimate to consumer mortgage applicants as an initial disclosure of the terms, features and costs of the mortgage they are offering.

A Loan Estimate revision may only be provided in a changed circumstance, as defined by Reg Z, affects the homebuyer's eligibility for the terms applied for, or the value of the real estate, or in other specific circumstances set forth in Reg Z. Outside of a bona fide changed circumstance, lenders are bound by the fees and amounts disclosed in Loan Estimates, subject to tolerances.

The Closing Disclosure provided by a Reg Z lender to a homebuyer contains the actual terms and costs of a consumer mortgage. The first page of the Closing Disclosure is a mirror image of the Loan Estimate. The duplicate appearance allows homebuyers to easily compare the initial estimates listed item by item on the Loan Estimate with the final terms and charges in the Closing Disclosure.

Chapter 27 Key Terms

Chapter 28

The right of rescission

Learning Objectives

After reading this chapter, you will be able to:

- identify the few consumer mortgages subject to rescission by the homeowner;
- determine the correct procedure for the homeowner using a notice of right to rescind; and
- understand the lender activities which extend the rescission period for up to three years.

Key Terms

notice of right to rescind **rescission**

The right to rescind

Rescission is the homeowner's cancellation of a consumer mortgage after origination to restore the lender and homeowner to their original positions.

rescission
The homeowner's termination of a non-purchase money consumer mortgage, restoring the lender and homeowner to their original positions.

By an after-closing *rescission*:

- the lender's security interest in the property is voided;
- the lender returns all fees paid to all parties in connection with the loan within 20 calendar days after receiving a signed notice of rescission; and
- the homeowner returns any funds or property acquired as a result of the mortgage.[1]

Also, and before recording the mortgage, a homeowner may rescind a signed consumer mortgage agreement and stop the closing of a mortgage when

1 12 Code of Federal Regulations §1026.23(d)

the consumer mortgage sought is an **equity loan or refinance** which will further encumber the homeowner's one-to-four unit principal residence (or personal property used as a principal residence).[2]

Mortgages which are not rescindable include:

- **purchase-assist consumer mortgages** funding the purchase of a principal residence, including home equity line of credit (HELOC) withdrawals funding the down payment of a purchase;[3]
- **mortgages extended by a state government;** and
- **business-purpose loans** funding a trade, business, investment or agricultural operation of the homeowner, even when the loan further encumbers the homeowner's one-to-four unit principal residence.[4]

When an existing consumer mortgage secured by the homeowner's principal residence is refinanced by the same lender who financed the existing mortgage, called a **streamline refinance**, the *streamline refinance* is only rescindable to the extent the principal on the refinance exceeds the payoff amount of the existing principal balance.[5]

Notice required

A lender hands each homeowner on a rescindable consumer mortgage application two copies of the *notice of the right to rescind***.** The right of rescission only applies to non-purchase money consumer mortgages secured by the homeowner's principal residence, such as refinances and non-purchase-money HELOCs.

When the lender delivers the notice electronically under the Electronic Signatures in Global and National Commerce Act (E-SIGN Act) provisions, only one copy needs to be sent to each homeowner.[6]

notice of right to rescind
A disclosure notifying a homeowner of their right to cancel a non-purchase money consumer mortgage secured by their principal residence, the circumstances allowing the homeowner to cancel and the effects of the rescission.

The **notice of right to rescind** discloses:

- the lender's security interest in the homeowner's principal residence;
- the homeowner's right to rescind the loan;
- how to exercise the right to rescind, including a separate form for that purpose which includes the lender's address;
- the effects of the rescission; and
- the date the **rescission period** expires. [See **RPI** Form 222][7]

A variation of the form exists for streamline refinances.[8]

On delivery of the notice of right to rescind, the homeowner's right of rescission runs until the end of the **rescission period**. The lender, the mortgage loan originator (MLO) and the escrow company involved are barred from releasing mortgage funds until the *rescission period* has lapsed without a rescission by the homeowner.[9]

2 12 CFR §1026.23, 12 CFR §1026.15
3 Official Interpretation of 12 CFR §1026.15(f)-1
4 12 CFR §1026.23, 12 CFR §1026.15(f)
5 12 CFR §1026.23(f)(2)
6 12 CFR §1026.23(b)(1), 12 CFR §1026.15(b)
7 12 CFR §1026.23(b)(1), 12 CFR §1026.15(b)
8 12 CFR §1026 Appendix H
9 12 CFR §1026.23(c)

Notice contents

On closed-end consumer mortgages, such as a 30-year fixed rate mortgage, the rescission period runs until midnight of the third business day following the latest of:

- the signing of loan documents;
- the delivery of **material disclosures**; or
- the delivery of the notice of right to rescind.[10]

Material disclosures for closed-end mortgages include:

- the annual percentage rate (APR), which includes notifying the homeowner of an adjustable rate feature;[11]
- the finance charge;
- the amount financed;
- the total of payments;
- the payment schedule;
- Section 32 high-cost mortgage loan disclosures, if applicable [See Chapter 26]; and
- limits on prepayment penalties for Section 35 higher-priced mortgages.[12]

For open-end mortgages (e.g., HELOCs), the homeowner has three business days after receiving the notice to rescind:

- the entire account, when opening the HELOC;
- an increase in the credit limit after opening the account;
- withdrawals on an increase in the credit limit; and
- the adding or increasing of a security interest in the homeowner's principal residence.[13]

In the case of a HELOC or other open-end mortgage, material disclosures include:

- the method of determining the finance charge and the mortgage amount the finance charge applies to;
- the APR;
- the amount or method of determining the amount of any membership or participation fee for the mortgage;
- the length of the draw period and repayment period;
- an method of calculating the minimum payments;
- the timing of the payments; and
- an explanation of the impact making a minimum payment which may result in a balloon payment.[14]

10 12 CFR §1026.23(a)(3)(i)
11 Official Interpretation of 12 CFR §1026.23(a)(3)-2
12 12 CFR §1026.23(a)(3)(ii)
13 12 CFR §1026.15(a)(1), Official Interpretation of 12 CFR §1026.15(a)(1)-1-2
14 12 CFR §1026.15(a)(3)

To rescind a consumer mortgage prior to closing, a homeowner signs and returns the notice of the right to rescind during the three-business-day rescission period.

When the mortgage involves multiple homeowners, a rescission notice from one homeowner cancels the consumer mortgage.[15]

Waiver for emergencies

The homeowner may waive the three-day right to rescind to meet a bona fide **personal financial emergency.**

The homeowner's waiver request needs to describe the emergency and indicate it is a waiver of the right to rescind the mortgage agreement. Each homeowner with the right to rescind is required to sign the waiver. The waiver may not be a pre-printed form.[16]

Improper notice extends the rescission period

Failure to timely and properly deliver a notice of right to rescind or a material disclosure to the homeowner extends the rescission period beyond closing to the earliest of:

- three years after the mortgage documents are signed;
- the transfer of the homeowner's interest in the principal residence securing the mortgage; or
- the sale of the principal residence securing the mortgage.[17]

The extension of the rescission period is liberally applied by courts in favor of the homeowner. Examples of improper notice practices triggering the extended homeowner's rescission period are:

- understating the finance charge or other material disclosure by the greater of 0.50% (1% on rate-and-term refinances from new lenders) or $100, as determined in a comparison of the Loan Estimate and Closing Disclosures (or the good faith estimate and final HUD-1, for HELOCs);[18]
- failing to deliver any notice of right to rescind;
- delivering only one copy of the notice of right to rescind (unless it is provided electronically);[19]
- delivering the notice of right to rescind on the wrong form, e.g., using the streamline rescission notice instead of the general rescission notice;[20]
- requiring a homeowner to sign a statement indicating the rescission period had elapsed, when it had not;[21] and
- failing to provide the correct date for the end of the rescission period.[22]

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15 12 CFR §1026.23(a)(4), 12 CFR §1026.15(a)(4)
16 12 CFR §1026.23(e)
17 Official Interpretation of 12 CFR §1026.23(a)(3)-3
18 12 CFR §1026.23(g)
19 **Sanders** v. **Mountain America Federal Credit Union** (10th Cir. 2012) 689 F3d 1138
20 **Handy** v. **Anchor Mortgage Corporation** (7th Cir. 2006) 464 F3d 760
21 **Rand Corporation** v. **Yer Song Moua** (8th Cir. 2009) 559 F3d 842
22 **Cornerstone Mortgage, Inc.** v. **Ponzar** (2008) 254 Mo.App 221

During the extended rescission period, any homeowner with the right to rescind may simply hand the lender a written rescission notice to exercise their right to rescind. A court action is not required.[23]

Additionally, a homeowner has three years from the date of signing mortgage documents to rescind when:

- foreclosure proceedings have been initiated on the property; AND
- a fee paid by the homeowner to a mortgage loan originator (MLO) arranging the mortgage was not properly included in the finance charge; OR
- the correct form of notice of right to rescind was not provided.[24]

Further, a foreclosure triggers lower tolerances for the accuracy of material disclosures. Instead of the 0.50% and 1% or $100 tolerances allowed for material disclosures when the mortgage is not in foreclosure, the foreclosure allows a homeowner to claim material disclosures were inaccurate if they exceeded the disclosed material disclosures by $35.[25]

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23 **Jesinoski** v. **Countrywide Home Loans, Inc.** (2015) 125 SC 790

24 12 CFR §1026.23(h)(1)

25 12 CFR §1026.23(h)(2)

Chapter 28 Summary

Rescission is the cancellation of a consumer mortgage to restore the lender and homeowner to their original positions.

A homeowner is able to rescind a signed consumer mortgage agreement before closing when the consumer mortgage is an equity loan or refinance which will further encumber the homeowner's one-to-four unit principal residence (or personal property used as a principal residence).

A lender needs to provide each homeowner on the consumer mortgage with two copies of the notice of the right to rescind.

Once the notice of right to delivered, the homeowner's right of rescission lasts until the end of the rescission period. The lender, the mortgage loan originator (MLO) and the escrow company involved are barred from releasing the mortgage funds until the rescission period has lapsed without a rescission.

On closed-end consumer mortgages, the rescission period runs until midnight of the third business day following the latest of:

- the signing of loan documents;
- the delivery of material disclosures; or
- the delivery of the notice of right to rescind.

For open-end mortgages, e.g., home equity lines of credit (HELOCs), the homeowner has three business days to rescind:

- the entire account, when opening the HELOC;
- an increase in the credit limit after opening the account;
- withdrawals on an increase in the credit limit; and
- the adding or increasing of a security interest in the homeowner's principal residence.

Chapter 28 Key Terms

Chapter 29

The Real Estate Settlement Procedures Act

Learning Objectives

After reading this chapter, you will be able to:

- identify a federally related mortgage controlled by the Real Estate Settlement Procedures Act (RESPA), called a consumer mortgage in contrast to a business-purpose mortgage; and
- determine lawful and unlawful charges on consumer mortgages.

Key Terms

federally related mortgage
kickback
Real Estate Settlement Procedures Act (RESPA)
service provider
settlement service

RESPA origins and general purpose

Beginning in 1974, homebuyers taking out purchase-assist consumer mortgages were given legal protection against abusive fee-charging practices of **service providers** by passage of the **Real Estate Settlement Procedures Act (RESPA).** RESPA rules are implemented by *Regulation X (Reg X)*.

service provider
An individual or company which offers services connected with a prospective or actual consumer mortgage origination.

Service providers in transactions involving a consumer mortgage origination include:

- mortgage loan originators (MLOs);
- mortgage lenders;
- real estate brokers and agents acting as transaction agents (TAs);
- escrow agencies; and
- title companies.[1]

1 12 Code of Federal Regulations §1024.2

Real Estate Settlement Procedures Act (RESPA)
A federal law governing the behavior of service providers on a federally related mortgage which prohibits them from giving or receiving unlawful kickbacks.

federally related mortgage
A consumer mortgage made, insured, guaranteed, assisted or otherwise connected to the federal government, controlled by the Real Estate Settlement Procedures Act (RESPA).

RESPA governs the behavior of service providers on transactions involving consumer mortgages, called **federally related mortgages** by RESPA.[2]

A *federally related mortgage* is a mortgage secured by a one-to-four unit residential property or manufactured housing which meets any one of the following criteria:

- the mortgage is made by a federally regulated lender whose deposits are insured by the federal government;
- the mortgage is made, insured, guaranteed, supplemented or assisted by the federal government;
- the mortgage will be sold to the Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac) or the Government National Mortgage Association (Ginnie Mae);
- the mortgage is made by a private lender who makes or invests in mortgages secured by residential properties totaling over $1,000,000 per year;
- the mortgage is originated by a mortgage broker and assigned to any of the above entities;
- the mortgage is originated by a seller, contractor or supplier of goods; or
- the mortgage is a home equity conversion mortgage (HECM) made by one of the entities listed in the first four bullet points above.[3]

Exemptions

However, the following mortgages are exempt from RESPA coverage:

- a mortgage on property of 25 acres or more;
- a mortgage made *primarily for business, commercial or agricultural purpose*;
- temporary financing, such as a construction loan;
- a mortgage secured by unimproved or vacant land, unless a one-to-four unit residential property will be built on the land using the mortgage funds within two years of closing;
- an assumption of a consumer mortgage in which the lender does not have the right to approve a subsequent homebuyer;
- the conversion of a consumer mortgage to different terms which are consistent with provisions of the original mortgage, as long as a new note is not required; and
- bona fide secondary market transactions selling a consumer mortgage in the secondary market.[4]

Editor's note — This chapter discusses charges, fees and disclosures in the context of purchase-assist consumer mortgage financing sought by a buyer-occupant of a one-to-four unit residential property. However, Reg X and Regulation Z (Reg Z) rules and disclosure requirements also apply to refinancing of consumer mortgages.

2 12 CFR §§1024 et seq.
3 12 CFR §1024.2(b)
4 12 CFR §1024.5(b)

Fees charged for services rendered

A fee qualifies as a charge for a **settlement service,** whether paid by a homebuyer, seller or owner, when the service is performed:

- directly for the benefit of the homebuyer, seller or owner; or
- at or before the closing.[5]

Service providers may charge a fee in any amount reasonably related to the performance of a *settlement service*, such as:

- brokerage activities;
- escrowing;
- mortgage processing;
- generating appraisal reports, pest control reports or home inspection reports; or
- conducting a title search.

settlement service
Any service provided in connection with a prospective or actual consumer mortgage origination.

Neither Reg X nor Reg Z limit the amount a service provider may charge for a settlement service actually rendered. Competition is encouraged among providers offering the same services to keep prices in check and avoid price gouging for services rendered to the homebuyer, seller or owner.

Corrupted practice

However, some lenders, brokers/agents and other service providers collude to "buy business" — manifested by the closed brokerage office syndrome — or make additional profits off the homebuyer, seller or owner in the form of **kickbacks** between providers.

Kickbacks are a **corrupting business policy**. Legitimate service providers find it difficult to compete with fraudulent competitors without also resorting to the same fraudulent actions.

kickback
A fee improperly paid to a transaction agent (TA) who renders no service beyond the act of referring when the TA is already providing another service in the transaction for a fee.

Kickbacks to brokers, in the form of referral or split fees or other indirect benefits (e.g., space rent, paid vacations, dividends, equipment) used to steer or capture business, deliberately interfere with the availability of lower and fewer charges by all providers involved.[6]

In this tortured closed-office business environment, a broker or their agent refers their homebuyer to the lender or servicer provider who promises the largest kickback for the referral. In the process, this navigates the homebuyer away from the legitimate non-participating competition who will not take part in the consumer fraud of paying referral fees to brokers and agents to direct business their way.

These are the corrosive activities Reg X seeks to prevent, by prohibiting:

- fees or other financial/economic benefits for referring the homebuyer or seller to a service provider such as a mortgage lender, MLO, escrow or title company; and
- split fees between providers, other than for valuable provider services *actually performed* for the share of the fee received.[7]

5 **Cohen** v. **J.P. Morgan Chase & Co.** (2nd Cir. 2007) 498 F3d 111
6 12 CFR §1024.14(d)
7 12 CFR §1024.14(b)-(c)

Additionally, while high fees are not alone proof of a RESPA violation, the Consumer Financial Protection Bureau (CFPB) will investigate high fees to determine when they are the result of an unlawful referral or kickback scheme. The value of any additional business garnered from the referral scheme is not a consideration when determining the kickback's prohibition.[8]

A referral is not a compensable service

No person in a transaction which includes the origination of a consumer mortgage, including brokers, agents or other third-party service providers, may give or *accept a kickback* or any other thing of value for advising a homebuyer, seller or owner participating in the transaction to employ a particular service provider.

The act of referring is not a service, and no service provider, such as a transaction agent, may collect a fee for a referral.

However, an exception exists for broker solicitation of sellers and buyers as clients for transactions that may include a consumer mortgage origination. Fees paid by a broker for referring buyers and sellers to a real estate broker or agent are allowable when paid by a real estate broker to:

- one of their employees, such as a finder they retain; or
- another real estate broker (whose agent may have referred a prospective client to the broker paying the referral fee).[9] [See **RPI** Form 114]

This exception for a broker paying others for a referral absolutely does not apply in reverse to a broker who receives a referral fee paid by a different service provider in a transaction, an unlawful kickback.

Worse, when a consumer mortgage lender pays a broker a fee — and the broker's only service is as a transaction agent (TA) acting on behalf of the seller or buyer — the broker is deemed an MLO by the very receipt of a fee. Thus, by the acceptance of a kickback referral fee from a lender, they subject themselves to all federal and state MLO registration, licensing, endorsement and compensation rules.[10] [See Chapter 6]

Split fees

Another type of unlawful kickback comes in the form of an otherwise legitimate settlement service charge, when it is split between:

- a person who provides a specific closing settlement service, say, title insurance, escrow or an MLO service; and
- a person who does not render any significant part of the service provider's services, say, a real estate broker or their agents.

The split of a settlement service charge with any person who has not provided a significant portion of the other provider's service in exchange for the split is unlawful.

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8 12 CFR §1024.14(g)(2)

9 12 CFR §1024.14(g)

10 12 CFR §1026.36(a)(1)(i)(C); Official Interpretation of 12 CFR §1026.36(a)-(1)(iv)

However, a broker is in compliance when the fee the broker is to receive on the split for the **second service** is due as:

- payment for **goods**; or
- payment for **services actually rendered** (recall that a referral is not a fee-earning service).[11]

For example, a broker and their agent are entitled to a **second fee** in a sales transaction when the fee is for their handling the mortgage escrow. The mortgage escrow service is a significant service since a broker does not normally perform the service as part of their representation of buyers and sellers when negotiating a sales transaction.

Here, handling the mortgage escrow is an additional closing service provided under a separate contract different from the listing employment in a sales transaction.

MLO services to justify the fee split

Guidance issued by the U.S. Department of Housing and Urban Development (HUD) creates an informal rule of thumb for determining the whether a fee is justified. A broker or agent acting as a TA on a sale and receiving any type of fee from a lender needs to perform at least **five** mortgage origination activities normally performed by the lender or an MLO broker to justify receipt of the fee.

Thus, the broker needs to act as an MLO and be MLO endorsed, as does any agent involved in the fee. Normally, MLO services include:

1. pre-qualifying the homebuyer to determine the maximum mortgage amount they can afford by analyzing their income and debt [See **RPI** Form 230];
2. advising the homebuyer on the purchase-assist consumer mortgage process, about the different types of mortgages available and the variations in costs, rates and payments on the various mortgage options;
3. gathering financial information from the homebuyer such as tax returns, profit and loss statements, bank statements and balance sheets needed to complete the application process [See Chapter 9];
4. making requests for verifications of employment and cash deposits [See **RPI** Form 210, 210-1 and 211];
5. making requests for verification on other debts owed by the homebuyer [See **RPI** Form 212, 212-1 and 213];
6. ordering the appraisal to determine the property's fair market value (FMV) [See **RPI** Form 200 and 207];
7. ordering property inspection and engineering reports [See **RPI** Form 130];
8. reviewing with the homebuyer the process for clearing credit problems which arise;

11 12 United States Code §2607(c)

9. apprising the homebuyer, broker and lender of the status of the application, and what further information or documentation each transaction participant needs to timely close, by continuing to conduct regular contacts after taking the mortgage application until the close of the transaction [See **RPI** Form 339];
10. ordering legal documents (statements) which are required for escrow to close, or a policy of title insurance to be issued;
11. ordering a flood hazard report on whether the property is located in a flood zone; and
12. assisting as an active participant in the closing of the mortgage.[12]

Unearned duplicate charges but no split

Splitting fees with any person — such as a mortgage lender paying a sales agent for a referral — who has not performed significant services for the fee is unlawful activity.

But what about the provider, such as a broker or escrow officer, charging twice for the same service when the charge is not split with others?

Consider a prospective homebuyer who enters into a buyer's listing agreement employing a broker to locate a property suitable for the homebuyer to occupy. The broker locates a suitable one-to-four unit residential property. The purchase price will be funded a consumer mortgage.

The buyer's broker negotiates a 3% broker fee due on closing and paid by the seller.

On closing, the broker charges the homebuyer a second fee in addition to the agreed-to 3% broker fee, a surcharge such as a transaction coordinator fee to help defray their overhead costs. The homebuyer refuses to pay the surcharge fee, claiming it violates RESPA since the broker provided no additional beneficial service to support the fee. The broker charged the fee for a service necessarily included when handling any sales transaction.

Can the broker collect an additional surcharge fee from the homebuyer for basic services which are normally provided when representing a homebuyer?

Yes! Prior to 2012, RESPA was interpreted broadly to prohibit any fees for which no new service was provided, called the *no-new-service, no-second-fee rule*.

However, in the 2012 **Freeman v. Quicken Loans**, a federal appeals court ruled that RESPA only prohibited the charging of a second, unearned fee when the fees were split. In other words, RESPA only prohibits kickbacks paid between service providers when one provides no service other than a referral. RESPA does not extend to prohibiting "junk fees" charged by escrow, title insurance and brokers, sometimes called garbage fees.[13]

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12 HUD Policy Statement 1991-1, Section C

13 **Freeman et al.** v. **Quicken Loans, Inc.** (5th Cir. 2012) 626 F3d 799

RESPA disclosures

When lenders and MLOs accept a homebuyer's application for a purchase-assist consumer mortgage, they must hand the buyer a written list of at least ten HUD-approved homeownership counseling organizations located in the homebuyer's area. This written disclosure is delivered within three business days after receiving the mortgage application.[14]

Homebuyers need not partake in the counseling unless the mortgage:

- is a Section 32 high-cost mortgage [See Chapter 26]; or
- has a negative amortization feature.[15]

14 12 CFR §1024.20(a)

15 12 CFR §§1026.34(a)(5), 1026.36(k)

Chapter 29 Summary

Beginning in 1974, homebuyers taking out purchase-assist consumer mortgages were given legal protection against abusive fee-charging practices of service providers by passage of the Real Estate Settlement Procedures Act (RESPA). RESPA rules are implemented by Regulation X (Reg X).

A fee qualifies as a charge for a settlement service, whether paid by a homebuyer, seller or owner, when the service is performed:

- directly for the benefit of the homebuyer, seller or owner; or
- at or before the closing.

However, some lenders, brokers/agents and other service providers collude to "buy business" or make additional profits off the homebuyer, seller or owner in the form of kickbacks between providers.

No person in a transaction which includes the origination of a consumer mortgage, including brokers, agents or other third-party service providers, may give or accept a kickback or any other thing of value for advising a homebuyer, seller or owner participating in the transaction to employ a particular service provider.

Further, the split of a settlement service charge with any person who has not provided a significant portion of the other provider's service in exchange for the split is unlawful.

Chapter 29 Key Terms

federally related mortgage .... pg. 322
kickback .... pg. 323
Real Estate Settlement Procedures Act (RESPA) .... pg. 322
service provider .... pg. 321
settlement service .... pg. 323

Notes:

Chapter 30

Affiliated business arrangements

Learning Objectives

After reading this chapter, you will be able to:

- differentiate acceptable and unacceptable referral conduct regarding affiliated business arrangements;
- determine when an affiliated business arrangement exists on a referral; and
- fill out an affiliated business arrangement form.

Key Term

affiliated business arrangement

The broker may benefit from a referral

In real estate transactions involving a consumer mortgage, a broker's ability to **profit from referrals** between providers of different services is regulated by the federal Real Estate Settlement Procedures Act (RESPA).[1]

However, entrepreneurial real estate brokers are not barred by RESPA from receiving a financial benefit beyond a fee for service as a sales transaction agent when they refer their client to another provider of real estate services in which the broker also holds an *ownership interest*, such as an escrow, mortgage originator or title company.

The ownership relationship between a real estate broker and a service provider which pays a fee to the broker as a transaction agent is a relationship known as an **affiliated business arrangement**.

affiliated business arrangement
A business arrangement in which a broker may lawfully profit from referring a client to a service provider the broker owns; requires the broker to make a disclosure of their ownership interest to the client.

1 12 Code of Federal Regulations §1024.15(b)

In a real estate transaction involving the origination of a consumer mortgage, the affiliated business arrangement arises when:

- a broker or their agents representing a buyer or seller has a direct or beneficial ownership interest of more than 1% in the settlement service provider used in the transaction; and
- the broker or their agents indirectly or directly refer the buyer or seller to the provider or influences the selection of the provider.[2]

The broker's receipt of a *referral fee* for influencing buyers or sellers to use a particular service provider is compensation prohibited by RESPA.[3]

However, when an affiliated business arrangement exists, a broker may financially benefit from a referral of the buyer or seller to a provider in which they have an ownership interest. The referral does not result in a fee paid for the referral. Instead, as a result of their ownership interest in the referred service provider, the broker will profit from any annual increase in the provider's earnings due to the patronage of the seller or buyer. The broker's receipt of a percentage of the affiliated service provider's annual profits is not subject to the RESPA prohibitions controlling referral fees.[4]

To protect the seller and homebuyer in their decision to choose the referred provider or a competitor, the transaction broker or their agent referring a seller or homebuyer to a service the broker owns or co-owns discloses their ownership of the service company *on or before* referring them to the service.

The AfBA disclosure

This disclosure, known as the **Affiliated Business Arrangement Disclosure Statement (AfBA disclosure)**, discloses the nature of the business relationship between the broker and the service provider, as well as an estimate of the cost or range of costs to be charged.[5]

*Editor's note — **RPI (Realty Publications, Inc.)** Form 205 is used by a loan broker when referring the buyer to affiliated settlement service providers while arranging a consumer mortgage secured by a one-to-four unit residential property, to disclose to the buyer that the loan broker shares in the provider's earnings.*

When the transaction agent refers a client to a service provider whose earnings are shared with the broker as an owner or co-owner, they disclose the business relationship and the financial or other benefit received from the referral with Form 519.

The AfBA disclosure is provided on a separate document when the referral is made, or at the time of the loan application when the lender requires the use of a particular service provider.

2 12 United States Code §2602(7)
3 12 CFR §1024.15((b)(iv)
4 12 CFR §1024.15(b)(3)
5 12 CFR §1024.15(b)(1)

AFFILIATED BUSINESS ARRANGEMENT DISCLOSURE STATEMENT
Loan Broker (Regulation X (RESPA); 12 CFR §1024.15)

NOTE: This form is used by a mortgage loan originator (MLO) when referring the borrower to affiliated settlement service providers while arranging a consumer mortgage, to disclose to the borrower that the MLO shares in the provider's earnings.

DATE: ______________, 20_____, at ______________________________, California.
Items left blank or unchecked are not applicable.

1. **NOTICE:**
   1.1 To ______________________________, as the Borrower,
   1.2 from ______________________________, as the Referring Party,
   1.3 regarding real estate referred to as ______________________________.
2. You are hereby given notice that ______________________________, as the Referring Party, has business relationships with the following settlement service providers:

	Provider	Percentage of Ownership	Description of Relationship
2.1	______________,	________%,	______________________________.
2.2	______________,	________%,	______________________________.
2.3	______________,	________%,	______________________________.

3. Because of these relationships, these referrals may provide ______________________________, as the Referring Party, a financial or other benefit.
4. Set forth at Section 5 below is the estimated charge or range of charges for the settlement services listed.
   4.1 You are not required to use the listed providers as a condition for the settlement of your mortgage on the subject property.
   4.2 **THERE ARE FREQUENTLY OTHER SETTLEMENT SERVICE PROVIDERS AVAILABLE WITH SIMILAR SERVICES. YOU ARE FREE TO SHOP AROUND TO DETERMINE THAT YOU ARE RECEIVING THE BEST SERVICES AND THE BEST RATE FOR THOSE SERVICES.**
5.

	Provider	Settlement Service	Charges or Range of Charges
5.1	______________,	______________________.	______________
5.2	______________,	______________________.	______________
5.3	______________,	______________________.	______________

6. Set forth below is the estimated charge or range of charges for the settlement services of a title company, credit reporting agency, or real estate appraiser that we, as your Lender, will require you to use, as a condition of your loan on this property, to represent our interest in this transaction.

	Provider	Settlement Service	Charges or Range of Charges
6.1	______________,	______________________.	______________
6.2	______________,	______________________.	______________
6.3	______________,	______________________.	______________

7. **ACKNOWLEDGMENT:**
   I/We have read this disclosure form and understand that ______________________________ as the Referring Party, is referring me/us to purchase one or more of the above described services and may receive a financial or other benefit as the result of this referral.

The above stated information is true and correct.	**The above stated information is true and correct.**
Date: ______________, 20_____	Date: ______________, 20_____
Borrower's Name: ______________________	Borrower's Name: ______________________
Signature: ______________________	Signature: ______________________

FORM 205 09-15 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

Form 205

Affiliated Business Arrangement Disclosure Statement

The following exceptions apply:

- if the lender is making a referral to an applicant, the AfBA disclosure may be provided at the same time as the **Loan Estimate**;
- if an attorney or law firm requires a client to use a particular **title company**, the AfBA disclosure is presented when the client retains the attorney or law firm; and
- no violation has occurred if the failure to provide the AfBA disclosure is the result of a **bona fide error**.[6]

6 12 CFR §1024.15(b)(1)

While a broker may refer an affiliated business to a person in their sales or mortgage transaction, in most cases they may not *require* the use of a particular service provider.

The two exceptions to this rule are in the case of:

- a lender requiring a buyer, applicant or seller to pay for the services of an attorney, credit reporting agency or real estate appraiser chosen by the lender to represent the lender's interest in the real estate transaction; or
- an attorney or law firm arranging for a title insurance policy for a client as part of the representation of that client in a real estate transaction.[7]

Compensation in an affiliated business arrangement

To comply with the affiliated business arrangement rules under RESPA, the only thing of value which can be received by a referring broker (or their agents) in an affiliated business arrangement, besides the sales transaction agent fee, is a return for the broker on their ownership interest or franchise relationship in the referred provider.[8]

The following items are considered a return on an ownership interest or franchise relationship:

- bona fide dividends and capital or equity distributions related to the ownership interest or franchise relationship with the affiliated business; and
- bona fide business loans, advances, and capital or equity contributions between entities in an affiliated relationship, as long as such loans, advances, capital or equity contributions are for ordinary business purposes and not fees masked referral or unearned fees triggered by the referral.[9]

The following items are NOT a return on ownership interest or franchise relationship, and may not be received by the referring broker in a sales transaction involving a consumer mortgage origination since it is RESPA-controlled affiliated business arrangement:

- any payment which is calculated based on the amount of their actual, estimated or anticipated referrals;
- any payment which varies according to the relative amount of referrals by different recipients of similar payments; or
- a payment based on ownership, partnership or joint venture share which has been adjusted based on the previous relative referrals by recipients of similar payments.[10]

Creative naming, complicated organization of documents in corporate, partnership or franchise agreements and attempts to mask a referral fee will

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7 12 CFR §1024.15(b)(2)
8 12 CFR §1024.15(b)(3)
9 12 CFR §1024.15(b)(3)(i)
10 12 CFR §1024.15(b)(3)(ii)

not insulate a "thing of value" from RESPA scrutiny. Whether a thing of value is truly an allowable return on ownership is to be determined by analyzing facts and circumstances on a case by case basis.[11]

Sham businesses: use of a dummy

While it almost goes without saying, the affiliated business owned or co-owned by a referring broker may not be a *sham* created by the referring broker to obtain a fee. An affiliated business arrangement is a sham if the company does not provide core settlement services to the applicant.

To be considered a **bona fide business**, the affiliated business must be a standalone operation capable of competing with rival businesses offering the same service.

In a 1996 policy statement, the Department of Housing and Urban Development (HUD) applied numerous factors for distinguishing a sham entity from a bona fide provider of title or settlement services, including:

Is the business undercapitalized to perform the duties it claims to provide? Does the business have sufficient net worth and initial capital standard in the industry?

- Is the business staffed with its own employees to perform the duties it claims to provide? Are the employees furnished by the broker making the referrals?
- Does the business independently manage its own professional affairs? Is the broker that aided in the creation of the business running it?
- Does the business have an independent office separate from the broker's? If the business is located at the same physical address, does it pay market value rent for the facilities furnished?
- Does the business receive a fee for performing services essential to the functioning of a real estate settlement service? Does the business experience the risks and rewards standard to the industry?
- Does the business perform the settlement services it claims to perform itself or does it contract out a portion of the work?
- If essential functions are contracted out, does the business contract services from an independent third party or are services contracted from the broker that helped create the business?
- If essential functions are contracted out, does the contracted party receive compensation reasonably related to the goods or services provided?
- Is the business actively competing with competitors in the market place? Does the business receive or attempt to obtain business from brokers other than the one which created the entity?
- Is the business referring business exclusively to the broker that created it, other settlement services, or a combination of both?[12]

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11 12 CFR §1024.15(b)(3)(iii)-(iv)

12 61 Federal Register 29258-29264

Thus, for a business to be a legitimate operation as an affiliated business, it must be adequately capitalized, have its own employees and office for which it pays fair market rent, manage its own business affairs and provide business comparable to its competitors. It must also be capable to take risks similar to its competitors, compete for business in the marketplace, not subcontract out services it should perform itself and not perform business exclusively for the referring broker.

Unless the broker meets these conditions, the business referred to is a mere scarecrow entity and the referring broker is prohibited from receiving compensation based on "profit sharing."

An individual who accepts a referral fee or fails to disclose the existence of the affiliated relationship as prescribed by RESPA is subject to criminal penalties of $10,000, one year in jail, or both, for each offense. Also, the person referred to the service provider may receive up to three times the amount of the improper referral fee received by the referring broker, plus attorney fees in a civil suit.[13]

Filling out the affiliated business arrangement disclosure statement

The following instructions are for the preparation and use of the AfBA disclosure.[14] [See Form 205]

RPI Form 205 fulfills the RESPA disclosure requirements, enabling the mortgage loan originator (MLO) or mortgage loan broker (MLB) to provide real estate services and share in the profits gained by the referral.

Each instruction corresponds to the provision in the form bearing the same number.

Document identification:

Enter the date and name of the city where the disclosure is being prepared. This date is used when referring to this disclosure.

1. *Notice:* **Establishes** the parties to the disclosure.

Enter the name of the applicant who is being referred to the service provider owned or co-owned by the mortgage loan broker or mortgage loan originator.

Enter the name of the mortgage loan broker making the referral.

Enter the property's legal description, common address, or the assessor's parcel number (APN).

1. *Business relationship:* **Enter** the name of the mortgage loan broker making the referral. This discloses the existence of the business relationship between the referring mortgage loan broker and the business the applicant is being referred to.

13 12 USC §§2607(a), (c)(4)(A), (d)
14 12 CFR §1024.15

2. *2.1-2.3 Description of relationship:* **Enter** the name of the service provider, percentage of ownership interest held by the referring mortgage loan broker, and a description of the relationship between the mortgage loan broker and the service provider.
3. *Financial benefit*: **Enter** the name of the mortgage loan broker making the referral. The mortgage loan broker may receive a financial or other benefit due to the relationships between the mortgage loan broker and provider.
4. *Estimate of charges:* **States** the estimated charge or range of charges for the settlement services is listed below to be performed by a nonrequired provider.
   - 4.1 *Nonrequired affiliated providers*: **States** the applicant is not required to use the listed providers as a condition for the settlement of their loan.
   - 4.2 *Other providers:* **States** there are other brokers available which offer comparable services and informs the applicant of his right to shop around.
5. *5.1-5.3 Nonrequired providers:* **Enter** the name of the broker, the settlement service performed for the applicant, and the charges or range of charges estimated to be charged.
6. *6.1-6.3 Required providers:* **Enter** the name of the service provider, the settlement service performed for the applicant and the charges or range of charges estimated to be charged.
7. *Acknowledgment:* **Enter** the name of the mortgage loan broker making the referral. The applicant has read this disclosure and understands the mortgage loan broker making this referral may receive a financial or other benefit as the result of this referral.

Signatures:

Applicant signature: **Enter** the date each applicant signs the disclosure and the name of each applicant. **Obtain** each applicant's signature on the disclosure.

Chapter 30 Summary

Entrepreneurial real estate brokers are not barred by federal Real Estate Settlement Procedures Act (RESPA) from receiving a financial benefit beyond a fee for service as a sales transaction agent when they refer their client to another provider of real estate services in which the broker also holds an ownership interest, such as an escrow, mortgage originator or title company.

The Affiliated Business Arrangement Disclosure Statement (AfBA disclosure), discloses the nature of the business relationship between the broker and the service, as well as an estimate of the cost or range of costs to be charged.

While a broker may refer an affiliated business to a person in their sales or mortgage transaction, they may not require the use of a particular service provider.

To comply with the affiliated business arrangement rules under RESPA, the only thing of value which can be received by a referring broker (or their agents) in an affiliated business arrangement, besides the sales transaction agent fee, is a return for the broker on their ownership interest or franchise relationship in the referred provider.

The affiliated business owned or co-owned by a referring broker may not be a sham created by the referring broker to obtain a fee. An affiliated business arrangement is a sham if the company does not provide core settlement services to the applicant. To be considered a bona fide business, the affiliated business must be a standalone operation capable of competing with rival businesses offering the same service.

Chapter 30 Key Term

affiliated business arrangement .... pg. 329

Chapter 31

The Fair Credit Reporting Act

Learning Objectives

After reading this chapter, you will be able to:

- the disclosures mandated by the Fair Credit Reporting Act (FCRA); and
- how the FCRA works with other fair lending laws.

Key Terms

adverse action notice
credit score disclosure
credit score exception notice
Fair Credit Reporting Act (FCRA)
Notice to Home Loan Applicant

Controlled use of credit reports

When a mortgage loan originator (MLO) or a mortgage lender processes a consumer mortgage application and collects, assembles or uses a **consumer credit report**, the federal **Fair Credit Reporting Act (FCRA)** governs their conduct.[1]

During the processing of an application for a consumer mortgage, the applicant is entitled to four sets of disclosures prepared and delivered to them by the MLO or lender, including:

- their **credit score**;
- a **Notice to Home Loan Applicant**;[2]
- a **credit score exception notice**;[3] and
- an **adverse action notice**.[4]

Fair Credit Reporting Act (FCRA)
A federal law controlling the collection and use of consumer credit reports, including the delivery of disclosures to credit consumers.

1 15 United States Code §1681a(d)
2 15 USC §1681g(g)(1)(D)
3 12 Code of Federal Regulations §1022.74(d)
4 15 USC §1681m(a)

All but the adverse action notice may be set out in one initial notice, which is the general practice.

Lenders typically use the *notice of action taken* form to meet the adverse action notice rules under by the Equal Credit Opportunity Act (ECOA). This notice fulfills both the ECOA and FCRA requirements. [See Chapter 32]

The credit score disclosure exception notice

credit score exception notice
A risk-based pricing notice disclosure provided to the consumer to fulfill the credit score disclosure and the Notice to Home Loan Applicant under the Fair Credit Reporting Act (FCRA).

An MLO or mortgage lender orders a credit report on receipt of a homebuyer or homeowner application for a consumer mortgage. The MLO or lender uses the information in the credit report to analyze the applicant's creditworthiness for borrowing money.

The use of a consumer credit report as the basis for setting the interest rates, charges and terms for originating a consumer mortgage is called *risk-based pricing*. Risk-based pricing triggers preparation by the MLO or lender of a risk-based pricing notice they hand to all consumer mortgage applicants entitled the **credit score disclosure exception notice**.[5]

The contents of the exception disclosure include:

- the *credit score disclosure*;
- the *Notice to Home Loan Applicant*;
- a statement that a credit report is a record of the applicant's credit history and includes information about whether the applicant pays their obligations on time and how much the applicant owes to creditors;
- a statement that a credit score is a number developed based on information in a credit report and that a credit score changes over time to reflect changes in the applicant's credit history;
- a statement that the applicant's credit score affects whether the applicant obtains a mortgage and what the cost of that mortgage will be;
- a chart or statement indicating how the applicant's credit score compares to other applicants who are scored under the same scoring model used to generate the applicant's credit score;
- a statement encouraging the applicant to verify the accuracy of the information contained in the credit report and that they may dispute any inaccurate information in the report;
- a statement that the applicant may obtain copies of their credit report directly from the credit reporting agencies, as well as a free report from each of the nationwide credit reporting agencies every 12 months;
- contact information of the source where applicants may obtain their free credit reports; and
- a statement directing applicants to the Consumer Financial Protection Bureau (CFPB)'s website for further information about credit reports.[6]

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5 12 CFR §1022.74(d)(1)
6 12 CFR §1022.74(d)(1)(ii)

Typically, the MLO or lender delivers this blanket credit score disclosure to the applicant within three business days after they receive the application when they make other required disclosures.[7]

In lieu of providing the blanket credit score disclosure exception notice to all applicants, an MLO or lender offering an applicant terms less favorable than requested in the application because of their credit history may simply deliver a standalone risk-based pricing notice only to affected applicants.[8]

However, the MLO or lender who does not use the blanket notice is still required to separately deliver to **all applicants** the credit score disclosure and the Notice to Home Loan Applicant. For simplicity (and for greater transparency), the common practice is to simply provide the blanket credit score disclosure exception notice to all applicants. It fulfills three of the four FCRA disclosure requirements at once.

The credit score disclosure

credit score disclosure
A disclosure of a consumer's credit score information as required by the Fair Credit Reporting Act (FCRA).

The **credit score disclosure** includes:

- the credit scores used in the mortgage risk-based rate setting decision;
- the range of possible credit scores under the model used;
- the date the credit score was created;
- the name of the organization that provided the credit score; and
- up to four **key factors** from the applicant's credit report that adversely affected their credit score.[9]

The MLO or lender uses as the *key factors* information taken from the credit report which provides the applicant's credit score. Key factors are credit report facts which adversely affect the credit score, listed in the order of their influence on the credit score.

Regardless of the outcome of the application, the MLO's or lender's use of a credit report always triggers their making this credit score disclosure.

When delivered separately from the blanket credit score disclosure exception notice, the MLO or mortgage lender prepares and hands the applicant the credit score disclosure as soon as practicable (ASAP) after they receive the applicant's credit report.

The Notice to Home Loan Applicant

Notice to Home Loan Applicant
A disclosure of the consumer's right to credit score disclosures and how consumer credit scores are used, as required by the Fair Credit Reporting Act (FCRA).

The Notice to Home Loan Applicant may be prepared as a standalone document. However, the MLO or lender in lieu of this separate document generally provides the information on the blanket credit score disclosure exception notice discussed above.

When used separately from the blanket credit score disclosure exception notice, the *Notice to Home Loan Applicant* discloses to the applicant information about:

- how their credit scores are used; and

7 76 FR 41596
8 12 CFR §1022.72(a)
9 15 USC §1681g(f)

- their right to credit score disclosures under the FCRA.

The first person to pull the applicant's credit score — whether MLO or lender — prepares and delivers this notice to all applicants whose credit scores are used.

The disclosure is delivered as soon as practicable (ASAP) after the MLO or lender receives the credit report, and always before closing.[10] [See **RPI** Form 217]

Like the credit score disclosure, the MLO or lender prepares and delivers the Notice to Home Loan Applicant regardless of the outcome of the mortgage application analysis.

Upon denial: the adverse action notice

adverse action notice
A disclosure notifying the applicant a negative action has been taken on their consumer mortgage application due to an unfavorable credit history, as required by the Fair Credit Reporting Act (FCRA).

When the MLO or lender denies a consumer mortgage application, they prepare and deliver an *adverse action notice* to the mortgage applicant. [See **RPI** Form 219]

An **adverse action** triggering the notice is defined as:

- a denial of a mortgage application;
- a revocation of a mortgage approval;
- a change in the terms of an existing mortgage; or
- a refusal to grant a mortgage with the amount or terms requested.[11]

The FCRA **adverse action notice** includes:

- the credit score, or credit scores upon which the adverse action is based;
- the range of possible credit scores under the model used;
- the date the credit score was created;
- the name of the person or entity that provided the credit score; and
- up to four key factors listed in the credit report that adversely affected the credit score (five, if one of one of the first four key factors is the number of inquiries);
- the name, address and telephone number of the credit reporting agency that furnished the report to the entity taking the adverse action;
- a statement the credit reporting agency did not make the decision to take the adverse action and is unable to provide the applicant the specific reasons why the lender took the adverse action;
- a disclosure of the applicant's right to receive a free copy of the credit report upon which the adverse action is based within 60 days of the receipt of the notice; and
- a disclosure of the applicant's right to dispute the accuracy or completeness of the information contained in the credit report.[12]

---

10 15 USC §1681g(g)(1)
11 15 USC §1681a(k)(1)(A); 15 USC §1691(d)(6)
12 15 USC §1681m(a)

The adverse action notice contains information similar to the credit score disclosure exception notice. However, the two are prepared and delivered at very different times during the mortgage origination process. The MLO or lender prepares and hands the credit score disclosure exception notice to the applicant early in the mortgage application process when they receive a credit report, to inform the applicant how their credit affects their mortgage rates and charges.

In contrast, an MLO or lender uses the adverse action notice on their denial of the mortgage the applicant seeks.[13]

Tandem notice(s)

The required **notice of action taken** statement has content similar to disclosures to be made in the *adverse action notice*.

Federal regulators use information in the **notice of action taken** and demographic information to locate patterns of unlawful discrimination, as required by the ECOA. [See Chapter 32]

The MLO or lender hand an applicant the notice of action taken every time the MLO or lender deny or unfavorably change the terms of the mortgage the applicant seeks. The notice also discloses the specific reasons for denial of credit.

The ECOA's notice of action taken and the FCRA's adverse action notice overlap extensively. To cut paperwork, the MLO or lender fulfills both requirements by preparing and delivering the notice of action taken to the applicant.[14]

The MLO's or lender's delivers a notice of action to the applicant within 30 days of receipt of a completed mortgage application.[15]

Which credit score is disclosed?

The credit score the MLO or lender uses to set the terms of the consumer mortgage is the credit score disclosed. For example, an MLO pulls all three credit scores, but uses the middle score to set the material terms of the consumer mortgage. Here, they disclose their use of the middle score on the form.

Occasionally, a lender uses multiple scores, or an average of the scores. Here, they may disclose one or more of the scores used to create the average.[16]

Multiple applicants

For a consumer mortgage file involving two or more applicants, the MLO or lender hands the required FCRA disclosures to each applicant. To protect the privacy of the applicants, each notice is separately prepared and may only contain the credit score(s) of the applicant receiving the notice.[17]

13 76 FR 41595
14 12 CFR §1002.9
15 12 CFR §1002.9(a)
16 12 CFR §1022.74(d)(4)
17 12 CFR §1022.75(c)(2)

Chapter 31 Summary

When a mortgage loan originator (MLO) or a mortgage lender processes a consumer mortgage application and collects, assembles or uses a consumer credit report, the federal Fair Credit Reporting Act (FCRA) governs their conduct.

During the processing of an application for a consumer mortgage, the applicant is entitled to four sets of disclosures prepared and delivered to them by the MLO or lender, including:

- their credit score;
- a Notice to Home Loan Applicant;
- a credit score exception notice; and
- an adverse action notice.

All but the adverse action notice may be set out in one initial notice, which is the general practice.

Lenders typically use the notice of action taken form to meet the adverse action notice rules under by the Equal Credit Opportunity Act (ECOA). This notice fulfills both the ECOA and FCRA requirements.

When the MLO or lender denies a consumer mortgage application, they prepare and deliver an adverse action notice to the mortgage applicant.

Chapter 31 Key Terms

Chapter 32

The Equal Credit Opportunity Act

Learning Objectives

After reading this chapter, you will be able to:

- recognize the protected classes under the federal Equal Credit Opportunity Act (ECOA);
- identify the mortgage lending activities of a broker subject to ECOA rules;
- determine what activities ECOA prohibits;
- review the information which may and may not be collected under the ECOA; and
- conform to the proper timing for ECOA notices to consumer mortgage applicants.

Key Terms

Equal Credit Opportunity Act (ECOA)

government monitoring information (GMI)

notice of action taken

notice of incompleteness

Federal fair lending rules

Consider an unmarried couple who submit an offer to purchase a home to a seller. The sale is contingent on the couple obtaining financing. The couple applies for a mortgage to be evidenced by a note and trust deed signed by both. The couple fills out a consumer mortgage application stating their separate incomes which, when combined, are sufficient to qualify for the mortgage.

The lender denies the mortgage application since the couple is not married and their separate incomes are not sufficient to allow each of them to independently qualify for the mortgage. The couple is unable to locate another lender before their purchase agreement is cancelled by the seller.

Equal Credit Opportunity Act (ECOA)
A federal law which prohibits discriminatory and unfair lending practices.

The couple seeks to recover their losses from the lender under the federal **Equal Credit Opportunity Act (ECOA),** claiming the lender has unlawfully discriminated against them based on their *marital status*.

The lender claims the denial of the mortgage to the unmarried couple is motivated by a legitimate business consideration. The lender states the couple presents a greater risk of default since each partner's separate income is not sufficient to alone cover the mortgage, and unmarried couples are not liable for each other's debts, as are married couples.

Was the lender's denial of the couple's mortgage unlawful discrimination?

Yes! The lender had no justifiable reason not to consider the couple's combined income in determining whether their combined income was sufficient to qualify for the mortgage. As both will sign the note, both will be liable for the mortgage – even though no liability exists under a purchase-assist mortgage which funds the price paid for a home the buyers will occupy.

Thus, the lender's denial of the couple's mortgage application is based on their marital status. Since marital status is the use of a prohibited classification of conduct for lending money, denial based on marital status is a form of **unlawful discrimination.**[1]

Fairness in lending

Homebuyers seeking a mortgage are protected from a lender's discriminatory and unfair lending practices by the ECOA, enacted in 1974. Regulation B implements the conduct required of lenders under the ECOA.

In pursuing consumer protection goals when seeking a mortgage, the ECOA protects mortgage applicants in three ways:

- discriminatory lending is prohibited;[2]
- on a denial of a consumer mortgage application, the lender is to give notice and reason for the denial;[3] and
- a copy of their appraisal report is to be given to a consumer mortgage applicant.[4] [See Chapter 14]

The **anti-discrimination rules** apply to all lenders, mortgage originators (MLOs) and mortgage brokers (MLBs) who *make or arrange any loan, be it a consumer or business mortgage.*[5]

1 **Markham** v. **Colonial Mortgage Service Co. Associates, Inc.** (1979) 605 F2d 566
2 15 United States Code §1691(a)
3 15 USC §1691(d)
4 15 USC §1691(e)
5 15 USC §1691a(e)

Only MLOs and MLBs who *make* a mortgage, not just arrange one, are subject to the notices a lender is required to give on consumer mortgage applications and appraisal report requirements.[6]

Discriminatory practices, defined

The *ECOA* prohibits discrimination in lending based on:

- race;
- color;
- religion;
- national origin;
- sex;
- marital status;
- age (provided an individual is of legal age); or
- whether the applicant receives income from a public assistance program, such as *welfare* or *social security*.[7]

Discriminatory practices take many forms, including:

- treating minority mortgage applicants less favorably than non-minority applicants;
- placing additional requirements on minority applicants;
- requiring a spouse's signature on a mortgage application when an applicant qualifies for a mortgage individually;[8]
- discouraging mortgage applicants based on their race, color, sex, etc.;[9] and
- using the marital status of mortgage applicants as a measure of their creditworthiness.[10]

However, requesting a spouse's signature to create a valid lien, passing clear title, waiving rights to property or assigning earnings is not considered discriminatory.[11]

The lender may request information about an applicant's spouse or former spouse if:

- the spouse is contractually liable for the account (when community property is involved);
- the applicant relies on the spouse's income to qualify for the mortgage requested; or
- the applicant is relying on alimony, child support or maintenance payments from a spouse to qualify for the mortgage requested.[12]

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6 Official Interpretation of 12 Code of Federal Regulations §1002.2(l)-2

7 15 USC §1691(a)

8 **Anderson** v. **United Finance Company** (1982) 666 F2d 1274

9 12 CFR §1002.5(b)

10 12 CFR §1002.5(d), 12 CFR §1002.6(b)(8)

11 12 CFR §1002.5(d), 12 CFR §1002.6(b)(8)

12 12 CFR §1002.5(c)

The lender may not inquire whether the applicant intends to bear children, nor may they base a mortgage decision on childrearing costs.[13]

Discrimination is rarely practiced overtly. Most lenders who discriminate are sufficiently stealthy and not transparent enough for the consumer to see the discrimination. Most often, discrimination takes the form of a lender denying a mortgage to a minority homebuyer without a valid reason, or applying different standards to minority and non-minority homebuyers.

The following scenarios are examples of unlawful discriminatory treatment:

- a lender provides information only on high-cost mortgages to minority applicants, but provides information on a variety of mortgages to similarly situated non-minority applicants;
- a lender provides more comprehensive information to men than to similarly situated women;
- a lender requires a minority applicant to provide greater documentation to obtain a mortgage than a similarly situated non-minority applicant; or
- a lender waives or relaxes mortgage standards for a non-minority applicant but not for a similarly situated minority applicant.[14]

Different treatment is discrimination

Lenders need to be careful not to provide more assistance to non-minority homebuyers than to minority homebuyers when preparing applications and working out problems which arise. The *different treatment* of minority and non-minority applicants is a classic form of unlawful discrimination.

For example, an African-American couple applies for an **Federal Housing Administration (FHA)-insured mortgage,** which will fund the purchase of a residence. The home the couple seeks to purchase is 75 miles from their place of work. The couple intends to occupy the home as their principal residence and commute to work.

The lender suspects the couple wants to purchase the home as an investment, and not to occupy it themselves. Since the type of FHA insurance sought may only be used to purchase homes which the buyer will occupy, the lender denies the mortgage application.

The lender does not discuss with the couple whether they intend to occupy the home. Also, the lender never suggests the couple can apply for a non-FHA mortgage. Due to a mortgage contingency, the couple loses their right to buy the home and incurs expenses in the process.

The couple seeks to recover their money losses from the lender under the *ECOA,* claiming the lender's denial of their mortgage application was due to unlawful discrimination.

13 12 CFR §1002.5(d)(3)

14 Official Interpretation of 12 CFR §1002.4(a)-2

The lender claims the denial of the mortgage application was proper since it believed the couple did not intend to occupy the home, and thus did not qualify for an FHA-insured mortgage.

A lender may not unilaterally decide whether a couple did or did not intend to occupy the home without first discussing the couple's intentions with them. An MLO's duty to the homebuyer they are assisting to arrange a purchase-assist mortgage is to advise them of other sources where mortgage money is available besides the type of mortgage requested. Lenders need to provide the same level of assistance to all homebuyers.

Thus, the lender discriminated against the African-American couple by denying their mortgage application without a valid reason. Further, there was a failure to use diligence in assisting the couple to obtain other financing.[15]

Discrimination by age and public assistance

Some exceptions to the anti-discrimination rules exist.

For example, a lender may lawfully consider a mortgage applicant's age when determining the applicant's creditworthiness. A lender may also consider whether the applicant receives income from a public assistance program, if such an inquiry is for the purpose of determining the amount and likely continuance of income levels from public assistance.[16]

Editor's note — Allowing lenders to consider an applicant's age or receipt of income from a public assistance program as an exception in determining the applicant's creditworthiness effectively removes these two factors from the anti-discrimination protection previously discussed.

While a lender may not refuse to accept applications or impose different mortgage terms based on an applicant's age or receipt of public assistance income, the lender can lawfully deny a mortgage based on these factors simply by stating the applicant is not creditworthy due to age or assistance.

Lenders may also consider an applicant's **immigration status** when considering a mortgage application. Immigration status is used by the lender to determine whether the applicant is a permanent resident of the United States.[17]

Further, a lender may affirmatively solicit members of a traditionally disadvantaged group to apply for a mortgage.[18]

For example, a lender may advertise and tailor advertisements for mortgage products to a minority community. The lender may not, however, disparately provide information for only high-cost or less favorable mortgages (e.g., "high-cost" mortgages) to that community if the lender also routinely provides other applicants with lower-cost or more favorable mortgages (e.g., "prime" mortgages).

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15 **Barber** v. **Rancho Mortgage & Investment Corp.** (1994) 26 CA4th 1819
16 15 USC §1691(b)(2)
17 12 CFR §1002.6(b)(7)
18 Official Interpretation of 12 CFR § 1002.4(b)-2

Collecting government monitoring information

Consumer mortgage lenders are required by the ECOA to collect information about the applicant's:

- ethnicity, using the categories "Hispanic or Latino" and "not Hispanic or Latino";
- race, using the categories "American Indian or Alaska Native", "Asian", "Black or African American", "Native Hawaiian or Other Pacific Islander" and "White";
- sex;
- marital status, using the categories "married", "unmarried", and "separated" (cannot ask about "divorced" "widowed"; and
- age.[19]

government monitoring information (GMI) Demographic information collected from mortgage applications used to monitor lenders' compliance with anti-discrimination laws.

This information is collectively referred to as **government monitoring information (GMI)**. GMI is collected to monitor the lender's compliance with federal statutes prohibiting lenders from unlawfully discriminating against applicants. GMI data may not to be used as criteria for making a mortgage decision.[20]

The applicant, however, is not required to furnish GMI data. If the applicant declines to provide the information, that fact is to be noted on the mortgage application.

The lender is then to determine the ethnicity, race and sex of the applicant based on the surname or visual observation, and inform the applicant they are doing so.

The ECOA does not require GMI to be reported to the government. However, several federal regulatory agencies, including the Consumer Financial Protection Bureau (CFPB), may request lender records to review possible violations of fair lending laws, based on GMI.

Editor's note — The Home Mortgage Disclosure Act (HMDA) does require broker-lenders who exceed set thresholds for mortgage volume and assets to report GMI and other mortgage data annually. [See Chapter 33]

Denial of a mortgage and notification

When a mortgage application is denied, counter-offered or withdrawn the lender is required by the ECOA to serve notice of the event on the applicant. [See **RPI** Form 219]

Lenders who took fewer than 150 applications during the preceding calendar year may give verbal, rather than written notifications of a denial, counteroffer or withdrawal.[21]

19 12 CFR §1002.13(a)(1)
20 12 CFR §1002.13(b)-(c)
21 12 CFR §1002.9(d)

An incomplete application

Before a lender can make a decision on an application, the application needs to contain all information regularly required to decide whether to make, counteroffer or deny the request for a mortgage. When all the information needed in the application has been provided to the lender, it is called a **completed application**.

Lenders are allowed to determine what they deem to be a complete or incomplete application. Information which makes a complete application includes information such as credit reports, the homebuyer's financial documentation, property information, etc.[22]

Within 30 days after receipt of an incomplete application, a lender must provide to the applicant either:

- a **notice of action taken**;[23] or
- a **notice of incompleteness**.[24]

A written *notice of incompleteness* is to:

- include a list of information needed to complete the application;
- designate a reasonable period of time for the applicant to provide the information;
- contain a statement informing the applicant that failure to provide the information requested will result in no further consideration being given to the application.[25]

notice of incompleteness
A notice requesting additional information to complete a mortgage application, as required by the Equal Credit Opportunity Act (ECOA).

If the applicant fails to respond to the notice of incompleteness within the designated time period, the lender has fulfilled its duties under the ECOA.

If the applicant supplies the requested information within the designated time period, the lender then follows ECOA rules for handling completed mortgage applications.[26]

A lender may verbally notify the applicant of the information needed to complete the application. However, if the application remains incomplete after a verbal notification, the lender must then send either a written notice of action taken or a written notice of incompleteness.[27]

Completed applications

After the lender's receipt of a completed mortgage application, the lender has 30 days to:

- notify the applicant the mortgage is approved;
- notify the applicant the mortgage is denied with the *notice of action taken*; or
- counteroffer the applicant's mortgage request.[28]

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22 12 CFR §1002.2(f); Official Interpretation of 12 CFR §1002.2(f)
23 12 CFR §1002.9(a)(1)(ii)
24 12 CFR §1002.9(c)(2)
25 12 CFR §1002.9(c)(2)
26 12 CFR §1002.9(c)(2)
27 12 CFR §1002.9(c)(3)
28 12 CFR §1002.9(a)(1)(i)

If the lender denies the mortgage, the lender needs to notify the applicant by delivery to them of a statement listing the specific reasons for the denial.[29] [See **RPI** Form 219]

If the applicant is notified of a counteroffer and does not respond, the lender must provide the notice of action taken within 90 days of the counteroffer.[30]

notice of action taken
A notice disclosing to the applicant the specific reasons for a denial of credit, as required by the Equal Credit Opportunity Act (ECOA).

A **notice of action taken** is to be in writing and contain:

- a statement of the action taken;
- the name and address of the lender;
- a statement identifying the purposes of the ECOA; and
- the name and address of the federal agency in charge of the lender's compliance with the ECOA.[31]

This statement identifying the purposes of the ECOA needs to read:

"The Federal Equal Credit Opportunity Act prohibits creditors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to enter into a binding contract); because all or part of the applicant's income derives from any public assistance program; or because the applicant has in good faith exercised any right under the Consumer Credit Protection Act. The Federal agency that administers compliance with this law concerning this creditor is [name and address as specified by the appropriate agency or agencies listed in appendix A of this part]."[32]

Additionally, the notice of action taken contains:

- a statement of the specific reasons for the action taken; OR
- a notice stating:
  - that within 60 days of the lender's notification, the applicant may request a statement listing the reasons for denial and the lender must deliver the statement within 30 days of the applicant's request; and
  - the name, address and telephone number of the person from whom the statement of reasons can be obtained.[33]

The statement of specific reasons may not be a boilerplate statement that the applicant did not meet the lender's internal standards. As its name implies, the reasons must be specific to the application, rather than generic.[34]

Applications withdrawn by the applicant do not require a notice. If a lender approves an application, and the applicant has not inquired about or otherwise acted on the application within 30 days after the application, the application is considered withdrawn.[35]

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29 15 USC §1691(d)
30 12 CFR §1002.9(a)(1)(iv)
31 12 CFR §1002.9(a)(2)
32 12 CFR §1002.9(b)
33 15 USC §1691(d)(2)
34 12 CFR §1002.9(b)(2)
35 12 CFR §1002.9(e)

Record retention

For 25 months after the date a lender notifies an applicant of action taken on an application, the lender must keep copies of:

- the application, including GMI;
- any other written or recorded information used in evaluating the application and not returned to the applicant at the applicant's request;
- the written notification of action taken, or a notation of an verbal notification;
- the written statement of specific reasons for adverse action, or a notation of an verbal notification; and
- any written statement submitted by the applicant alleging a violation of the ECOA or Regulation B.[36]

Penalties for discrimination in lending include actual money losses sustained by a person who has been discriminated against and punitive money awards of up to $10,000, plus court costs and attorney fees.[37]

A lawsuit alleging a violation of the ECOA must be brought in court within five years after the violation.[38]

36 12 CFR §1002.12(b)
37 15 USC §1691e
38 12 CFR §1002.16(b)(2)

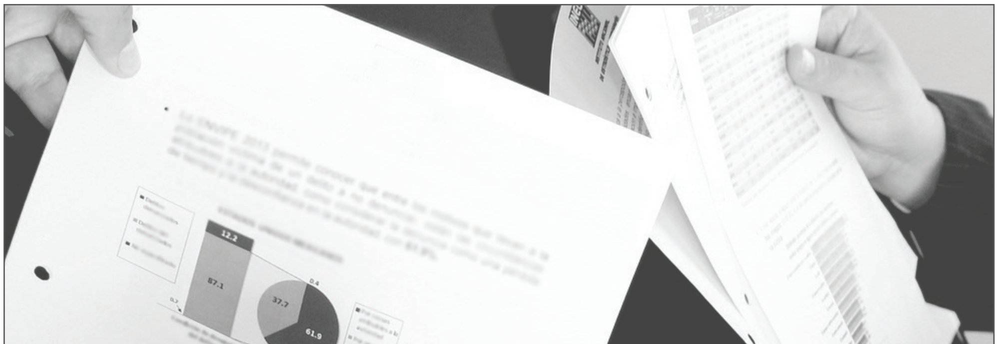
Chapter 32 Summary

The Equal Credit Opportunity Act (ECOA) prohibits discrimination in lending based on race, color, religion, national origin, sex, marital status, age (provided an individual is of legal age) and whether the applicant receives income from a public assistance program, such as welfare or social security.

Consumer mortgage lenders are required by the ECOA to collect information about the applicant's ethnicity, race, sex, marital status and age. This information is collectively referred to as government monitoring information (GMI). GMI is collected to monitor the lender's compliance with federal statutes prohibiting lenders from unlawfully discriminating against applicants. GMI data may not to be used as criteria for making a mortgage decision.

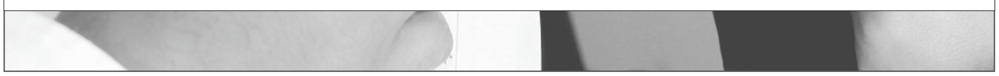
When a mortgage application is denied, counter-offered or withdrawn the lender is required by the ECOA to serve notice of the event on the applicant.

Chapter 32 Key Terms



Chapter 33

The Home Mortgage Disclosure Act



Learning Objectives

After reading this chapter, you will be able to:

- identify the consumer protection goals of the federal Home Mortgage Disclosure Act (HMDA);
- identify lenders who report under HMDA;
- determine the information collected under HMDA;
- identify California lenders who file the California residential mortgage loan activity report; and
- understand the purpose of the California residential mortgage loan activity report.

Key Terms

government monitoring information (GMI)

Home Mortgage Disclosure Act (HMDA)

Loan/Application Register (LAR)

metropolitan statistical area (MSA)

residential mortgage loan report

Lenders release mortgage data

Department of Real Estate (DRE)-licensed brokers acting as lenders making mortgages are barred from discriminating based on factors such as ethnicity, race, sex or marital status when considering an application for a mortgage secured by any type of residential real estate. Individual brokers who arrange, but do not make mortgages are otherwise covered by licensing laws controlling their discriminatory conduct with the public.

To detect potential patterns of unlawful discrimination, the **Home Mortgage Disclosure Act (HMDA)** requires DRE-licensed broker-lenders

Home Mortgage Disclosure Act (HMDA)
A federal law mandating data collection on mortgage originations and applications of lenders who meet Home Mortgage Disclosure Act (HMDA) threshold requirements.

who make consumer or business mortgages secured by residential real estate to annually disclose to the public their mortgage origination and application data.

HMDA is implemented by the Consumer Financial Protection Bureau (CFPB) under Regulation C.[1]

State and federally regulated banks, broker-lenders making mortgages secured by any residential real estate — whether consumer or business and regardless of the number of units — are required by HMDA to compile data on mortgages they originate.

For non-exempt DRE-licensed broker-lenders, this data is submitted through the CFPB to the U.S. Department of Housing and Urban Development (HUD).[2]

Individual mortgage loan originators (MLOs), brokers or agents employed by a reporting MLO broker are not required to report. However, they do need to understand HMDA reporting to properly collect HMDA data for their employers.

Federal disclosure requirements

DRE-licensed broker-lenders who make mortgages for the purchase or improvement of residential real estate need to collect HMDA mortgage data in the current calendar year if:

- they engage in mortage origination for profit;
- in the preceding year, they were located in, or originated or purchased a mortgage secured by property located in a **metropolitan statistical area (MSA)**; and
- in the preceding two years, they originated:
  - 25 or more closed-end mortgages; or
  - 500 open-end lines of credit.[3]

Editor's note — The threshold for open-end lines of credit will lower to 100 open-end lines of credit in 2020.

metropolitan statistical area (MSA)
A large region connected by common economic ties, considered as a unit for statistical purposes.

A HMDA broker-lender is required to report closed-end loan data only if they meet the threshold for closed-end loans. Likewise, they are only required to report open-end loan data if they met the open-end loan threshold.[4]

An *MSA* is a region defined by the U.S. Office of Management and Budget (OMB) and used by different government agencies for statistical purposes. MSAs represent regions linked by common economic ties, e.g. Riverside-San Bernardino-Ontario.

Data collected

HMDA data is collected electronically on a form known as the **Loan/Application Register (LAR)**.

1 12 Code of Federal Regulations §§1003 et seq.
2 12 United States Code §§2802, 2803
3 12 CFR §1003.2(g)(2)
4 12 CFR §1003.3(c)(11)-(12)

Consider a Department of Real Estate (DRE)-licensed and endorsed broker-lender who enters into a warehouse lending agreement with a bank. The broker-lender, now a direct lender with funds to invest, solicits and takes a consumer mortgage application from a buyer.

The broker-lender processes and underwrites the mortgage, and is responsible for approving the mortgage based on their bank's underwriting criteria. The bank is uninvolved in any aspect of the mortgage origination process.

After the mortgage is funded by the broker-lender, the mortgage is sold to the bank to pay down and replenish the broker-lender's warehouse line of credit.

If both the broker-lender and the bank are required to collect mortgage data under the Home Mortgage Disclosure Act (HMDA), which participant is responsible for collecting HMDA data on mortgages originated and sold by the broker-lender?

Under Regulation C, the person making the decision on whether to approve or deny the mortgage application is responsible for collecting HMDA data and reporting the data to the U.S. Department of Housing and Urban Development (HUD) and the public. In this scenario, that person is the broker-lender.

However, if the broker-lender in this scenario is required to submit the mortgage to the bank for approval prior to closing, the bank, and not the broker-lender collects and reports the HMDA data.

Direct lenders or investors: who reports?

HMDA data for mortgage applications on which a final decision has been made is entered by the broker-lender on the LAR within 30 calendar days after each calendar quarter.[5]

Loan/Application Register (LAR)
The electronic form used to collect Home Mortgage Disclosure Act (HMDA) data.

The LAR is then sent to the appropriate regulatory agency by March 1 of the calendar year following the year the data is collected.[6]

HMDA-covered broker-lenders need to collect data on mortgage applications, originations and acquisitions of:

- purchase-assist financing for residential real estate, regardless of occupancy or the number of units, called *home purchase mortgages*;
- financing used to construct a new home;
- financing used to fund the improvement of the owner's home, called *home improvement mortgages*; or
- *refinances* of existing mortgages secured by residential real estate, regardless of the number of units or occupancy.[7]

The data includes:

- a unique loan identifier;
- whether the mortgage is insured by the Federal Housing Administration (FHA), guaranteed by the U.S. Department of Veterans Affairs (VA) or guaranteed by the Rural Housing Service or the Farm Service Agency;

5 12 CFR §1003.4(f); Official Interpretation of §1003.4(a)-3
6 12 CFR §1003.5(a)
7 12 CFR §1003.1(c), 12 CFR §1003.4(a)

- the type and purpose of the mortgage;
- whether the application involved a preapproval request;
- whether the property is site-built or a manufactured home;
- the owner-occupancy status of the real estate securing the mortgage;
- the mortgage amount;
- whether the application resulted in a preapproval, denial or origination;
- an identification of the MSA and census tract in which the property is located;
- the ethnicity, race and sex of the mortgage applicant;
- the type of investor that will purchase the mortgage;
- the spread between the annual percentage rate (APR) and the average prime offer rate (APOR);
- whether the mortgage is subject to the Home Ownership and Equity Protection Act (HOEPA)[8] [See Chapter 26];
- the lien status;
- the buyer or applicant's credit score;
- the main reason for denial, if applicable;
- points and fees paid;
- buyer-paid origination charges;
- discount points;
- lender credits;
- interest rate;
- the term of any prepayment period;
- the applicant's debt-to-income ratios (DTIs);
- the mortgage term;
- the number of months until the interest rate may change, if applicable;
- wheter the mortgage allows for balloon payments, interest-only payments or negative amortization;
- property value;
- the number of units in the property;
- the lending channel, e.g., retail or broker;
- the NMLS ID of the mortgage loan originator;
- automated underwriting information;
- whether the mortgage is a reverse mortgage;
- whether the mortgage is an open-end line of credit; and
- whether the mortage is primarily for a business or commercial purpose.

8 12 CFR §1003.4(a)

Government monitoring information

A mortgage applicant's ethnicity, race, sex and marital status are of interest to the government for tracking discriminatory practices. This information about an applicant's personal classifications is collectively called **government monitoring information (GMI)**.

government monitoring information (GMI)
Demographic information collected from mortgage applications used to monitor lenders' compliance with anti-discrimination laws.

Similar to data collection requirements under the Equal Credit Opportunity Act (ECOA), the MLO taking the mortgage application — whether a broker-lender also making the mortgage, or a broker arranging the mortgage for a third-party lender — needs to ask for GMI.

The applicant is not required to supply any GMI. If the applicant refuses, the MLO enters the information based on the applicant's last name and appearance. [See Chapter 32]

Further, the MLO informs the applicant the federal government requires the MLO to enter this information for government to monitor compliance with anti-discrimination rules when dealing with mortgage applicants.[9]

For most mortgages secured by residential real estate, GMI is collected on page 8 of the Uniform Residential Loan Application (URLA). The URLA also provides the information regarding compliance with federal statutes.

GMI collected using the URLA meets requirements for both ECOA and HMDA. [See **RPI** Form 202]

Disclosure of HMDA data

Annually reported HMDA data is compiled by the Federal Financial Institutions Examination Council (FFIEC) for each reporting MLO broker-lender.

This report is known as the **disclosure statement**.[10]

On request from any member of the public, the lender needs to provide written notice that the disclosure statement can be obtained on the CFPB's website.[11]

Aggregate HMDA data is available online from the CFPB at *http://www.consumerfinance.gov/hmda/explore*.

Lenders are subject to investigation and penalties by federal authorities.[12]

The residential mortgage loan report

The **residential mortgage loan report** is the California equivalent of the federal HMDA LAR disclosure. [See Form RE 857A]

MLO brokers and Mortgage Loan Broker (MLBs) who make consumer or business mortgages to purchase or improve one-to-four unit residential real estate — not all residential properties as under HMDA reporting — file the California *residential mortgage loan report* if their mortgage volume or size falls below the thresholds triggering federal HMDA reporting.

residential mortgage loan report
A report filed by Department of Real Estate (DRE)-licensed mortgage brokers who act as direct lenders.

9 12 CFR §1003 Appendix B
10 12 USC §2803(k)(1)(A), 12 USC §2803(a)(1); 12 CFR §1003.5(b)(3)
11 12 USC §2803(a)(1)
12 12 USC §2803(h)

Similar to HMDA reporting requirements, the reporting is only required by the broker of record on behalf of the broker-lender. Individual MLOs are not required to report separately for mortgages originated by their employing brokers.

Completion of the residential mortgage loan report is *monitored* by the California State Transportation Agency and the California Business, Consumer Services and Housing Agency (BCSH).

Like HMDA, the report data is reviewed to identify potentially discriminatory lending patterns based on the demographics of a community.[13]

Broker reporting threshold

A broker-lender making mortgages as a direct lender files the California *residential mortgage loan report* with the DRE if, during the prior calendar year they:

- make consumer or business mortgages secured by one-to-four unit residential real estate exceeding 10% of the total dollar amount of all mortgages they make;[14]
- make 12 or more consumer or business mortgages secured by one-to-four unit residential real estate during the calendar year with a total amount of $500,000; and
- have assets of $10 million or less. [See DRE Form RE 857]

Data collected

A reporting broker-lender collects data on applications and closed consumer or business mortgages secured by and used to purchase or improve one-to-four unit residential real estate. This includes cash-out refinancing which funds some improvement to the property.[15]

A residential mortgage does not include:

- a mortgage secured by unimproved land;
- a rate and term refinance by modification;
- a mortgage or cash-out refinance which funds a purpose other than the purchase or improvement of the secured real estate;
- a mortgage applied for outside of California;
- a mortgage made in California, but secured by property outside of California;[16] or
- a mortgage made by a lender when an MLO or MLB broker arranges the mortgage.[17]

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13 Calif. Health and Safety Code §35816
14 21 Code of California Regulations §7121(a)
15 21 CCR §7117(d), 7118(b)-(c)
16 21 CCR §7118(c)
17 21 CCR §7121(b)

Reporting forms and timeline

A separate residential mortgage loan report is completed for each MSA in which the broker-lender has a branch.[18]

A broker-lender files a residential mortgage loan report, DRE Form 857, in duplicate every March 31. The report provides data on the prior calendar year's mortgage activity.[19]

For instance, if the broker falls under the reporting requirements during 2018 as a lender, they are required to file the report on 2018 mortgage activity by March 31, 2019.

A broker-lender also makes the residential mortgage loan report available to the public for *five years*. This is accomplished by having the report available in every branch, and providing it upon request.

The five-year period commences from the filing due date. For example, a report due by March 31, 2019 needs to be available to the public until March 31, 2024.[20]

No fees are incurred for filing this report.

Brokers can look up MSA codes and boundaries manually at *http://www.census.gov/geo/maps-data/maps/statecbsa.html*

Data collected

In the top portion of the residential mortgage loan report, the broker-lender provides:

- their name;
- their DRE license number;
- their address and phone number;
- the enforcement agency (pre-filled with "Department of Real Estate");
- the address of the enforcement agency (pre-filled with DRE's address);
- the census map on which the MSA is based (pre-filled with 2010 data, the latest census data available);
- the year of the data being reported; and
- the MSA covered in the report.

Section 1 contains information about originations and applications, sorted by census tract. The census tract is also pulled by reviewing the census maps linked above.[21]

For each census tract within the MSA, the report provides:

- the total number of applications taken;
- the total number of mortgages made; and

18 21 CCR §7118(b)
19 21 CCR §7119(b)
20 21 CCR §7119(a)
21 21 CCR §7118(b)

- the total dollar amount of mortgages made, shown in terms of thousands;

for each of the following situations:

- the total of FHA-insured mortgages, Farmers Home Administration (FmHA) mortgages and VA-guaranteed mortgages used to purchase a property occupied by the buyer;
- conventional mortgages used to purchase a property occupied by the buyer;
- home improvement mortgages on one-to-four unit residential properties occupied by the owner; and
- all home improvement loans on one-to-four unit residential properties not occupied by the owner.[22]

In Section 2, the broker provides the same totals for mortgages secured by one-to-four residential properties located outside of the MSA for their branch. The data is not broken down by census tracts for financed properties in MSAs other than where the broker has a branch.[23]

22 21 CCR §7118(b)(2)
23 21 CCR §7118(b)(1)(B)

Chapter 33 Summary

To detect potential patterns of unlawful discrimination, the Home Mortgage Disclosure Act (HMDA) requires Department of Real Estate (DRE)-licensed broker-lenders who make consumer or business mortgages secured by residential real estate to annually disclose to the public their mortgage origination and application data.

DRE-licensed broker-lenders who make mortgages for the purchase or improvement of residential real estate need to collect HMDA mortgage data in the current calendar year if:

- they engage in mortage origination for profit;
- in the preceding year, they were located in, or originated or purchased a mortgage secured by property located in a **metropolitan statistical area (MSA)**; and
- in the preceding two years, they originated:
  - 25 or more closed-end mortgages; or
  - 500 open-end lines of credit.

HMDA-covered broker-lenders need to collect data on mortgage applications, originations and acquisitions of home purchase mortgages, home improvement mortgages and refinances.

The data collected includes information about the property, mortgage, owner and investor.

Mortgage loan originator (MLO) brokers and mortgage loan broker (MLBs) who make consumer or business mortgages to purchase or improve one-to-four unit residential real estate — not all residential properties as under HMDA reporting — file the California residential mortgage loan report if their mortgage volume or size falls below the thresholds triggering federal HMDA reporting.

Chapter 33 Key Terms

Notes:

Chapter 34

California mortgage disclosures

Learning Objectives

After reading this chapter, you will be able to:

- understand the California state law prohibiting discriminatory lending practices;
- identify the practices in lending and mortgage brokering which are considered discriminatory in California; and
- determine the proper timing and procedure for delivering the Mortgage Loan Disclosure Statement (MLDS).

Key Terms

Mortgage Loan Disclosure Statement (MLDS)

redlining

California's fair lending laws

To achieve a healthy state economy, all residential housing for sale needs to be available to any homebuyer who qualifies as creditworthy for **purchase-assist financing.**[1]

An efficient real estate market requires the value of housing to be immune from fluctuations caused by lenders who arbitrarily deny financing to qualified homeowners based on their status in a protected demographic. Thus, the California Housing Financial Discrimination Act prohibits discriminatory lending practices. The goal of anti-discrimination law in home financing is to:

- increase the availability of housing to creditworthy buyers; and
- increase lending in communities where lenders have made conventional home mortgages unavailable.[2]

1 Calif. Health and Safety Code §35801(b)
2 Health & S C §35802

The California-specific prohibitions and requirements under the Housing Financial Discrimination Act apply to all institutions which make, arrange or buy mortgages funded to buy, build, repair, improve or refinance one-to-four unit, owner-occupied housing. This includes mortgage loan originators (MLOs) or lenders offering consumer mortgage services, whether endorsed by the Department of Real Estate (DRE) or licensed by the Department of Financial Protection and Innovation (DFPI).[3]

Increased availability of home mortgages

Lenders offer financing to *qualified, creditworthy mortgage applicants,* to:

- buy, build, repair, improve or refinance an existing mortgage on a one-to-four unit, owner-occupied residence; or
- improve one-to-four unit residences which are not owner-occupied.[4]

Lenders violate California's public policy for housing when they indicate a **discriminatory preference** by denying or approving financing to creditworthy home mortgage applicants based on the applicant's:

- race;
- color;
- religion;
- sex;
- gender or gender identity;
- marital status;
- sexual orientation,
- source of income;
- genetic information;
- familial status;
- disability;
- national origin; or
- ancestry.[5]

Discrimination in specific communities

In a community or enclave which is composed mainly of residents of a particular race, color, religion or other protected class, a lender may not:

- refuse to fund a mortgage based on the **demographics** of that community; or
- appraise real estate in that community at a lower value than comparable real estate in communities predominantly composed of non-minority residents.[6]

3 Health & S C §35805
4 Health & S C §35805(d)
5 Health & S C §35811
6 Health & S C §§35810, 35812

Failure to provide financing in a community based on the demographics of that community is called **redlining.** The state specifically targets lenders who *redline* for correction since redlining adversely affects the health, welfare and safety of California residents.[7]

redlining
Failure to provide financing in certain communities based on the demographics of that community.

Lenders who deny mortgage applications based on the characteristics of the community discourages homeownership in that community. Thus, redlining leads to a decline in the quality and quantity of housing in areas – economic obsolescence – where financing is generally unavailable.[8]

However, a lender can consider neighborhood conditions when making a mortgage. When doing so, the lender needs to demonstrate they denied a mortgage based on neighborhood conditions which render the mortgage unsafe and unsound as a matter of good business practice.[9]

For example, a lender is not precluded from considering the **fair market value** of real estate as sufficient to qualify the property as security for a home mortgage. A property *appraisal,* however, cannot be based in any part on the demographic makeup of the area where the real estate is located.

Further, when the property's topography, structure or location is unsafe or unhealthy, the lender need not provide purchase-assist financing.[10]

Notice of a mortgage applicant's rights

Lenders post in a conspicuous public location at their place of business a written notice informing applicants for mortgages to be secured by an owner-occupied, one-to-four unit residential property of:

- their right to file a lending discrimination claim; and
- the name and address of the Secretary of the California Business, Consumer Services and Housing Agency (BCSH).[11]

Lenders subject to this posting requirement include **state regulated:**

- banks;
- thrifts;
- public agencies; or
- other institutions which make, arrange or buy mortgages funded to buy, build, repair, improve or refinance one-to-four unit, owner-occupied housing.[12]

Agency administrative remedies

A mortgage applicant may file a discrimination claim with the BCSH against a state regulated lender when the applicant believes their mortgage application was denied due to:

- their race, color, religion, sex, marital status, national origin, ancestry or any of the other protected classifications described above; or

7 Health & S C §35801(e)(4)
8 Health & S C §35801
9 Health & S C §35810(a)
10 Health & S C §35813
11 Health & S C §35830
12 Health & S C §35805

- trends, conditions or characteristics of the community where the real estate is located.[13]

A home mortgage applicant who believes a state lending institution has unfairly discriminated against them exhausts their BCSH administrative remedies before suing the lender for money losses.

Federally regulated banks and thrifts, such as federally chartered banks, are not subject to state regulation and discipline.[14]

Once the claim is received, the BCSH will attempt to work with the lender to end any unlawful discriminatory lending practices.[15]

The BCSH will determine when the lender has engaged in an unlawful discriminatory practice within 30 days of receiving the complaint. The BCSH will then serve the lender with its written decision and an order requiring the lender to end the unlawful discriminatory practice.[16]

The order will require the lender to review the mortgage application under nondiscriminatory terms and provide the denied financing, if feasible. The lender may also be held liable for the applicant's money losses in an amount no greater than $1,000.[17]

The Mortgage Loan Disclosure Statement

The California **Mortgage Loan Disclosure Statement (MLDS)** is prepared and delivered to mortgage applicants by:

- MLOs who negotiate the terms of a consumer mortgage with a lender on a homebuyer's or homeowner's behalf; and
- mortgage loan brokers (MLBs) who negotiate the terms of a business mortgage with a lender on a buyer's or owner's behalf.[18] [See Figure 1]

Mortgage Loan Disclosure Statement (MLDS)
A California disclosure provided to a borrower by a mortgage broker who negotiates a mortgage on the borrower's behalf.

Mortgages which allow the buyer to defer principal or interest, or pay interest only, called nontraditional mortgages, require the use of an alternative nontraditional MLDS.[19] [See **RPI** Form 204-2]

When making or arranging a consumer mortgage, the federal Loan Estimate form may be used in lieu of the MLDS when the mortgage amount is:

- greater than $30,000 on first lien mortgages; or
- greater than $20,000 on junior lien mortgages.[20]

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13 Health & S C §§35800 et seq.
14 **Conference of Federal Savings and Loans Associations** v. **Stein** (1979) 604 F2d 1256
15 Health & S C §35821
16 Health & S C §35822
17 Health & S C §§35822(a), 35822(b)
18 Calif. Business and Professions Code §10240(b)
19 10 Calif. Code of Regulations §2842
20 Bus & P C §10240(c)

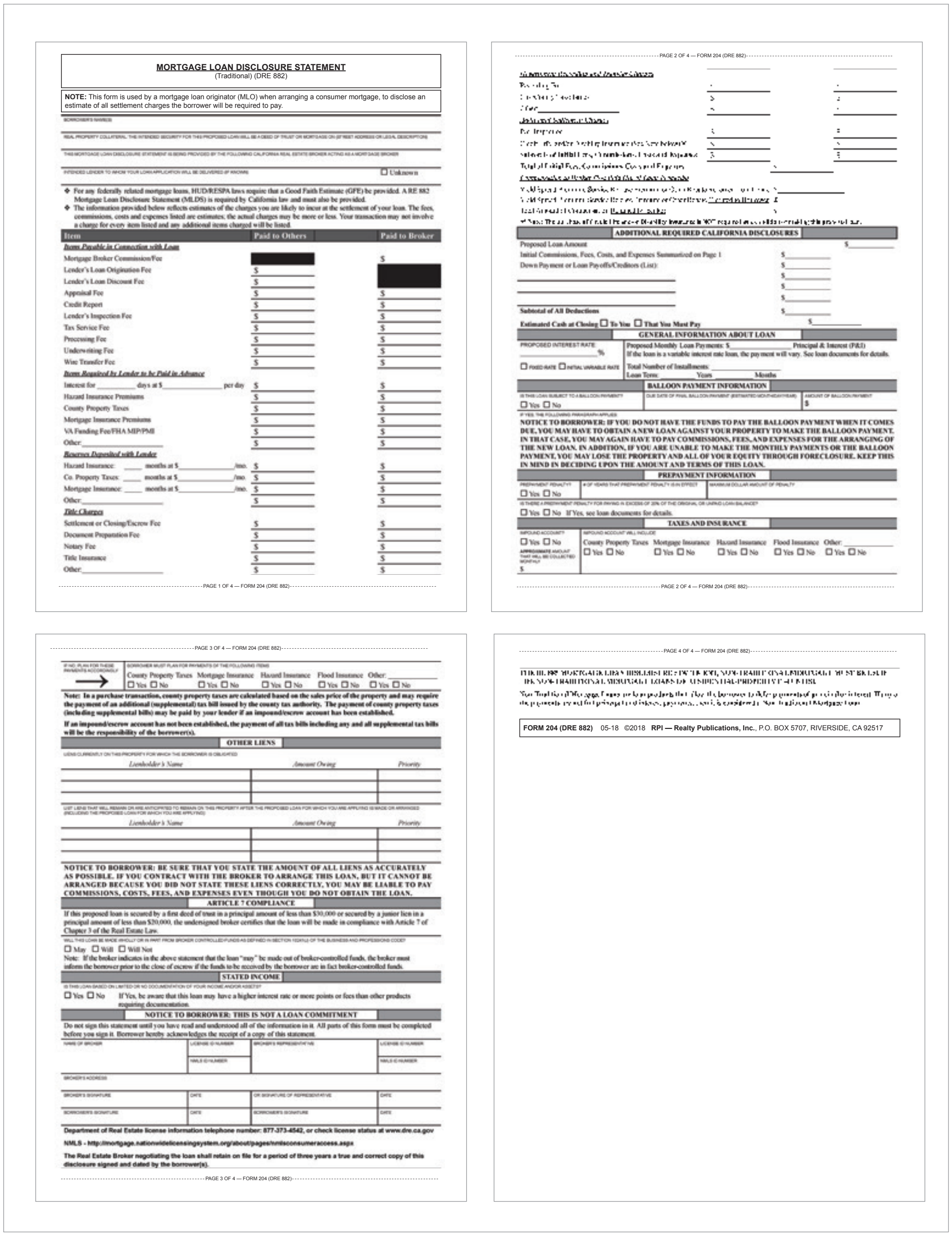

Figure 1

Form 204

Mortgage Loan Disclosure Statement

However, when an MLO uses the Loan Estimate form to fulfill the California disclosure requirement, an additional California MLO disclosure is handed to the homebuyer, indicating:

- the Loan Estimate does not constitute a mortgage commitment;[21] and
- the buyer or owner may check the license status of the MLO broker by calling the DRE's license information phone number, or visiting DRE's website.[22] [See **RPI** Form 204-6]

21 Bus & P C §10240(c)

22 Bus & P C §10236.4(b)

MLDS contents

Alternatively, MLOs may simply provide the MLDS in addition to the federal Loan Estimate disclosures required under the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA).

The *MLDS* discloses to the buyer:

- the estimated maximum costs incurred by the buyer in connection with the mortgage;
- the total fees which will be received by the MLO or MLB negotiating the mortgage;
- any liens against the property, and their amounts and positions;
- the estimated amounts paid by the buyer in connection with the mortgage;
- the estimated amount paid to the buyer upon closing;
- the mortgage principal;
- the interest rate;
- the terms of the mortgage, including a notice regarding balloon payments;
- the name, license number, address and Nationwide Mortgage Licensing System (NMLS) number (if applicable) of the MLO or MLB;
- whether the funds are *coming* from the MLB;
- any prepayment penalties;
- a statement that credit or credit disability insurance is not required as condition of making the mortgage; and
- whether the mortgage is subject to Article 7 designation.[23] [See Chapter 8]

The MLO or MLB hands the buyer or owner the MLDS by the earlier of:

- three business days after receiving a complete mortgage application; or
- before the buyer or owner is obligated to pay the mortgage note.[24]

Both the MLO/MLB and the buyer or owner sign and date the MLDS. A copy of the executed MLDS is kept by the MLO or MLB as part of the mortgage file for at least three years.[25]

When the mortgage is negotiated in Chinese, Spanish, Tagalog, Vietnamese or Korean, a translated version of the MLDS is provided.[26]

23 Bus & P C §§10241, 10236.4(b)
24 Bus & P C §10240(a)
25 Bus & P C §10240(a)
26 Calif. Civil Code §1632(b)(4)

Chapter 34 Summary

The California Housing Financial Discrimination Act prohibits discriminatory lending practices. The Housing Financial Discrimination Act applies to all institutions which make, arrange or buy mortgages funded to buy, build, repair, improve or refinance one-to-four unit, owner-occupied housing.

Lenders offer financing to qualified, creditworthy mortgage applicants to buy, build, repair, improve or refinance and existing mortgage on a one-to-four unit residence, owner-occupied or not. Lenders violate California's public policy for housing when they indicate a discriminatory preference by denying or approving financing to creditworthy home mortgage applicants based on the applicant's race, color, religion, sex, marital status, sexual orientation, source of income, genetic information, disability, national origin, or ancestry.

Failure to provide financing in a community based on the demographics of that community is called redlining. However, a lender can consider neighborhood conditions which render the mortgage unsafe and unsound as a matter of good business practice when making a mortgage.

State-regulated lenders publicly post notices informing applicants of their right to pursue recourse should the lender practice unlawful discrimination.

The California Mortgage Loan Disclosure Statement (MLDS) is prepared and delivered to mortgage applicants by mortgage loan originators (MLOs) who negotiate the terms of a consumer mortgage and mortgage loan brokers (MLBs) who negotiate the terms of a business mortgage.

When making or arranging a consumer mortgage, the federal Loan Estimate form may be used in lieu of the MLDS when the mortgage amount is:

- greater than $30,000 on first lien mortgages; or
- greater than $20,000 on junior lien mortgages.

However, when an MLO uses the Loan Estimate form to fulfill the California disclosure requirement, an additional California MLO disclosure needs to be handed to the homebuyer, indicating the Loan Estimate does not constitute a mortgage commitment and the buyer or owner may check the license status of the MLO broker by calling the Department of Real Estate's (DRE's) license information phone number, or visiting DRE's website.

Chapter 34 Key Terms

Notes:

Chapter 35

Foreclosure consultant services

Learning Objectives

After reading this chapter, you will be able to:

- understand the purpose and function of the Mortgage Assistance Relief Services (MARS) rule controlling the services of foreclosure consultants;
- comply as a foreclosure consultant with the disclosure requirements of the MARS rule to avoid deceptive mortgage relief practices; and
- identify signs that a foreclosure consultant's services are fraudulent.

Key Terms

commercial communication

foreclosure consultant

Mortgage Assistance Relief Services (MARS) rule

servicer

The MARS rule

Regulation O (Reg O) enacts the **Mortgage Assistance Relief Services, (MARS) rule**. Reg O is designed to protect homeowners by banning potentially deceptive practices of mortgage assistance relief service providers, better known as *foreclosure consultants*.

> **Mortgage Assistance Relief Services (MARS) rule**
> A federal regulation protecting homeowners by controlling the activities of mortgage assistance relief providers.

In response to widespread abuse of homeowners in mortgage distress during the Great Recession, the MARS rule and Reg O went into effect in 2010. The guidelines and restrictions are intended to maintain transparency and honest dealings between foreclosure consultants and homeowners. Rule-making authority over the MARS rule is held by the *Consumer Financial Protection Bureau (CFPB)*.[1]

1 12 Code of Federal Regulations §1015

foreclosure consultant
An individual offering services which claim to aid homeowners with mortgage-related issues, for a fee.

A **foreclosure consultant** is any individual offering services to homeowners, for a fee, which claim to aid homeowners with mortgage-related issues.[2]

By design, foreclosure consultants aid **homeowners**, individuals who are obligated under a consumer mortgage secured by their residence.[3]

In addition to the MARS Rule, California has its own laws governing the conduct of foreclosure consultants.

A **dwelling** refers to a one-to-four unit residential structure used for personal, family or household purposes. The structure does not need to be attached to real property to be considered a dwelling. Residences considered a dwelling include individual condominium units, cooperative units, mobile homes, manufactured homes or trailers.[4]

servicer
An individual responsible for receiving scheduled payments from a homeowner by arrangement with the mortgage holder.

A **dwelling loan** is a consumer mortgage secured by a residence. The **dwelling loan holde**r is the mortgage holder whose portfolio contains the dwelling loan — consumer mortgage — which has become the subject of foreclosure consultant services.[5]

Mortgage **servicers** are persons responsible for receiving scheduled payments from a homeowner by arrangement with the mortgage holder.[6]

Foreclosure consultant

Any person who holds themselves out to provide any mortgage relief assistance qualifies as a foreclosure consultant, or more formally, a **mortgage assistance relief service provider**.[7]

The dramatic increase in foreclosures during the Great Recession of 2008 provoked additional California legislation regulating foreclosure consultants. To be a foreclosure consultant an individual needs to:

- obtain a surety bond of $100,000 in favor of the state of California for the benefit of homeowners for damages caused by the foreclosure consultant's violation of any applicable laws. One copy needs to be filed with the Secretary of State, and a second copy needs to be provided to the California Department of Justice (DOJ); and
- register with the DOJ by submitting the required fees and a completed registration form, which includes:
  - all names, addresses, telephone numbers, web sites and email addresses which will be used in connection with foreclosure consultant activities;
  - a statement that the person has not been convicted of any crime, or subject to a criminal judgment for misrepresentation, dishonesty or a violation of the requirements;

2 12 CFR §1015.2
3 12 CFR §1015.2
4 12 CFR §1015.2
5 12 CFR §1015.2
6 12 CFR §1015.2
7 12 CFR §1015.2

- copies of all print and electronic advertising material and scripts of all telephone or broadcast advertising to be used in connection foreclosure consultant activities; and
- a copy of the required surety bond.[8]

A Department of Real Estate (DRE) licensed broker or agent acting on behalf of an owner-in-foreclosure avoids being labeled a foreclosure consultant when they:

- receive only a contingency fee (paid on closing) from the seller for negotiating the sale of their residence when in foreclosure;
- receive no advance fees or costs from the homeowner, an activity which will convert the broker into a foreclosure consultant;
- make a Regulation Z (Reg Z) consumer mortgage as a principal for an amount sufficient to cure defaults, or arrange a Reg Z consumer mortgage as an mortgage loan originator (MLO)-endorsed broker employed by the homeowner; and
- receive no ownership interest in the property from the owner, except a security interest under a trust deed when acting solely as a principal (lender) making a MLO loan.[9]

Broker referrals

When a broker arranges for an owner-in-foreclosure to employ a foreclosure consultant, or pay a fee or transfer title to a foreclosure consultant, the broker is considered the agent of the foreclosure consultant. Thus, the broker becomes a sort of agent-once-removed of the owner who retains the foreclosure consultant they referred.[10]

Further, a foreclosure consultant retained by an owner-in-foreclosure is barred from acquiring any interest in a residence in foreclosure — even if they hire a broker to represent them to buy the property.[11]

A DRE broker or their agent may be employed by a foreclosure consultant only when the DRE licensee:

- provides the owner-in-foreclosure with a written statement they are a DRE licensed broker; and
- is bonded by a surety insurer for an amount equal to twice the value of the residence in foreclosure.[12]

Failure of the foreclosure consultant's broker to provide the broker's statement to the owner-in-foreclosure will, at the owner's option, void the advisory agreement with the foreclosure consultant.[13]

Mandatory disclosures in commercial communication

Reg O requires disclosures to be made in *commercial communications* between foreclosure consultants and the homeowners who use their services.

8 Calif. Civil Code §2945.45
9 CC §2945.1(b)(3)
10 CC §2945.9(b)
11 CC §2945.4(e)
12 CC §2945.11(a)
13 CC §2945.11(b)

Disclosures are required to meet a "clear and prominent" standard under the regulations.[14]

commercial communication Anything written or spoken used to attract homeowners to a service.

A **commercial communication** is anything written or spoken, regardless of language, used to attract homeowners to a service — solicitations.[15]

Two different categories of commercial communications exist:

- the general commercial communication made to all members of the public; and
- the homeowner-specific commercial communication addressed to a homeowner.

Disclosures for general commercial communication

A *general commercial communication* is a commercial communication that is:

- geared towards the general public, not a specific homeowner; and
- takes place as a solicitation before a homeowner authorizes a foreclosure consultant to investigate mortgage relief on behalf of the homeowner or otherwise consents to use the foreclosure consultant's services.[16]

The following statements need to be placed on all general commercial communication in a clear and prominent manner:

1. "(Name of company) is not associated with the government, and our service is not approved by the government or your lender."
2. When a foreclosure consultant has represented in any way that homeowners are guaranteed a modification, forbearance, extension or waiver of the obligations under a consumer mortgage: "Even if you accept this offer and use our service, your lender may not agree to change your loan."
3. "IMPORTANT NOTICE" at the beginning of disclosures, printed together in text communications in bold face font at least two point-type larger than the font size of the disclosures.
4. "Before using this service, consider the following information," at the beginning of audible or spoken communications.[17]

Disclosures for homeowner-specific commercial communication

When commercial communication is geared towards a specific homeowner and takes place before the homeowner authorizes the foreclosure consultant to investigate offers of mortgage relief on behalf of the homeowner or consents to use the foreclosure consultant, the communication is considered *homeowner-specific commercial communication*.[18]

14 12 CFR §1015.2
15 12 CFR §1015.2
16 12 CFR §1015.2
17 12 CFR §1015.4(a)
18 12 CFR §1015.2

All homeowner-specific commercial communication needs to include the following statements in a clear and prominent manner:

1. "You may stop doing business with us at any time. You may accept or reject the offer of mortgage assistance we obtain from your lender [or servicer]. If you reject the offer, you do not have to pay us. If you accept the offer, you will have to pay us (insert amount or method for calculating the amount) for our services."
2. "(Name of Company) is not associated with the government, and our service is not approved by the government or your lender."
3. When a foreclosure consultant has represented in any way that homeowners are guaranteed a modification, forbearance, extension or waiver of the obligations under a consumer mortgage: "Even if you accept this offer and use our service, your lender may not agree to change your loan."
4. "IMPORTANT NOTICE" at the beginning of disclosures, which must be listed together in text communications in bold face font at least two point-type larger than the font size of the required disclosures.
5. "Before using this service, consider the following information," at the beginning of audible or spoken communications, such as telephone communications.[19]

The method for calculating the amount a homeowner agrees to pay when they accept the offer will include the total amount the homeowner is to pay to receive all of the foreclosure consultant's services offered, including items such as fees and charges.

Whether general or homeowner-specific, any communication by a foreclosure consultant recommending the homeowner might benefit from temporarily or permanently discontinuing payments, in whole or in part, on a consumer mortgage must include, clearly and prominently, the disclosure, "If you stop paying your mortgage, you could lose your home and damage your credit rating."[20]

Textual communication

Any communication in printed or written form is considered textual communication. Examples of textual communications are letters, documents and web pages. To meet the qualifications of a "clear and prominent" disclosure for a textual communication, the disclosures must be:

- easily readable;
- in a high degree of contrast from the immediate background on which it appears;
- in the same languages that are extensively used in the communication;
- distinct from other text, such as inside a border;
- in a distinct type style, such as bold;
- parallel to the base of the commercial communication; and

19 12 CFR §1015.4(b)
20 12 CFR §1015.4(c)

- displayed with each letter at least the larger of 12-point type or one-half the size of the largest letter or numeral used in the name of the advertised web site or telephone number provided for homeowners to acquire more information on any mortgage relief assistance.[21]

Oral and audible communication

Oral and audible communication includes any communications such as radio or streaming audio. Applicable communications must contain disclosures delivered in a slow, deliberate manner in a reasonably understandable volume and pitch. When the commercial communication is program-length, it must contain disclosures at the beginning, middle and end.[22]

Video communication

Video communication includes mediums like television and streaming video. Compliant communications will audibly state and display disclosures simultaneously. The audible form of the disclosure must be delivered in a slow, deliberate manner in a reasonably understandable volume and pitch. Visual disclosures must:

- be at least four percent of the vertical picture or screen height;
- remain on display for the entire duration of the audio disclosure;
- meet all requirements for *textual communication* as stated previously; and
- if program-length, contain disclosures at the beginning, middle and end.[23]

Interactive media communication

Interactive media communication includes mediums like the internet, online services and software. Adherent interactive media communication disclosures will:

- meet the requirements for *textual communication*, *oral and audible communication* and *video communication*, if applicable;
- be stated on the page where homeowners take an action to incur a fiscal obligation to the foreclosure consultant, or on the page immediately prior;
- be obviously displayed to homeowners without requiring them to scroll down the webpage;
- appear in type at least the same size as the largest character of the advertisement; and
- if program-length, contain disclosures at the beginning, middle and end.[24]

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21 12 CFR §1015.2
22 12 CFR §1015.2
23 12 CFR §1015.2
24 12 CFR §1015.2

Prohibited representations and actions

Reg O prohibits actions by foreclosure consultants that impair homeowners' understanding of offered services and their characteristics.

Recommending against or barring homeowners from contacting or communicating with their lenders or servicers is prohibited.[25]

Other unlawful acts include misconstruing, overtly or by implication, any aspect or feature of any mortgage relief assistance, including:

- the chances of arranging any represented service or result;
- the timeframe expected or needed for the foreclosure consultant to fulfill any represented service or result;
- leading the homeowner to believe a foreclosure consultant is affiliated with or affirmed by:
    - any federal, state or local government agency, unit, department or program;
    - any nonprofit housing counselor agency or program;
    - the maker, holder or servicer of the homeowner's consumer mortgage; or
    - any other individual, entity or program;
- the homeowner's duty to submit scheduled payments or any additional payments required by the terms of the homeowner's consumer mortgage;
- the total debt the homeowner owes or any other terms or conditions of the homeowner's consumer mortgage;
- the terms or conditions of any refund, cancellation, exchange or repurchase policy for a foreclosure consultant's services, such as the chances of obtaining a full or partial refund, or the circumstances in which a full or partial refund will be granted, for their mortgage relief assistance;
- that the foreclosure consultant has completed the represented services or has a right to receive payment or other consideration;
- that the homeowner is entitled to legal representation;
- the availability, performance, cost or features of any substitute to for-profit foreclosure consultant services through which the homeowner can receive mortgage relief assistance, including negotiating directly with the consumer mortgage holder or servicer, or using any nonprofit housing counselor agency or program;
- the amount of money or the percentage of the debt amount that a homeowner may save by using the foreclosure consultant;
- the total cost the homeowner must pay to obtain the foreclosure consultant service; or
- the terms of any offer of mortgage relief assistance the consultant obtains from the homeowner's consumer mortgage holder or servicer.[26]

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25 12 CFR §1015.3(a)

26 12 CFR §1015.3(b)

Proof of honest representation

A foreclosure consultant needs to provide evidence to substantiate all of the services the foreclosure consultant claims to offer. Claiming services or features and capabilities of those services exist when they do not is unlawful, as is any misrepresentation of services or their features. Sufficient and reliable evidence includes:

- tests;
- analyses;
- research;
- studies; or
- other evidence based on the knowledge of professionals in a relevant field.[27]

Prohibition on collection of advance payments

A foreclosure consultant may not ask for or accept payment until the homeowner has signed and delivered an agreement entered into by the homeowner and the homeowner's consumer mortgage holder or servicer integrating the offer the foreclosure consultant acquired from the homeowner's consumer mortgage holder or servicer.[28]

Thus, there are three requirements that need to be met before the foreclosure consultant may collect payment:

1. **The foreclosure consultant needs to get an offer of mortgage relief from the homeowner's lender or servicer.** It needs to have persuaded the homeowner's consumer mortgage lender or servicer to modify the terms of the customer's mortgage.
2. **The foreclosure consultant needs to have given the homeowner the written offer of mortgage relief from the homeowner's lender or servicer.** It needs to provide the homeowner with a written agreement from the mortgage lender or servicer to modify the terms of the homeowner's mortgage.
3. **The homeowner needs to have accepted the written offer.** The homeowner's acceptance needs to be in the form of a written agreement signed by the homeowner's mortgage lender or servicer that incorporates the changes in the terms of their consumer mortgage.

It is illegal to charge separately for individual steps in the foreclosure consultant process.

Additionally, when the foreclosure consultant gives the homeowner the mortgage holder's written offer for consideration, the consultant needs to provide a disclosure which includes the following words and content:

"This is an offer of mortgage assistance we obtained from your lender [or servicer]. You may accept or reject the offer. If you reject the offer, you do not have to pay us. If you accept the offer, you will have to pay us [same amount as disclosed according to guidelines for homeowner-specific communication] for our services."

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27 12 CFR §1015.f3(c)

28 12 CFR §1015.5(a)

The disclosure needs to be delivered:

- in a clear and prominent manner;
- on a separate written page from any other disclosure required; and
- following the heading: "IMPORTANT NOTICE: Before buying this service, consider the following information," which must be written in bold face font that is two point-types larger than the font size on the mandatory disclosure.[29]

A *second notice* needs to be delivered to the homeowner from the homeowner's consumer mortgage holder or servicer when the homeowner accepts the consumer mortgage holder's or servicer's offer.

This second notice needs to include differences between the terms in the homeowner's current mortgage and the modified terms in the new proposed consumer mortgage, including the difference between the:

- principal balances;
- contract interest rates, including the maximum rate and any applicable adjustable rates;
- amounts and numbers of the homeowner's scheduled periodic payments;
- monthly amounts owed for principal, interest, taxes, and any mortgage insurance;
- amounts of any delinquent payments owing or outstanding;
- assessed fees or penalties; and
- terms.

A second notice

This second notice is also to be preceded by the heading: "IMPORTANT NOTICE: Before buying this service, consider the following information," which must be written in bold face font that is two point-types larger than the font size on the mandatory disclosure.[30]

When the offer of mortgage relief negotiated by the foreclosure consultant with the consumer mortgage holder or servicer is a trial mortgage modification, the terms and conditions of this offer must be disclosed in the notice. Examples of potential terms, conditions and limitations that need to be disclosed include:

- the fact that the homeowner may not qualify for a permanent mortgage modification; and
- the likely amount of the scheduled periodic payments and any arrears, payments or fees that the homeowner would owe when failing to qualify.[31]

29 12 CFR §1015.4(b)(1); 12 CFR §1015.5(b)
30 12 CFR §1015.5(c)
31 12 CFR §1015.5(d)

Recordkeeping and compliance requirements

Foreclosure consultants must maintain records as evidence of compliance. Reg O dictates the compliance records consultants need to maintain. Consultants may keep the records in the same manner, format and location as other documentation used in the regular course of business.[32]

Required records are maintained for 24 months, beginning at the document creation date. Required records include:

- all contracts or other agreements between the foreclosure consultant and a homeowner for their services;
- copies of all textual communications between the foreclosure consultant and a homeowner taking place before the date on which the homeowner entered into an agreement with the foreclosure consultant for any mortgage relief services;
- copies of all documents or telephone recordings created with the intention of complying with the requirement to monitor employees and contractors representing the foreclosure consultant;
- all files containing the names, phone numbers, dollar amounts paid and descriptions of foreclosure consultant services purchased;
- copies of all substantially different sales scripts, training materials, commercial communications or other marketing materials, including web sites and weblogs, for any mortgage relief services; and
- copies of the documentation provided to the homeowner by the foreclosure consultant when the homeowner executed a contract between the homeowner and the homeowner's consumer mortgage holder or servicer integrating the mortgage holder's or servicer's offer of mortgage relief the foreclosure consultant negotiated for the homeowner.[33]

In addition, compliant foreclosure consultants will take reasonable steps to monitor and ensure all employees and independent contractors comply with Reg O. Compliance checks will include evaluations of telemarketing practices, which include any plan, program or campaign used to encourage homeowners to purchase any service by use of one or more telephones and which involves more than one interstate telephone call. Steps will include, at a minimum:

- making random performance checks by recording individuals engaged in telemarketing sales or customer service roles to confirm compliance;
- establishing guidelines for receiving and responding to customer complaints; and
- determining the number and content of homeowner complaints and handling those complaints by:
    - initiating a prompt and thorough investigation;
    - disciplining, training or terminating employees or contractors who fail to comply with Reg O; and
    - maintaining evidence the complaint was received and responded to.[34]

32 12 CFR §1015.9(c-d)

33 12 CFR §1015.5(a); 12 CFR §1015.9(a); 12 CFR §1015.9(b)(1)(i)

34 12 CFR §1015.2; 12 CFR §1015.9(b)

Conditions of attorney exemption

Attorneys are exempt from all requirements of Reg O except the prohibition against advance fees, and the advance fee disclosures, when they:

- offer foreclosure consultant services as part of the practice of law;
- are licensed to practice law in the state in which the homeowner for whom the attorney is providing the foreclosure consultant services resides or in which the homeowner's residence is located; and
- comply with all state laws and regulations, including licensing regulations, applicable to client trust accounts.[35]

Attorneys who meet the qualifications for exemption from Reg O may also be exempt from the advance fee prohibitions if the attorneys deposit funds received from homeowners before conducting legal services in a client trust account and comply with all state laws and regulations, including licensing regulations, related to client trust accounts.[36]

Penalties for failing to comply

The CFPB can seek equitable monetary relief for homeowner redress or the disgorgement of ill-gotten gains. State attorneys general can also bring actions to enforce this section.[37]

Further, any individual who acts as a foreclosure consultant without meeting the requirements will be punished for each violation by:

- a fine between $1,000 and $25,000;
- imprisonment in the county jail for up to a year; or
- both the fine and imprisonment.[38]

Authorization required

Mortgage lenders require homeowners to sign a third-party authorization form before they will deal directly with a third-party handling the homeowner's consumer mortgage modification negotiations. [See **RPI** Form 124]

The model authorization form released by the CFPB prompts the foreclosure consultant to identify themselves and their credentials. The form also reviews the activities which the homeowner is authorizing the foreclosure consultant to perform. Finally, the form puts the homeowner on notice of potential scams and provides a phone number for reporting scams.

Even if the MLO does not perform or advertise that they perform mortgage relief assistance, remember that the MARS rules holds an MLO liable for referring homeowners to programs which are known to violate the MARS rule.

Instead of referring a homeowner to a foreclosure consultant, the mortgage originator can refer the homeowner to contact a credit counselor through the Homeownership Preservation Foundation (HPF), a nonprofit organization

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35 12 CFR §1015.7(a)

36 12 CFR §1015.7(b)

37 12 CFR §1015.10

38 CC §2945.45

that operates the national 24/7 toll-free hotline (1.888.995.HOPE) with free, bilingual, personalized assistance to help at-risk homeowners avoid foreclosure.

Chapter 35 Summary

Regulation O (Reg O) enacts the Mortgage Assistance Relief, (MARS) rule. Reg O is designed to protect homeowners by banning potentially deceptive practices of mortgage assistance relief service providers, better known as foreclosure consultants.

In addition to the MARS Rule, California has its own laws governing the conduct of foreclosure consultants.

When a broker arranges for an owner-in-foreclosure to employ a foreclosure consultant, or pay a fee or transfer title to a foreclosure consultant, the broker is considered the agent of the foreclosure consultant. Thus, the broker becomes a sort of agent-once-removed of the owner who retains the foreclosure consultant they referred.

Reg O requires disclosures to be made in commercial communications between foreclosure consultants and the homeowners who use their services.

Reg O prohibits actions by foreclosure consultants that impair homeowners' understanding of offered services and their characteristics.

A foreclosure consultant needs to provide evidence to substantiate all of the services the foreclosure consultant claims to offer. Claiming services or features and capabilities of those services exist when they do not is unlawful, as is any misrepresentation of services or their features.

A foreclosure consultant may not ask for or accept payment until the homeowner has signed and delivered an agreement entered into by the homeowner and the homeowner's consumer mortgage holder or servicer integrating the offer the foreclosure consultant acquired from the homeowner's consumer mortgage holder or servicer.

Foreclosure consultants must maintain records as evidence of compliance. Reg O dictates the compliance records consultants need to maintain.

Chapter 35 Key Terms

Due-on-sale regulations

Chapter 36

Learning Objectives

After you read this chapter, you will be able to :

- understand the nature of a due-on clause in trust deeds as a restriction on the mobility of an owner's title and pricing;
- explain ownership activities which trigger due-on enforcement for profit by mortgage holders;
- apply the exemptions barring mortgage holders from due-on enforcement; and
- negotiate a limitation or waiver of a mortgage holder's due-on rights.

Key Terms

acceleration

due-on clause

Garn-St. Germain Federal Depository Institutions Act of 1982

inter vivos trust

waiver agreement

Rising rates bring lender interference

During times of upward sales volume, increasing mortgage originations and rising absorption rates for space available to rent, the marketplace functions at full throttle. This is known economically as a **virtuous cycle**.

Responsibility for this frenzy lies with the gatekeepers to real estate ownership — brokers, builders and lenders. To keep those responsible for the activity from harming the rest of society, the government implements regulations to reduce adverse conduct by these gatekeepers in our real estate and mortgage markets.

During times of rising prosperity, buyers put up with the onerous threshold of entry procedures maintained by the gatekeepers. In their rush to close deals, all the numerous steps to ownership seem justified by the buyers.

due-on clause
A trust deed provision used by lenders to call the loan immediately due and payable, a right triggered by the owner's transfer of any interest in the real estate, with exceptions for intra-family transfers of their home.

However, when short-term interest rates and mortgage rates rise, lending standards likewise tighten. At this point, buyers become unwilling to further cope with the regime of higher rates, increased credit standards, seller price expectations, and excessive documentation demands. This recurring paradigm shift triggers a **vicious cycle** which begins quickly but takes years to unwind after it hits bottom.

Enter the seller-crippling **due-on-sale** restrictions remaining from 1982 mortgage deregulation.

When the boom turns to bust, and stagnation

A burden on the use and mobility of ownership is created by the existence of the *due-on clause* buried within all trust deeds serviced by mortgage holders.

During long-term cyclical episodes of declining interest rates such as 1980 to 2012, the due-on clause is not an issue. The clause lays dormant and is unused. The decades of the '80s, '90s and '00s are examples of a period when buyers could easily qualify for new mortgages at ever decreasing interest rates to cash out the seller. Further, sellers are relatively unconcerned about the size of any prepayment penalty on the payoff of their mortgages during these prosperous times.

However, as the boom turns to bust and buyers are induced to purchase property as prices fall, the most efficient arrangement for financing the purchase price is for *the buyer to take over the seller's mortgage* — if it has an interest rate lower than the current rates charged by lenders.

However, mortgage holders in the past have refused to consent to any type of mortgage takeover or assumption. The reason: they prefer to receive a prepayment penalty and re-lend the money at the higher current rate. Consumer mortgages greatly restrict the duration (three years) and amount (declines yearly) of these penalties for payoff of the debt.

Thus, though the due-on clause was not a burden during the quarter century leading up to the Millennium Boom, it becomes a noose around the seller's neck during periods like the **long-term (secular) stagnation** of the 2010s. The combination of generally rising interest rates (following the 2009-2015 zero lower bound interest rates) and the existence of due-on clauses in recorded mortgages tends to tie the seller to their property, a self-imposed prison. Thus, sellers are too often fettered to their home without a financially suitable way out when they owe more on the mortgage than the amount of the resale price for the home.

Editor's note — Prepayment penalties on consumer mortgages are restricted in their use to fixed- and step-rate qualified mortgages (QMs).[1]

1 12 Code of Federal Regulations §1026.43(g)

Attempts to circumvent the lender's sales restraint

Consider a parcel of real estate listed for sale in a market of rising mortgage rates. The parcel is encumbered by a mortgage with an interest rate below current market rates, but contains a due-on clause. The seller's agent locates a buyer for the property.

The purchase agreement negotiated by the seller's agent calls for closing to be contingent on the buyer entering into an **assumption agreement** with the existing mortgage holder allowing the buyer to take over the mortgage on the property based on the present terms of the mortgage. The seller will carry back a note secured by a second trust deed for the balance of the purchase price after the buyer's down payment.

Editor's note – For mortgage holders under Regulation Z (Reg Z), when an assumption involves a consumer mortgage, mortgage holder acceptance and a written assumption/modification agreement, it is considered a new consumer mortgage subject to new disclosures, ability-to-repay (ATR) and QM rules.[2]

The buyer is advised the senior mortgage holder may:

- refuse to allow the mortgage to be assumed, forcing the buyer to arrange new financing if they do not elect to cancel the purchase agreement; or
- require a modification of the note at a higher interest rate than the current note rate on the mortgage and demand a large assumption fee.

Before contacting the mortgage holder to process the assumption, the buyer suggests the sale of the property be structured as a *lease-option* in an attempt to avoid due-on enforcement by the mortgage holder. [See **RPI** Form 163]

The buyer and seller discuss entering into a two-year lease agreement with an option to extend the lease for an additional two years at an increased monthly payment. The buyer will be granted an option to purchase the property from the seller for the life of the lease.

The down payment will be restated as **option money**. The *option money* will apply to the purchase price of the property, as will a portion of each monthly rent payment.

Meanwhile, the seller will continue making payments on the underlying mortgage. When the buyer exercises their purchase option, the mortgage will be assumed or paid off and the buyer will become the record owner of the property.

Does the lease-option sale avoid due-on enforcement by the mortgage holder?

No! Any lease agreement which contains an *option to purchase* triggers due-on enforcement by the mortgage holder on discovery.[3]

2 12 CFR §1026.20(b)

3 12 CFR §591.2(b)

Interference by mortgage holders is federal policy

Generally, mortgage holders are allowed to enforce due-on sale clauses in mortgages on most transfers of any interest in any type of real estate.[4]

Thus, federal mortgage law deprives Californians of their state law right to convey real estate subject to trust deed liens without the mortgage holder interfering with the transfer of ownership for additional profit.

To interfere with the sale of the secured property solely under state law, the mortgage holder needs to demonstrate the buyer:

- lacks **creditworthiness**; or
- is **wasteful** of property in their management.

Essentially, the mortgage holder must prove the buyer is an *insolvent arsonist*. However, the federal legislative process of **preemption** bars application of state law to the contrary.

acceleration
A demand for immediate payment of all amounts remaining unpaid on a mortgage or extension of credit by a lender or carryback seller.

The occurrence of an event triggering due-on enforcement automatically allows the mortgage holder to:

- *call the mortgage*, demanding the full amount remaining due to be paid immediately, also known as **acceleration**; or
- *recast the mortgage*, requiring a modification of the note's terms as a condition for the mortgage holder's consent to a transfer, called a **waiver by consent**.

Garn-St. Germain Federal Depository Institutions Act of 1982
A federal law which preempts state-level limitations on a mortgage holder's enforcement of the due-on clause contained in mortgages.

The **Garn-St. Germain Federal Depository Institutions Act of 1982 (Garn)** itself encourages mortgage holders to allow buyers to assume real estate mortgages at existing rates, but provides mortgage holders no incentives for doing so. The congressional intent in 1982 when passing *Garn* was to preempt state law restrictions of due-on enforcement for the sole purpose of allowing mortgage holders to increase their profits on an old mortgage whenever the owner:

- sells;
- leases for a term over three years; or
- further encumbers the secured property.

However, the enforcement of the due-on clause by mortgage holders was not intended to occur at the expense of permitting excessive interference by mortgage holders with real estate transactions.[5]

Yet, when the Federal Home Loan Bank Board (which later became the now defunct *Office of Thrift Supervision (OTS)*) issued due-on regulations to implement *Garn*, no notice was taken of the congressional request for leniency when exercising due-on rights. The following 30 years saw mortgage rates drop. As rates dropped, buyers were no longer willing to take over existing mortgages at higher than current rates. Thus, the granting of leniency was never an issue during the following 30 year period of constantly declining rates. However, leniency will certainly become an issue in the coming years, as occurred in the 1960s as interest rose over a 30-year period.

4 12 United States Code §1701j-3; Garn-St. Germain Depository Institutions Act of 1982 (Garn)

5 12 USC §1701j-3(b)(3)

No leniency when exercising due-on rights

The regulations under *Garn* allow automatic due-on enforcement on any transfer of an interest in real estate, with only a few family-related, owner-occupied single family residence (SFR) exceptions.

No encouragement or guidelines were established in the regulations for consent by a mortgage holder to mortgage assumptions or to limit interference in commonplace transactions. Now, regulatory encouragement will be needed to avoid the inevitable interference as buyers attempt to take over the seller's low-rate mortgages of the early 2010s when the seller will not lower their price.

In the absence of any regulatory obligations, mortgage holders use their due-on clauses to maximize their financial advantage over owners by calling or recasting mortgages on the sale of the secured property. Thus, they increase their portfolio yield in a rising interest rate market by adjusting the rate of interest — and payments.

Economic recessions and recoveries

In times of stable or falling interest rates, mortgage holders generally permit assumptions of mortgages at the existing note rate, unless a **prepayment penalty clause** exists. Mortgage holders have no financial incentive to recast mortgages, or call and re-lend the funds at a lower rate when interest rates are in a decline.

However, in times of continuously rising rates, mortgage holders seize any event triggering the due-on clause to increase the interest yield on their portfolio. Here, mortgage holders employ title companies to advise them on recorded activity affecting title to the properties their mortgages encumber. Once the due-on clause is triggered, the mortgage holder requires the mortgage to be recast at current market rates as a condition for allowing:

- a loan assumption;
- a lease with a term over three years; or
- a further encumbrance of the property by the owner.

Thus, real estate ownership encumbered by due-on mortgages becomes increasingly difficult to sell as interest rates rise.

Adverse economic effects on sales

The **inhibiting effect** the due-on clause has on buyers during recessions has a similar adverse economic effect on all real estate sales, as well as the availability of private junior financing and long-term leasing.

Ultimately, as rates and interference by mortgage holders rise, many buyers, equity lenders and long-term tenants are driven out of the market, further depressing property values.

Meanwhile, owners are faced with the prospect of watching the value of their property fall below the remaining balance on encumbrances, often leaving owners with *negative equity* in the property. It is a vicious cycle which

It has recently come to our attention

Mortgage called or recast at mortgage holder's option

Events triggering the due-on clause

Sale:

- *transfer of legal title (grant or quitclaim deed);*
- *land sales contract or holding escrow;*
- *court-ordered conveyance; or*
- *death.*

Lease:

- *lease for more than three years; or*
- *lease with an option to buy.*

Further encumbrance:

- *creation or refinance of a junior lien; or*
- *foreclosure by junior lienholder.*

Transfers not triggering due-on enforcement (owner-occupied, four-or-less residential)

- *creation of junior lien where owner continues to occupy;*
- *transfers to spouse or child who occupies;*
- *transfer into inter vivos trust (owner obtains lender's consent and continues to occupy);*
- *death of a joint tenant; or*
- *transfer on death to a relative who occupies.*

evolves into a dramatic increase in mortgage **foreclosures**, the antithesis of the mortgage holder's profit motive for automatic enforcement of the due-on clause.

Due-on-sale

Due-on clauses are most commonly known as **due-on-sale** clauses. However, "due-on clause" is a more accurate term. A sale is not the only event triggering the clause. Still, as the name "due-on-sale" suggests, the primary event triggering the mortgage holder's due-on clause is a sale of property subject to the mortgage holder's trust deed lien.

The due-on clause is triggered not only by a transfer using a grant deed or quitclaim deed, but by any conveyance of legal or equitable ownership of real estate, recorded or not. [See **RPI** Form 404 and 405]

Examples include:

- land sales contracts;
- lease-option sales; or
- other wraparound carryback devices, such as **all-inclusive trust deeds (AITDs)**.

For example, a land sales contract does not involve a conveyance of real estate to the buyer by grant deed until the price is fully paid by the buyer. The seller retains title as security for the carryback debt owed by the buyer. However, the buyer under a land sales contract becomes the *equitable owner* of the property as soon as the land sales contract is entered into and possession transferred. This structuring of a carryback sale triggers the due-on clause in any existing trust deed.[6]

Due-on-lease

The due-on clause is also triggered by:

- a lease with a term over three years; or
- a lease for any term when coupled with an option to buy.[7]

For example, an owner with a short-term construction loan for nonresidential rental property obtains a conditional commitment from a lender for long-term financing to pay off the construction loan. Funding of the loan is conditioned on the property being 80% occupied by tenants with an initial lease term of at least five years.

The owner locates tenants for 80% of the newly constructed property, all with a lease term of five years or more. The lender funds the mortgage which contains a due-on clause. The existing five-year leases do not trigger the due-on clause in the trust deed. The long-term leases were entered into before the loan funded and the trust deed recorded.

However, after obtaining the mortgage, the owner continues to lease out space in their property for five-year terms. Later, after interest rates rise, a representative of the lender visits the property and observes the new tenants. On inquiry, the lender learns that some of the tenants entered into leases, or had their leases extended for periods greater than three years, events that occurred after the mortgage was originated.

The lender sends the owner a letter informing them it is calling the mortgage due since the owner entered into lease agreements with terms over three years without their prior consent.

The owner claims the lender cannot call the mortgage since long-term leases were initially required by the lender as a condition for funding the mortgage.

Can the lender call the mortgage due or demand a recast of its terms?

Yes! By requiring leases with terms over three years as a condition for funding the mortgage, the lender did not waive its right to call or recast the mortgage under its due-on clause if a lease with a term over three years is entered into after the mortgage was originated.

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6 **Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629

7 12 CFR §591.2(b)

Due-on modification

An **assignment** or **modification** of an existing lease does not trigger the due-on clause, unless:

- the lease is modified to extend the term beyond three years; or
- a purchase option is granted to the tenant.

For example, consider an owner of real estate who enters into a lease with an initial term of ten years. The owner takes out a mortgage containing a due-on clause. Later, the tenant assigns the lease with the owner's approval, as provided in the lease agreement which has priority to the mortgage.

Here, the due-on clause is not triggered by the lease assignment. The trust deed is attached as a lien only on the owner's fee interest, not the leasehold interest the owner previously conveyed to the tenant. The fee owner whose interest is encumbered by the mortgage transferred nothing. The assignment of a leasehold by a tenant is not a transfer of any interest in the fee encumbered by the mortgage.

Now consider a landlord who releases the original tenant from all liability under the lease as part of an assumption of the lease by the new tenant and substitution of liability. The release of the original tenant from liability creates a **novation** of the lease — a new agreement conveying an interest in the secured property to the new tenant by the owner of the fee. Since the *novation* included a leasing period of over three years, the mortgage holder may call the mortgage.[8]

Thus, an assumption of the lease by a new tenant, and a release of the former tenant from liability by the landlord, constitutes a present transfer of an interest affecting the fee ownership of the real estate since it is a novation.

Accordingly, a lease novation triggers the due-on clause if the lease has a remaining term of over three years or includes an option to purchase.

This interference addresses owners of commercial income property. Typically, the owners want long-term leases which run more than three years in their term. Here, the leasing periods have to be held to three years each, the initial term, and for each extension of the periods of occupancy under a lease agreement. Otherwise, the mortgage holder may call the mortgage if the initial period is more than three years, or when exercised, the extension of the lease term is for more than three years.

Due-on-further encumbrance

Consider an owner-occupant of an SFR subject to a first mortgage. The owner applies for an *equity loan* to be secured by a second trust deed on their property. The first mortgage contains a due-on clause.

The lender tells the owner they are concerned about due-on enforcement by the senior mortgage holder during times of rising rates. The lender is aware encumbering the property with a second mortgage triggers the existing

8 **Wells Fargo Bank, N.A.** v. **Bank of America NT & SA** (1995) 32 CA4th 424

mortgage holder's due on clause, unless the activity is exempt. On inquiry, the owner informs the lender they will continue to occupy the property as their residence.

The lender assures the owner that as long as they continue to occupy the property, the second mortgage will not trigger the senior mortgage's due-on clause. Due-on enforcement based on a further encumbrance of an owner-occupied, one-to-four unit residential property is not permitted.[9]

However, on real estate other than an owner-occupied, one-to-four unit residential property, any further encumbrance without first obtaining the existing mortgage holder's consent and waiver of their due-on clause triggers the due-on clause.

Thus, junior financing in the form of an equity loan without a waiver of the senior mortgage's due-on clause becomes a risky enterprise for lenders in times of rising interest rates. Increasing market rates give mortgage holders an incentive to call mortgages on the transfer of any interest in the secured real estate — with the exception of owner-occupied, one-to-four unit residential properties.

Due-on waiver

A lender who accepts a junior position on a property other than an owner-occupied, one-to-four unit residence without first obtaining a **due-on waiver** from the senior mortgage holder risks having the economic value of its position in title:

- **reduced** by an increase in the interest rate on the senior mortgage; or
- **wiped out** by the senior mortgage's foreclosure if its due-on rights were exercised based on the further encumbrance and it was not paid in full.[10]

Owners are driven to look elsewhere for funds when the existing mortgage holder does not grant a due-on waiver. Thus, an owner is forced to unnecessarily refinance existing mortgages in order to generate cash from their equity in the property, a more expensive process due to prepayment penalties and increased rates than had they obtained an equity loan.

Now consider a seller who carries back a second mortgage on the sale of property without the consent of the holder of the first mortgage which contains a due-on clause.

The holder of the first mortgage learns of the sale and calls the mortgage. To avoid the call, the buyer assumes the first mortgage and modifies the note by shortening the due date.

The carryback seller claims their second mortgage now has priority over the first mortgage since the modification of the first mortgage substantially impairs their security by increasing the potential for default on the carryback mortgage.

9 12 CFR §591.5(b)(1)(i)

10 **La Sala** v. **American Savings & Loan Association** (1971) 5 C3d 864

Here, the modification of the first mortgage without the consent of the junior carryback seller does not result in a change in mortgage priorities since the existence of the second mortgage is in violation of the due-on clause in the first mortgage.

When the secured property is sold and the seller accepts a second mortgage without receiving the mortgage holder's prior written consent, the due-on clause has been breached under federal mortgage law. Thus, no duty is imposed on the holder of the first mortgage to avoid further subordinating the interest of the holder of the unconsented-to junior mortgage by recasting the first mortgage.[11]

Due-on-foreclosure

Consider a parcel of real estate subject to a first and a second mortgage which the holder of the first mortgage previously consented to.

The property owner defaults on the first mortgage. The junior mortgage holder reinstates the first mortgage and forecloses on the second, acquiring the property at the trustee's sale. At all times, the second mortgage holder keeps the first mortgage current and remains advised of the foreclosure proceedings.

On acquiring title at foreclosure, the junior mortgage holder advises the senior mortgage holder they are now the **owner-by-foreclosure**. The senior mortgage holder then informs the junior mortgage holder, now the owner of the property, that they are calling their mortgage due based on the transfer of the property by trustee's deed — unless they are to receive points for an assumption of the mortgage and a modification of the note's interest rate and payments to current market rates.

May the senior mortgage holder call their mortgage due based on the completion of foreclosure by the second mortgage holder?

Yes! A senior mortgage holder may call a mortgage due on completion of the **foreclosure sale** by a junior mortgage holder on any type of real estate. A **trustee's deed** on foreclosure is considered a voluntary transfer by the owner, since the power-of-sale authority in the junior mortgage was agreed to by the owner of the real estate.

The due-on clause is not only triggered by the voluntarily agreed-to trustee's sale, it is also triggered by any involuntary foreclosure, such as a tax lien sale.[12]

Federal regulations allow due-on enforcement on *any transfer* of real estate which secures the lien, whether the transfer is voluntary or involuntary.[13]

The risk of a senior mortgage holder enforcing their due-on clause on a trustee's sale by the junior mortgage holder has a **debilitating effect** on

11 **Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869

12 **Garber** v. **Fullerton Savings and Loan Association** (1981) 122 CA3d 423 [Disclosure: the legal editor of this publication was an attorney in this case]

13 12 CFR §591.2(b)

the availability of junior mortgages and carryback sales. Prudent lenders and sellers are unwilling to accept a junior position which exposes them to paying off a senior debt if they are forced to foreclose on the real estate.[14]

Due-on-death and exceptions

Transfers of real estate which trigger due-on enforcement include the inevitable transfer resulting from the death of a vested owner. However, as with due-on enforcement triggered by further encumbrances, narrow exceptions apply to the death of an owner who occupied a one-to-four unit residential property.

For example, the transfer of a one-to-four unit residential property to a relative on the death of the owner-occupant does not trigger the due-on clause. However, this is conditioned on the relative becoming an occupant of the property.[15]

Also, when two or more people hold title to one-to-four unit residential property as **joint tenants**, the death of one *joint tenant* does not trigger due-on enforcement.

However, at least one of the joint tenants, whether it was the deceased or a surviving joint tenant, needs to have occupied the property when the mortgage was originated. Conversely, occupancy is not required for a surviving joint tenant who qualifies for the joint tenancy exception.[16]

On all other transfers, the death of a vested owner, joint tenant or other co-owner triggers the mortgage holder's due-on clause.

Thus, due-on enforcement is triggered on death by:

- a transfer of the deceased's residence to a non-relative, by will or by trust, following the death of the owner;
- the death of a joint tenant owning a one-to-four unit residential property which was not originally occupied by any of the surviving joint tenants;
- the death of a co-owner of any type of property other than one-to-four residential units; and
- the transfer of any property, other than the deceased's residence, to a relative or anyone else on the death of the owner.

Divorce and inter-family transfers

Consider a married couple who occupies a residence vested in the name of the husband and owned as his separate property. The residence is encumbered by a mortgage containing a due-on clause.

The couple separates and the residence is transferred to the wife as part of the property settlement to dissolve the marriage. The wife continues to occupy the residence.

14 Pas v. Hill (1978) 87 CA3d 521
15 12 CFR §591.5(b)(1)(v)(A)
16 12 CFR §591.5(b)(1)(iii)

Does the transfer of the residence to the wife on divorce trigger due-on enforcement by the mortgage holder?

No! Federal due-on regulations bar due-on enforcement on the transfer of one-to-four unit residential property to a spouse after a divorce, so long as the acquiring spouse occupies the property.[17]

However, if the acquiring spouse chooses to lease the residential property for any period of time rather than occupy it, the mortgage holder may call or recast the mortgage.

Inter-family exception

The due-on clause is not triggered by an owner's transfer of their one-to-four unit residential property to a **spouse or child** who occupies the property.[18]

This *inter-family transfer exception* applies only to transfers from an owner to a spouse or child. Any transfer from a child to a parent triggers due-on enforcement.

Consider an owner-occupant of one-to-four unit residential property who transfers the property into an **inter vivos trust**, naming themselves as beneficiary. The owner continues to occupy the property after transferring title into the living trust.

The owner notifies the mortgage holder prior to transfer. The owner agrees to give the mortgage holder notice of any later transfer of their beneficial interest in the trust or change in occupancy of the property as requested by the mortgage holder.

inter vivos trust
A title holding arrangement used as a vesting by a property owner for probate avoidance on death.

Does this transfer into the *inter vivos trust* trigger the due-on clause in a mortgage encumbering the owner's residence?

No! The owner met the federal regulatory conditions for avoiding due-on enforcement based on a transfer of owner-occupied, one-to-four unit residential property into an inter vivos trust.[19]

To meet regulations, the owner needs to provide means acceptable to the mortgage holder by which the mortgage holder is given notice of any later transfer of the beneficial interest in the trust or change in occupancy. If the owner conveys the property into the inter vivos trust without the mortgage holder's approval, the mortgage holder may call the mortgage due.

Thus, if the owner does not continue to occupy the property, or later transfers the beneficial interest in the trust, the mortgage holder may call or recast the mortgage.

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17 12 CFR §591.5(b)(1)(v)(C)
18 12 CFR §591.5(b)(1)(v)(B)
19 12 CFR §591.5(b)(1)(vi)

Lender waiver by negotiations or by conduct

An owner intending to enter into a transaction to sell, lease or further encumber their real estate without interference by the mortgage holder needs to first negotiate a *limitation* or *waiver* of the mortgage holder's due-on rights.

Waiver agreements are trade-offs. In return for waiving or agreeing to limit the exercise of its due-on rights in the future, the mortgage holder demands consideration such as:

- additional points in the instance of an origination;
- additional security;
- the borrower's pay-down of principal balance;
- increased interest;
- a shorter due date; or
- an assumption fee.

waiver agreement
An agreement in which a mortgage holder consents to the owner's present or future transfer of an interest in the mortgaged property as a waiver of the mortgage holder's due-on rights. Also known as an assumption agreement.

Consider a buyer who applies for a mortgage to purchase a residence they intend to occupy for only a few years. The buyer is concerned due-on enforcement will later make it more difficult to resell their property since interest rates are likely to continue to rise.

The buyer and lender negotiate the conditions on which a qualified buyer in a later sale of the property will be able to assume the buyer's mortgage without a call by the mortgage holder. In exchange, the buyer agrees to pay increased points or a higher interest rate, subject to applicable Reg Z fee caps.

The mortgage holder's waiver of their due-on rights under an *assumption agreement* applies only to the present transfer to the buyer. Unless additionally agreed to, any *later transfer* of an interest in the property will trigger the due-on clause, allowing the mortgage holder to call or recast the mortgage again.

In addition to a *waiver agreement*, waiver of the mortgage holder's due-on rights may occur *by conduct* when the mortgage holder fails to promptly enforce its due-on rights.

For example, a buyer purchases real estate subject to a mortgage containing a due-on clause. The mortgage holder is informed or discovers the transfer and immediately calls the mortgage. However, the mortgage holder then accepts payments from the buyer for over 12 months. After interest rates increase, the mortgage holder later seeks to enforce their prior call by refusing further payments.

Here, the mortgage holder waived the right to enforce their due-on clause by their conduct.[20]

20 **Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292

Broker liability for due-on avoidance

When the seller intends to transfer ownership of the property to the buyer, the senior mortgage holder's due-on clause is triggered regardless of the form used to document the sales transaction.

Regardless, the mortgage holder can only call the mortgage when they actually discover a change of ownership has taken place. If the buyer's option is not recorded, and the lease agreement is for a term of three years or less, the mortgage holder may not discover any transfer of an interest in the real estate which triggered their due-on clause has taken place.

If the mortgage holder later discovers a change of ownership has taken place, their only remedy against the buyer and seller is to call the mortgage due, or arrange to recast the mortgage as a condition for waiving their right to call and allowing an assumption by the buyer. Additionally, the mortgage holder may not recover the *retroactive interest differential* (RID) for the period before they discovered the transfer and called the mortgage.[21]

However, an **adviser**, such as a broker or attorney, assisting the buyer or seller to *mask the change of ownership* from the mortgage holder with the primary purpose of avoiding due-on enforcement may be held liable for wrongfully interfering with the mortgage holder's right to call or recast the mortgage, an offense called **tortious interference with prospective economic advantage**.

The *adviser's* liability arises based on the extent to which their actions were *specifically intended* to conceal the transfer and prevent a call by the mortgage holder, and on the foreseeability the mortgage holder will incur losses due to the concealment.[22]

The mortgage holder's losses caused by the adviser's wrongful interference are calculated based on the *interest differential* between the note rate and the market rate on the date of sale, retroactively applied from the date of discovery by the mortgage holder to the date of the transfer.

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21 **Hummell** v. **Republic Federal Savings & Loan** (1982) 133 CA3d 49

22 **J'Aire Corporation** v. **Gregory** (1979) 24 C3d 799

Chapter 36 Summary

A burden on the use and mobility of ownership is created by the existence of the due-on clause buried within all trust deeds serviced by mortgage holders.

Generally, mortgage holders are allowed to enforce due-on sale clauses in mortgages on most transfers of any interest in any type of real estate.

In times of stable or falling interest rates, mortgage holders generally permit assumptions of mortgages at the existing note rate, unless a prepayment penalty clause exists. Mortgage holders have no financial incentive to recast mortgages, or call and re-lend the funds at a lower rate when interest rates are in a decline.

However, in times of continuously rising rates, mortgage holders seize any event triggering the due-on clause to increase the interest yield on their portfolio. Thus, real estate ownership encumbered by due-on mortgages becomes increasingly difficult to sell as interest rates rise.

The inhibiting effect the due-on clause has on buyers during recessions has a similar adverse economic effect on all real estate sales, as well as the availability of private junior financing and long-term leasing.

Ultimately, as rates and interference by mortgage holders rise, many buyers, equity lenders and long-term tenants are driven out of the market, further depressing property values.

The due-on clause is triggered not only by a transfer using a grant deed or quitclaim deed, but by any conveyance of legal or equitable ownership of real estate, recorded or not.

However, federal due-on regulations bar due-on enforcement on the transfer of one-to-four unit residential property to a spouse after a divorce, so long as the acquiring spouse occupies the property. Further, the due-on clause is not triggered by an owner's transfer of their one-to-four unit residential property to a spouse or child who occupies the property.

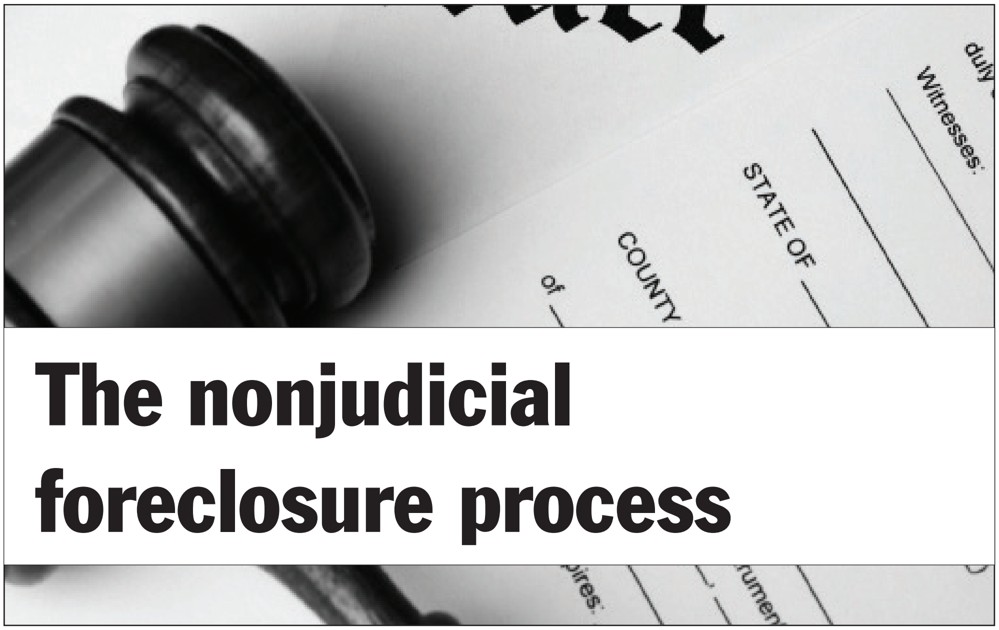
An assignment or modification of an existing lease does not trigger the due-on clause, unless:

- the lease is modified to extend the term beyond three years; or
- a purchase option is granted to the tenant.

An owner intending to enter into a transaction to sell, lease or further encumber their real estate without interference by the mortgage holder needs to first negotiate a limitation or waiver of the mortgage holder's due-on rights.

An adviser, such as a broker or attorney, assisting the buyer or seller to mask the change of ownership from the mortgage holder with the primary purpose of avoiding due-on enforcement may be held liable for wrongfully interfering with the mortgage holder's right to call or recast the mortgage, an offense called tortious interference with prospective economic advantage.

Chapter 36 Key Terms



Chapter 37

The nonjudicial foreclosure process

Learning Objectives

After you read this chapter, you will be able to :

- identify a mortgage or other lien on real estate by its power-of-sale authority to nonjudicially foreclose on the secured property if the owner defaults;
- determine the pre-foreclosure workout process mandated for a first lien, one-to-four unit residential property;
- understand an owner's rights during the different periods in the trustee's foreclosure process;
- determine whether the trustee has abided by recording and posting procedures governing the foreclosure process and rights of residential tenants;
- advise buyers and owners on the procedures for a trustee's sale, including advertising, postponing and accepting bids; and
- distinguish the priority for disbursements of excess proceeds from a trustee's sale.

Key Terms

bona fide purchaser (BFP)
declaration of default and demand for sale
full credit bid
lis pendens
nonjudicial foreclosure
notice of default (NOD)
notice of trustee's sale (NOTS)
power-of-sale provision
pre-foreclosure workout
recourse debt
surplus funds
trustee (on a mortgage)
trustee's sale guarantee

Power-of-sale provision

nonjudicial foreclosure
When property is sold at a public auction by a trustee as authorized under the power-of-sale provision in a trust deed.

power-of-sale provision
A trust deed provision authorizing the trustee to initiate a non-judicial foreclosure sale of the described property on instructions from the beneficiary.

recourse debt
A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

A mortgage holder or carryback seller holding a note secured by a trust deed in default has two foreclosure methods available to enforce collection of the mortgage debt. These two foreclosure methods are:

- a **judicial foreclosure** sale, also called a *sheriff's sale* [See Chapter 38];[1] or
- a **nonjudicial foreclosure** sale, also called a *trustee's sale*.[2]

The key to the mortgage holder's ability to *nonjudicially foreclose* by a trustee's sale on the mortgaged real estate is the *power-of-sale provision* contained in the mortgage, also called a trust deed. [See Figure 1]

Other security devices used to create a lien on real estate to secure a debt which may also contain a **power-of-sale provision** include:

- a land sale contract [See **RPI** Form 165];[3]
- a lease-option sale [See **RPI** Form 163 §19];
- a homeowners' association (HOA)'s conditions, covenants and restrictions (CC&Rs) regarding assessment liens;
- bonded improvement assessments; or
- a UCC-1 financing statement. [See **RPI** Form 436-1][4]

The grant of the power-of-sale by the owner of a property provides a private contract remedy for the **recovery of money** by a creditor, typically a mortgage holder. The power-of-sale is voluntarily agreed to by the owner of the mortgaged property, authorizing the mortgage holder on a default to hold a nonjudicial foreclosure sale of the property by public auction.[5]

If the note evidences a **recourse debt** with a remaining balance exceeding the *fair price* of the mortgage holder's security position in real estate, the mortgage holder may want to choose a *judicial foreclosure*. A judicial foreclosure action allows the mortgage holder to seek a money judgment for any deficiency in the property's value to satisfy the debt. [See Chapter 38]

However, by foreclosing under the power-of-sale provision, the mortgage holder avoids a costly (and potentially time-consuming) court action for judicial foreclosure.

Editor's note — When a mortgage holder completes a nonjudicial foreclosure, it cannot later obtain a deficiency judgment against the owner of the mortgaged real estate. Alternatively, the owner cannot redeem the property after the mortgage holder's trustee's sale as they can after a judicial foreclosure sale. [See Chapter 38]

Who conducts the sale

A trust deed is a **security device** which imposes a mortgage lien on real estate. The mortgage wording purports to create a *fictional trust* which is said to "hold title" to the mortgaged real estate for the benefit of the mortgage

1 Calif. Code of Civil Procedure §726
2 Calif. Civil Code §2924
3 **Petersen** v. **Hartell** (1985) 40 C3d 102
4 **Lovelady** v. **Bryson Escrow, Inc.** (1994) 27 CA4th 25
5 CC §2924

Figure 1

Excerpt from Form 450

Trust Deed and Assignment of Rents

3.6 **TRUSTEE'S SALE —** On default of any obligation secured by this Deed of Trust and acceleration of all sums due, Beneficiary may instruct Trustee to proceed with a sale of the secured property under the power of sale granted herein, noticed and held in accordance with Calif. Civil Code §2924 et seq.

holder. As you will observe, the trustee holds no interest in the property and has no duty owed to anyone, until they voluntarily undertake to reconvey or foreclose on a declaration by the mortgage holder.

Thus, a mortgage has three parties:

- at least one **trustor** (the owner(s) of the mortgaged real estate);
- a **trustee** who need not be named; and
- at least one **beneficiary** (a lender, carryback seller, HOA, bonded assessment or other mortgage holder).

trustee (on a mortgage)
A party to a mortgage who, as a legal fiction, holds title to property as security for the performance of an obligation with the authority to sell the property or reconvey the trust deed on instructions from the mortgage holder.

The trustee's sale is conducted by the *trustee* who is either:

- named in the mortgage; or
- appointed by the *beneficiary* of the mortgage at the time the beneficiary initiates the foreclosure process.

A broker, attorney, mortgage servicer, subsidiary of the mortgage holder, or the mortgage holder itself may be appointed at any time as the trustee.

The trustee begins the nonjudicial foreclosure process by recording a **notice of default (NOD)**. The trustee ends the process on delivery of the trustee's deed and disbursement of any sales proceeds.[6] [See Figure 2]

notice of default (NOD)
The notice filed to begin the nonjudicial foreclosure process. Generally, it is filed following three or more months of delinquent mortgage payments.

Generally, trust deed forms are prepared and distributed by title or escrow companies naming their corporation as the trustee. However, a trust deed or other security device does not need to name the trustee at all. The mortgage holder later simply appoints a trustee to handle the *NOD* or reconveyance. [See **RPI** Form 450]

Also, the mortgage holder may appoint a substitute trustee to replace the trustee named in the trust deed.

Pre-foreclosure workout prior to NOD

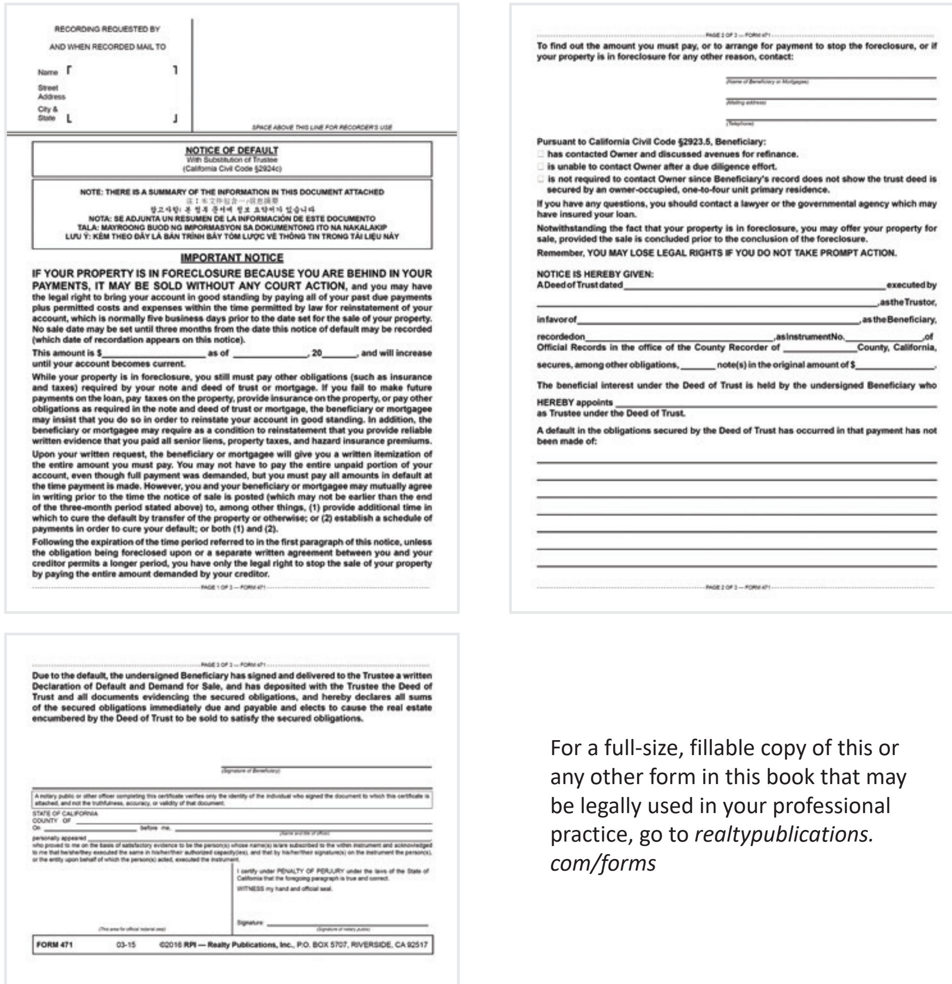
Before recording an NOD on a first lien mortgage securing a purchase-assist loan on a *principal residence*, a mortgage holder needs to conduct a **pre-foreclosure workout** with the homeowner.

6 **Bank of America National Trust & Savings Association** v. **Century Land & Water Co.** (1937) 19 CA2d 194

Figure 2

Form 471

Notice of Default



RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

NOTICE OF DEFAULT
With Substitution of Trustee
(California Civil Code §2924c)

NOTE: THERE IS A SUMMARY OF THE INFORMATION IN THIS DOCUMENT ATTACHED
注：本文件包含一个信息摘要
참고사항: 본 첨부 문서에 정보 요약서가 있습니다
NOTA: SE ADJUNTA UN RESUMEN DE LA INFORMACIÓN DE ESTE DOCUMENTO
TALA: MAYROONG BUOD NG IMPORMASYON SA DOKUMENTONG ITO NA NAKALAKIP
LƯU Ý: KÈM THEO ĐÂY LÀ BẢN TRÌNH BÀY TÓM LƯỢC VỀ THÔNG TIN TRONG TÀI LIỆU NÀY

IMPORTANT NOTICE

IF YOUR PROPERTY IS IN FORECLOSURE BECAUSE YOU ARE BEHIND IN YOUR PAYMENTS, IT MAY BE SOLD WITHOUT ANY COURT ACTION, and you may have the legal right to bring your account in good standing by paying all of your past due payments plus permitted costs and expenses within the time permitted by law for reinstatement of your account, which is normally five business days prior to the date set for the sale of your property. No sale date may be set until three months from the date this notice of default may be recorded (which date of recordation appears on this notice).

This amount is $____________ as of ____________, 20______, and will increase until your account becomes current.

While your property is in foreclosure, you still must pay other obligations (such as insurance and taxes) required by your note and deed of trust or mortgage. If you fail to make future payments on the loan, pay taxes on the property, provide insurance on the property, or pay other obligations as required in the note and deed of trust or mortgage, the beneficiary or mortgagee may insist that you do so in order to reinstate your account in good standing. In addition, the beneficiary or mortgagee may require as a condition to reinstatement that you provide reliable written evidence that you paid all senior liens, property taxes, and hazard insurance premiums.

Upon your written request, the beneficiary or mortgagee will give you a written itemization of the entire amount you must pay. You may not have to pay the entire unpaid portion of your account, even though full payment was demanded, but you must pay all amounts in default at the time payment is made. However, you and your beneficiary or mortgagee may mutually agree in writing prior to the time the notice of sale is posted (which may not be earlier than the end of the three-month period stated above) to, among other things, (1) provide additional time in which to cure the default by transfer of the property or otherwise; or (2) establish a schedule of payments in order to cure your default; or both (1) and (2).

Following the expiration of the time period referred to in the first paragraph of this notice, unless the obligation being foreclosed upon or a separate written agreement between you and your creditor permits a longer period, you have only the legal right to stop the sale of your property by paying the entire amount demanded by your creditor.

PAGE 1 OF 3 — FORM 471

PAGE 2 OF 3 — FORM 471

To find out the amount you must pay, or to arrange for payment to stop the foreclosure, or if your property is in foreclosure for any other reason, contact:

(Name of Beneficiary or Mortgagee)

(Mailing address)

(Telephone)

Pursuant to California Civil Code §2923.5, Beneficiary:

☐ has contacted Owner and discussed avenues for refinance.

☐ is unable to contact Owner after a due diligence effort.

☐ is not required to contact Owner since Beneficiary's record does not show the trust deed is secured by an owner-occupied, one-to-four unit primary residence.

If you have any questions, you should contact a lawyer or the governmental agency which may have insured your loan.

Notwithstanding the fact that your property is in foreclosure, you may offer your property for sale, provided the sale is concluded prior to the conclusion of the foreclosure.

Remember, YOU MAY LOSE LEGAL RIGHTS IF YOU DO NOT TAKE PROMPT ACTION.

NOTICE IS HEREBY GIVEN:

A Deed of Trust dated ____________ executed by ____________, as the Trustor, in favor of ____________, as the Beneficiary, recorded on ____________, as instrument No. ____________, of Official Records in the office of the County Recorder of ____________ County, California, secures, among other obligations, ______ note(s) in the original amount of $____________.

The beneficial interest under the Deed of Trust is held by the undersigned Beneficiary who HEREBY appoints ____________ as Trustee under the Deed of Trust.

A default in the obligations secured by the Deed of Trust has occurred in that payment has not been made of:

PAGE 2 OF 3 — FORM 471

PAGE 3 OF 3 — FORM 471

Due to the default, the undersigned Beneficiary has signed and delivered to the Trustee a written Declaration of Default and Demand for Sale, and has deposited with the Trustee the Deed of Trust and all documents evidencing the secured obligations, and hereby declares all sums of the secured obligations immediately due and payable and elects to cause the real estate encumbered by the Deed of Trust to be sold to satisfy the secured obligations.

(Signature of Beneficiary)

A notary public or other officer completing this certificate verifies only the identity of the individual who signed the document to which this certificate is attached, and not the truthfulness, accuracy, or validity of that document.

STATE OF CALIFORNIA
COUNTY OF ____________
On ____________ before me, ____________ (Name and title of officer)
personally appeared ____________
who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

(This area for official notarial seal)

Signature ____________ (Signature of notary public)

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pre-foreclosure workout
Negotiations between a mortgage holder and defaulting property owner with the purpose of exploring options to avoid foreclosure.

At least 30 days prior to recording an NOD, the mortgage holder needs to contact the homeowner to:

- assess the homeowner's financial situation;
- explore options for the homeowner to avoid foreclosure;
- advise the homeowner of their right to an additional meeting within 14 days to discuss their financial options; and
- provide homeowners with the toll-free Department of Housing and Urban Development (HUD) phone number to find a HUD-certified housing counseling agency.[7]

Further, after attempting the initial contact, the servicer must send a written statement to the owner informing the owner of their right to:

- additional protections and services if they are a servicemember or a dependent of a servicemember; and
- request the note, trust deed, assignment and payment history.[8]

7 CC §2923.5(a)

8 CC §2923.55

If the mortgage holder is unable to make contact with the homeowner, the mortgage holder:

- sends the homeowner a first-class letter containing a toll-free number for a housing counselor certified by the *HUD*; and
- calls the homeowner by the primary telephone number on file at least three times at different hours on different days.[9]

The mortgage holder may record an NOD on a mortgage without complying with any of these 30-day pre-foreclosure requirements when the homeowner has:

- surrendered the property to the mortgage holder either by a letter confirming the surrender or by delivery of the keys to the mortgage holder;
- contracted with a person who facilitates a homeowner's decision to leave their home by extending the foreclosure process and avoiding the mortgage holder's enforcement of the loan; or
- filed a bankruptcy petition which is pending.[10]

The nonjudicial stages of foreclosure

To successfully complete a trustee's foreclosure sale under a *power-of-sale provision*, the trustee and mortgage holder need to adhere to the procedures detailed in the California foreclosure statutes for handling a trustee's sale.[11]

The nonjudicial foreclosure process has three stages:

1. the **NOD** is recorded and mailed;
2. the **notice of trustee's sale (NOTS)** is recorded, posted and mailed; and
3. the **trustee's sale** of the real estate by auction occurs, followed by the execution of the trustee's deed and distribution of sales proceeds.

notice of trustee's sale (NOTS)
The notice recorded, posted and mailed to evidence an impending trustee's sale to the property owner and potential bidders.

Editor's note — Mortgage servicers are required to wait until a mortgage is at least 120 days delinquent before commencing foreclosure on a first lien mortgage secured by an owner's principal residence.[12]

While the trustee is concerned about the three stages for processing the foreclosure, the owner of the real estate and the mortgage holder are concerned primarily with two different periods of time which control payment of the debt:

- the **reinstatement period**, which runs from the recording of the NOD and ends prior to five business days before the trustee's sale; and
- the **redemption period,** which also runs from the recording of the NOD but ends with the completion of the trustee's sale of the secured property. [See Chapter 39]

The owner of a unit in a **common interest development (CID)** has 90 days after the trustee's foreclosure sale on an HOA assessment lien to redeem

9 CC §2923.5(e)
10 CC §2920.5(c)(2)
11 **Garfinkle** v. **Superior Court of Contra Costa County** (1978) 21 C3d 268
12 12 Code of Federal Regulations §1024.41(f)(1)

How does California's Homeowner Bill of Rights affect the foreclosure process?

Protections for homeowners going through the nonjudicial foreclosure process are afforded under The California Homeowner Bill of Rights.

- **Dual track foreclosures** are restricted. This prohibits a mortgage holder from continuing the foreclosure process if the homeowner applies for a loan modification no later than five days before a scheduled foreclosure sale. The foreclosure process may only resume if the loan modification application is formally denied in writing. [Calif. Civil Code §2923.5(a)(1)(B)]
- **Single points of contact** are to be provided by mortgage holders to homeowners pursuing foreclosure alternatives. [CC §2923.7(a)]
- **Verification of foreclosure documents** is required. A mortgage holder who records and files "multiple" unverified foreclosure documents may be fined up to $7,500 per violation. These documents include an NOD, a Notice of Trustee's Sale (NOTS), assignment of the trust deed or a substitution of the trust deed. Each of these documents needs to be verified for substantial evidence of the mortgage holder's right to foreclose. [CC §2924.17(c)]
- **Tenants of foreclosed** homes are also protected by the Homeowner Bill of Rights. Upon completion of the trustee's sale, the new owner needs to honor an existing lease if it has a fixed-term. If the home is to be occupied as a principal residence, the new owner may serve the tenant with a 90-day eviction notice. [See **RPI** Form 573; CC §2924.8(a)(1)]

The Homeowner Bill of Rights also provides relief if a foreclosure sale has already taken place.

Violations of foreclosure law by mortgage holders result in the homeowner receiving money sufficient to cover their economic losses, including attorney fees and court costs. [CC §2924.12]

the unit. This is distinct from the standard redemption period applicable to non-HOA units which expires five business days before the trustee's sale. This HOA-specific legislation was adopted to stymie the efforts of an HOA attempting to initiate foreclosure to collect overdue HOA assessments of minimal value.[13]

Trustee's sale guarantee

When a mortgage is in default and the mortgage holder has chosen to foreclose, the mortgage holder hands a **declaration of default and demand for sale** to the trustee.

declaration of default and demand for sale
A document delivered to the trustee under a power of sale provision by the mortgage holder instructing the trustee to initiate foreclosure on the secured real estate by recording a notice of default (NOD).

The declaration contains instructions directing the trustee to initiate foreclosure on the mortgaged property as authorized under the power-of-sale provision contained in the mortgage. [See Figure 2]

Even though the trustee may have received the mortgage holder's declaration of default, the trustee's foreclosure process and the periods imposing rights and obligations do not begin until the trustee or mortgage holder records an NOD.[14]

Once the NOD is recorded, the trustee is required to strictly comply with statutory notice requirements. To be assured the required notices are served on all the proper persons, the trustee orders a **trustee's sale guarantee** from a title company before or at the time the NOD is recorded.

13 CCP §2924.1
14 **System Investment Corporation** v. **Union Bank** (1971) 21 CA3d 137

The *trustee's sale guarantee* provides coverage to the trustee for failure to serve notices on any party due to an omission of that person's identity in the guarantee.

trustee's sale guarantee
A policy issued by a title insurance company to a trustee before or at the time the notice of default is recorded providing coverage for the trustee should they fail to serve notices on any party of record due to an omission in the guarantee.

The trustee's sale guarantee contains:

- the name and address of each person who has recorded a request for a copy of the NOD;
- the name and address of each party with a recorded interest in the real estate securing the obligation in default;
- any junior (later recorded) easements and to whom the easements were granted;
- the property's legal description;
- a plat map locating the property; and
- the names of the newspapers in general circulation in which the NOTS, and the NOD if necessary, are to be published.

The notice of default and election to sell

When ordering a trustee's sale guarantee from a title insurance company, the trustee instructs the title company to record the NOD in the office of the county recorder in the county where the real estate is located.[15]

The NOD contains statutorily mandated statements which set forth the *monetary default* on the note or other obligation secured by the mortgage.[16]

The monetary default statement informs the owner:

- they need to continue to pay other obligations required of them by the mortgage, such as hazard insurance premiums and property taxes; and
- if they do not make future payments on the obligations in default, the owner is required to make the payments to reinstate the loan. [See Figure 2]

The NOD does not need to state the actual amounts of the monetary defaults on the recurring obligations. However, the NOD needs to state the nature of the *present defaults* on the mortgage.[17]

For one-to-four unit residential property, a summary of key information contained in the NOD needs to be attached to the NOD. The summaries do not have to be published or recorded.[18] [See **RPI** Form 471-1]

Further, if the mortgage was originally negotiated in one of five languages other than English, the summary is to be provided in that language. These languages are:

- Chinese;
- Korean;
- Spanish;

15 CC §2924(a)(1)
16 CC §2924c(b)(1); CC § 2924(a)(1)
17 CC §2924c(a)(1)(B); CC §2924c(a)(1)(C)
18 CC §2923.3(c)

No address for trustor

The trustee must send a copy of the notice of default (NOD) to:

- *the trustor's address as noted in the trust deed; and*
- *the address given by the trustor in a recorded request for NOD. [Calif. Civil Code §2924b(b)(3)]*

If the trust deed does not contain a request for NOD, or contains a request for NOD but no address for the trustor, the trustee can do one of the following within 10 business days after recording the NOD:

- *publish the NOD in a newspaper of general circulation in the county in which the property is located (the trustee's sale guarantee issued by the title company advises which newspaper to use), and continue publishing once a week for at least four weeks;*
- *personally serve the NOD on the trustor; or*
- *post the NOD in a conspicuous place on the secured property and mail the notice to the last known address of the trustor. [CC §2924b(d)]*

*A trustee is not required to discover a trustor's address if the current address is not actually known to the trustee. [**I.E. Associates** v. **Safeco Title Insurance Company** (1985) 39 C3d 281]*

Unless the trustee has actual knowledge of the trustor's last known physical address, which does not include the use of an email address, the trustee is not liable if the trustor does not receive a copy of the NOD. [CC §2924b(b)(3)]

- Tagalog; or
- Vietnamese.[19] [See **RPI** Form 474-1 through 474-6]

To determine the amount needed to cure the default, the NOD directs the owner seeking to *reinstate* the mortgage or *redeem* the property to contact the trustee. Thus, the trustee insulates the mortgage holder from all direct contact with the owner or junior mortgage holder after the date the NOD is recorded until cancelled or a trustee's sale occurs.

If the NOD does not list a default known to the mortgage holder at the time of recording, the unnamed default does not need to be cured for the loan to be reinstated.[20]

However, the mortgage holder may later record a separate NOD to notice the omitted default, and pursue a separate foreclosure based on the omitted default.[21]

Delivering the NOD

Within **ten business days** after recording a NOD, two copies of the NOD are mailed to:

- the owner of the property;
- the administrator of a deceased owner's estate; and
- each person who has recorded a request to receive a copy of the NOD.[22]

19 CC §2923.3(a)
20 **In re Peters** (9th Cir. BAP 1995) 184 BR 799
21 CC §2924(e)
22 **Estate of Yates** v. **West End Financial Corporation, Inc.** (1994) 25 CA4th 511; CC §2924b(b)(1)

One copy of the NOD is sent by registered or certified mail, the other copy is sent by first-class mail.[23]

Within **one month** after recording the NOD, the trustee sends a copy of the NOD by registered or certified mail and another copy by first-class mail to holders of a **recorded interest** in the mortgaged property, including:

- the owner's successor-in-interest;
- any junior mortgage holder;
- the assignee of a junior mortgage;
- a buyer on a land sales contract;
- a lessee on a lease; and
- the state Office of the Controller, if a *Notice of Lien for Postponed Property Taxes* is recorded against the property.[24]

Any other person interested in obtaining a copy of the NOD records a **request for NOD.** The request for NOD assures the interested person they will be notified of the default. [See **RPI** Form 412]

A trustee or person depositing the NOD into the mail to give notice to others prepares a *proof of service* and includes a copy of the form with the NOD in each mailing.[25]

The notice of trustee's sale

A trustee or mortgage holder may begin noticing the date set for the sale of a property on the day following **three months after** the NOD is recorded.[26]

The date of the sale may be set for any business day, Monday through Friday, between the hours of 9 a.m. and 5 p.m.[27]

In general practice, a **date down** of the trustee's sale guarantee issued to the trustee is ordered out from the title company the day before or on the day the title company records the NOTS.

The *date down* notifies the trustee of any interests recorded on the title to the property after the NOD is recorded. However, the trustee is not required to give notice of the impending trustee's sale to any person who recorded an interest in the property after the NOD was recorded.[28]

The trustee prepares an NOTS which contains:

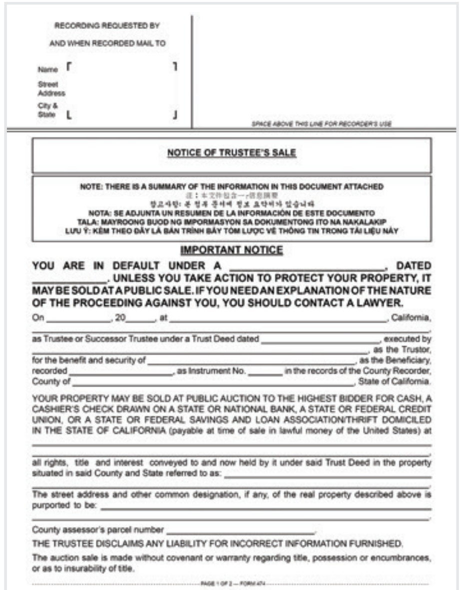
- the trustee's name or their agent's name, street address and telephone number (or toll-free number if located out of state);
- the street address or common designation of the mortgaged property;
- the county assessor's parcel number of the mortgaged property;

23 CC §2924b(b)(1), (e)
24 CC §2924b(c)
25 CC §2924b(e)
26 CC §2924(a)(3)
27 CC §2924g(a)
28 CC §2924b(c)(1)

Figure 3

Form 474

Notice of Trustee's Sale



RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

NOTICE OF TRUSTEE'S SALE

NOTE: THERE IS A SUMMARY OF THE INFORMATION IN THIS DOCUMENT ATTACHED

NOTA: SE ADJUNTA UN RESUMEN DE LA INFORMACIÓN DE ESTE DOCUMENTO

TALA: MAYROONG BUOD NG IMPORMASYON SA DOKUMENTONG ITO NA NAKALAKIP

LƯU Ý: KÈM THEO ĐÂY LÀ BẢN TRÌNH BÀY TÓM LƯỢC VỀ THÔNG TIN TRONG TÀI LIỆU NÀY

IMPORTANT NOTICE

YOU ARE IN DEFAULT UNDER A ____________, DATED ____________. UNLESS YOU TAKE ACTION TO PROTECT YOUR PROPERTY, IT MAY BE SOLD AT A PUBLIC SALE. IF YOU NEED AN EXPLANATION OF THE NATURE OF THE PROCEEDING AGAINST YOU, YOU SHOULD CONTACT A LAWYER.

On ____________, 20____, at ____________, California, ____________, as Trustee or Successor Trustee under a Trust Deed dated ____________, executed by ____________, as the Trustor, for the benefit and security of ____________, as the Beneficiary, recorded ____________, as Instrument No. ______ in the records of the County Recorder, County of ____________, State of California.

YOUR PROPERTY MAY BE SOLD AT PUBLIC AUCTION TO THE HIGHEST BIDDER FOR CASH, A CASHIER'S CHECK DRAWN ON A STATE OR NATIONAL BANK, A STATE OR FEDERAL CREDIT UNION, OR A STATE OR FEDERAL SAVINGS AND LOAN ASSOCIATION/THRIFT DOMICILED IN THE STATE OF CALIFORNIA (payable at time of sale in lawful money of the United States) at ____________, all rights, title and interest conveyed to and now held by it under said Trust Deed in the property situated in said County and State referred to as: ____________.

The street address and other common designation, if any, of the real property described above is purported to be: ____________.

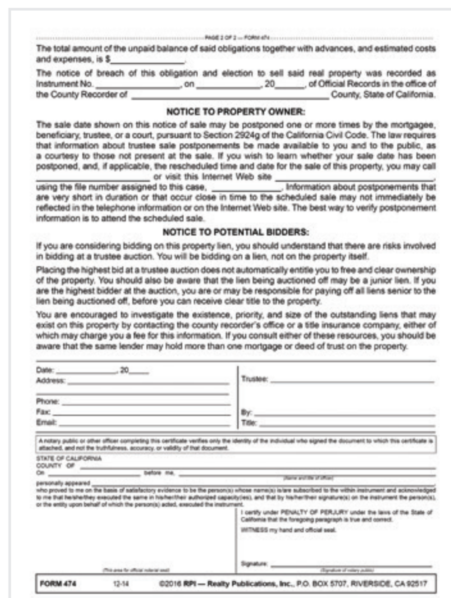
County assessor's parcel number ____________.

THE TRUSTEE DISCLAIMS ANY LIABILITY FOR INCORRECT INFORMATION FURNISHED.

The auction sale is made without covenant or warranty regarding title, possession or encumbrances, or as to insurability of title.

PAGE 1 OF 2 — FORM 474

For a full-size, fillable copy of this or any other form in this book that may be legally used in your professional practice, go to *realtypublications.com/forms*



PAGE 2 OF 2 — FORM 474

The total amount of the unpaid balance of said obligations together with advances, and estimated costs and expenses, is $____________.

The notice of breach of this obligation and election to sell said real property was recorded as Instrument No. ____________, on ____________, 20____, of Official Records in the office of the County Recorder of ____________ County, State of California.

NOTICE TO PROPERTY OWNER:

The sale date shown on this notice of sale may be postponed one or more times by the mortgagee, beneficiary, trustee, or a court, pursuant to Section 2924g of the California Civil Code. The law requires that information about trustee sale postponements be made available to you and to the public, as a courtesy to those not present at the sale. If you wish to learn whether your sale date has been postponed, and, if applicable, the rescheduled time and date for the sale of this property, you may call ____________ or visit this Internet Web site ____________, using the file number assigned to this case, ____________. Information about postponements that are very short in duration or that occur close in time to the scheduled sale may not immediately be reflected in the telephone information or on the Internet Web site. The best way to verify postponement information is to attend the scheduled sale.

NOTICE TO POTENTIAL BIDDERS:

If you are considering bidding on this property lien, you should understand that there are risks involved in bidding at a trustee auction. You will be bidding on a lien, not on the property itself.

Placing the highest bid at a trustee auction does not automatically entitle you to free and clear ownership of the property. You should also be aware that the lien being auctioned off may be a junior lien. If you are the highest bidder at the auction, you are or may be responsible for paying off all liens senior to the lien being auctioned off, before you can receive clear title to the property.

You are encouraged to investigate the existence, priority, and size of the outstanding liens that may exist on this property by contacting the county recorder's office or a title insurance company, either of which may charge you a fee for this information. If you consult either of these resources, you should be aware that the same lender may hold more than one mortgage or deed of trust on the property.

Date: ____________, 20____

Address: ____________

Phone: ____________

Fax: ____________

Email: ____________

Trustee: ____________

By: ____________

Title: ____________

A notary public or other officer completing this certificate verifies only the identity of the individual who signed the document to which this certificate is attached, and not the truthfulness, accuracy, or validity of that document.

STATE OF CALIFORNIA

COUNTY OF ____________

On ____________ before me, ____________ (Name and title of officer)

personally appeared ____________, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

(This area for official notarial seal)

Signature: ____________ (Signature of notary public)

FORM 474 12-14 ©2016 RPI — Realty Publications, Inc., P.O. BOX 5707, RIVERSIDE, CA 92517

- the dollar amount of the debt in default, including reasonably estimated advances for hazard insurance premiums, property taxes due and foreclosure costs; and
- a statutory statement informing the owner they are in default.[29] [See Figure 3]

If the billing address of the defaulting owner is different from the mortgaged property's address, an additional notice needs to be posted on the property concurrent with the NOTS. The notice states in English and five other mandated languages that any tenant has the right to a 90-day notice to

29 CC §2924f

vacate the property. A copy of the tenant's rights is also to be mailed at the time of posting to the "Resident of property subject to foreclosure sale."[30] [See **RPI** Form 474-1]

Like the NOD, the NOTS needs to contain a summary of key information in the language the mortgage was originally negotiated in.[31] [See **RPI** Form 474-2]

The NOD and NOTS in Spanish

If the mortgage was negotiated in Spanish, the mortgage may contain a request for a Spanish-language NOD. The trustee is then obligated to serve the owner an NOD in Spanish.[32]

Delivering the NOTS

At least **20 calendar days** before the trustee's sale, the trustee sends two copies of the NOTS to each party who previously received the NOD.[33]

As with the NOD, one copy of the NOTS is sent by registered or certified mail, while the other is sent by first-class mail.[34]

To ensure the sale at a public auction is properly advertised, the notice requirements for the NOTS are more comprehensive than the notice requirements for the NOD.

In addition to mailing the notice to all interested parties of record, the trustee performs all of the following at least 20 calendar days prior to the sale:

- **post a copy** of the NOTS in one public place in the city of the sale, or if the sale is not to be held in a city, the judicial district in which the property is to be sold;
- **post a copy** of the NOTS in a conspicuous place on the property to be sold; and
- **start publishing a copy** of the NOTS once a week for three consecutive calendar weeks in a newspaper of general circulation in the city where the property is located.[35]

The location of the sale

A trustee's sale is held in the county where the mortgaged real estate is located.[36]

If the property or properties being foreclosed are located in two or more counties, the trustee's sale may take place in any one of the counties.

30 CC §2924.8(a)
31 CC §2923.3
32 CC §2924c(b)(1)
33 CC §2924b(c)(3)
34 CC §2924b(b)(2), (e)
35 CC §2924f(b)(1)
36 CC §2924g(a)

For example, consider a trustee who is to conduct a foreclosure sale of two properties which secure the same debt by the same mortgage and are located in different counties. The trustee can sell both properties at one sale, in either county the trustee chooses.

Postponing the sale

A trustee's sale may be postponed by the trustee at any time prior to the completion of the foreclosure sale. The trustee's sale may be postponed on the instruction of the mortgage holder or by the trustee at their discretion.[37]

To postpone or reschedule a trustee's sale, the trustee gives a **notice of postponement** at the time and place stated in the NOTS for the sale by a public declaration of:

- the reason for the postponement; and
- the new date and time of the foreclosure sale. [See **RPI** Form 474-8]

The postponed trustee's sale is held at the same place originally stated in the recorded NOTS.[38]

When a trustee's sale is postponed for ten or more business days, the mortgage holder or trustee is to provide written notice to the owner within five business days following the postponement. This notice is to include the new sale date and time.[39]

Sold to the highest bidder

A trustee's sale is a **public auction** by private agreement where the property is sold to the highest bidder.[40]

Before the auction begins, the trustee may:

- demand all prospective bidders show evidence of their financial ability to pay as a precondition to recognizing their bids; and
- hold the prospective bidders' amounts to be bid.[41]

A bidder at auction can tender their bid amount in U.S. dollars in the form of:

- cash;
- a cashier's check drawn on a state or national bank;
- a check issued by a state or federal thrift, savings bank or credit union; or
- a cash equivalent designated by the trustee in the NOTS, such as a money order.[42]

Each bid made at a trustee's sale is an **irrevocable offer** to purchase the property. However, any subsequent higher bid cancels a prior bid.[43]

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37 CC §2924g(c)(1)
38 CC §2924g(d)
39 CC §2924(a)(5)
40 CC §2924h
41 CC §2924h(b)(1)
42 CC §2924h(b)(1)
43 CC §2924h(a)

The trustee's sale is considered final on the trustee's *acceptance* of the last and highest bid.[44]

Once the highest bid has been accepted by the trustee, the trustee may require the successful bidder to immediately deposit the full amount of the final bid with the trustee.[45]

If the successful bidder tenders payment by a check issued by a credit union or a thrift, the trustee can refrain from issuing the trustee's deed until the funds become available.[46]

Failure to deliver payment of a bid

If a successful bidder tenders payment by check and the funds are not available for withdrawal:

- the trustee's sale is automatically **rescinded**; and
- the trustee will send the successful bidder a *notice of rescission* for failure of consideration.[47]

To hold a new trustee's sale auction, the trustee sets a new trustee's sale date and records, serves and publishes a new NOTS. The new NOTS follows all the same statutory requirements as the original NOTS.

The successful bidder who fails to tender payment when demanded is liable to the trustee for all resulting damages, including:

- court costs;
- reasonable attorney fees; and
- the costs for recording and serving the new NOTS.[48]

Bids by the mortgage holder, a credit

The mortgage holder is frequently the only bidder at the trustee's sale. Thus, the mortgage holder automatically becomes the successful bidder.

The mortgage holder may bid without tendering funds up to an amount equal to the debt secured by the property being sold, plus trustee's fees and foreclosure expenses. This amount is called a **full credit bid**.[49]

If the mortgage holder is the successful bidder under a *full credit bid*, the trustee retains possession of the mortgage holder's note (or other evidence of the mortgaged debt) in exchange for the trustee's deed to the property.

The mortgage holder is not required to bid the full amount of the indebtedness to acquire the property at the trustee's sale. The mortgage holder can bid an amount below the full amount of the debt, called an **underbid**.

full credit bid
The maximum amount the foreclosing mortgage holder may bid at a trustee's sale without adding cash, equal to the debt secured by the property being sold, plus trustee's fees and foreclosure expenses.

44 CC §2924h(c)
45 CC §2924h(b)(2)
46 CC §2924h(c)
47 CC §2924h(c)
48 CC §2924h(d)
49 CC §2924h(b)(2)

Conveyance by a trustee's deed

bona fide purchaser (BFP)
A buyer who purchases a property for valuable consideration in good faith without notice or knowledge of pre-existing encumbrances or conditions affecting their right to full ownership.

On the completion of a trustee's sale, the trustee uses a **trustee's deed** to transfer title to the property on to the successful bidder at the auction.

When a buyer other than the mortgage holder purchases the property for value and without notice of title or trustee's sale defects, the buyer is considered a **bona fide purchaser (BFP).**

The *BFP's* interest in the property sold is *perfected* as of 8 a.m. on the date of the trustee's sale, if the trustee's deed conveying the property to the BFP is recorded:

- within **15 calendar days** after the date of the trustee's sale; or
- the **next business day** following the 15th day after the sale if the county recorder is closed on the 15th day.[50]

The title received by the third-party BFP is clear of any interest claimed by the owner, mortgage holders or tenants whose interests are junior to the foreclosed mortgage.[51]

However, upon completion of the trustee's sale, the new owner needs to honor an existing residential lease if it has a fixed-term. If the home is to be occupied as a principal residence, the new owner may serve the tenant with a *90-day eviction notice*.[52] [See **RPI** Form 573]

More importantly, title is taken clear of any *unrecorded prior interests* or **claims** in the property held by others not in possession of the real estate. However, to take clear title free of claims, the BFP needs to have no *constructive notice* or actual knowledge of any existing priority claims when acquiring title to the property at the trustee's sale.[53]

lis pendens
A notice recorded for the purpose of warning all persons that the title or right to possession of the described real property is in litigation.

A **lis pendens** recorded against the real estate prior to the trustee's sale places bidders on constructive notice of a lawsuit involving a claim to a right in title or to possession of the real estate. If the claim has priority to the foreclosed mortgage, the *lis pendens* destroys the BFP status of the successful bidder.

Surplus funds

Occasionally, the price paid for property by the successful bidder at a trustee's sale exceeds the amount of debt and costs due under the foreclosed mortgage. The excess amounts are called **surplus funds**. [See **RPI** Form 479]

surplus funds
The price paid for property by the successful bidder at a trustee's sale in excess of the amount of debt and costs due under the foreclosed trust deed.

The trustee has a duty to distribute the *surplus funds* to the junior mortgage holders and the owner(s).

The gross proceeds from the trustee's sale are distributed in the following order:

- to pay the costs and expenses of the trustee's sale, including trustee's fees or attorney fees;

50 CC §2924h(c)
51 **Hohn** v. **Riverside County Flood Control and Water Conservation District** (1964) 228 CA2d 605
52 CC §2924.8(a)(1)
53 CC §§1107, 1214

- to pay the indebtedness secured by the property in default, including advances made by the mortgage holder;
- to satisfy the outstanding balance of junior mortgage holders of the property, distributed in the order of their priority; and
- to the owner, the owner's successor-in-interest or the vested owner of record at the time of the trustee's sale.[54]

54 CC §2924k(a)

Chapter 37 Summary

A mortgage holder or carryback seller holding a note secured by a trust deed in default has two foreclosure methods available to enforce collection of the mortgage debt. These two foreclosure methods are a judicial foreclosure sale, also called a sheriff's sale, and a nonjudicial foreclosure sale, also called a trustee's sale. A trustee's sale is a public auction by private agreement where the property is sold to the highest bidder.

A mortgage has three parties:

- at least one trustor (the owner(s) of the mortgaged real estate);
- a trustee who need not be named; and
- at least one beneficiary (a lender, carryback seller, homeowners' association (HOA), bonded assessment or other mortgage holder).

The trustee holds no interest in the property and has no duty owed to anyone, until they voluntarily undertake to reconvey or foreclose on a declaration by the mortgage holder.

Before recording an Notice of Default (NOD) on a first lien mortgage securing a purchase-assist loan on a principal residence, a mortgage holder needs to conduct a pre-foreclosure workout with the homeowner.

To successfully complete a trustee's foreclosure sale under a power-of-sale provision, the trustee and mortgage holder need to adhere to the procedures detailed in the California foreclosure statutes for handling a trustee's sale.

When a mortgage is in default and the mortgage holder has chosen to foreclose, the mortgage holder hands a declaration of default and demand for sale to the trustee.

When ordering a trustee's sale guarantee from a title insurance company, the trustee instructs the title company to record the NOD in the office of the county recorder in the county where the real estate is located.

A trustee's sale may be postponed by the trustee at any time prior to the completion of the foreclosure sale. The trustee's sale may be postponed on the instruction of the mortgage holder or by the trustee at their discretion.

The mortgage holder is frequently the only bidder at the trustee's sale. Thus, the mortgage holder automatically becomes the successful bidder.

On the completion of a trustee's sale, the trustee uses a trustee's deed to transfer title to the property on to the successful bidder at the auction.

Occasionally, the price paid for property by the successful bidder at a trustee's sale exceeds the amount of debt and costs due under the foreclosed mortgage. The trustee has a duty to distribute the surplus funds to the junior mortgage holders and the owner(s).

Chapter 37 Key Terms

Chapter 38

Judicial foreclosure

Learning Objectives

After you read this chapter, you will be able to :

- distinguish foreclosure proceedings as either judicial or nonjudicial;
- discuss the judicial foreclosure process;
- advise an owner of their right to reinstate a mortgage in default or redeem a property following a judicial foreclosure sale; and
- calculate any deficiency in value an owner may owe the holder of a recourse mortgage after the secured property is sold at a judicial foreclosure sale.

Key Terms

certificate of sale

fair value hearing

foreclosure decree

judicial foreclosure

lis pendens

litigation guarantee

money judgment (on foreclosure)

nonjudicial foreclosure

probate referee (on foreclosure)

recourse debt

Deficient property value and recourse debt

When a loan is in default, the mortgage holder's *collection efforts* are limited to judicial or nonjudicial activities, both of which are very structured. If the note evidences a **recourse debt**, the mortgage holder may recover against both the property and the owner as the named borrower, but only if a judicial foreclosure sale takes place.

recourse debt
A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

To initiate a collection effort, the mortgage holder needs to first *exhaust the security* by foreclosing on the security, i.e., the real estate. The mortgage holder's security interest in a property is exhausted when the mortgage holder completes a foreclosure sale on the property. Alternatively, the mortgage holder's security interest may have been wiped out — exhausted — by a senior trust deed holder's foreclosure sale. Thus, the note is now unsecured and the noteholder unable foreclose.

money judgment (on foreclosure)
An award for any unpaid balance remaining after a judicial foreclosure sale due to the secured property's insufficient fair market value (FMV) on the date of the sale to satisfy the debt owed, also called a deficiency.

Only when the note evidences a *recourse debt* may the mortgage holder pursue a **money judgment** against the property owner for any deficiency in the property's value to fully satisfy the debt. To obtain a *money judgment*, the holder of a recourse mortgage is limited to using the judicial foreclosure process, or if their security interest has otherwise been exhausted suing directly on the now unsecured recourse note.[1]

A mortgage holder may foreclose on a property and sell it to exhaust their security interest in one of two ways:

- **judicial foreclosure**, under mortgage law, also called a **sheriff's sale;**[2] or
- **nonjudicial foreclosure**, under the power-of-sale provision in the trust deed or other security device, also called a **trustee's sale**.[3]

Judicial foreclosure versus nonjudicial foreclosure

Judicial foreclosure is the court-ordered sale by public auction of the secured property. It can take eight months to multiple years to complete a judicial foreclosure.

Alternatively, when a mortgage holder *nonjudicially forecloses* by a trustee's sale, the property is sold as authorized by the trust deed provisions at a public auction, called a **trustee's sale**. *Trustee's sales* can be completed on property other than a one-to-four unit residential property within four months after a property owner defaults. On average, it takes approximately nine months to nonjudicially foreclose on a one-to-four unit residential property. [See Chapter 37]

nonjudicial foreclosure
When property is sold at a public auction by a trustee as authorized under the power-of-sale provision in a trust deed.

Unlike a judicial foreclosure sale, the completion of a trustee's sale bars the foreclosing mortgage holder from obtaining a money judgment for any unpaid balance remaining after the foreclosure sale due to *insufficient value* in the secured property.[4]

judicial foreclosure
The court-ordered sale by public auction of the mortgaged property. Also known as a sheriff's sale.

Trustee's sales are considerably less expensive and quicker than judicial foreclosures. Alternatively, a judicial sale requires the filing of a lawsuit, which includes:

- litigation expenses;
- appraisals; and
- attorney fees.

1 Calif. Code of Civil Procedure §726(b)
2 CCP §725a
3 Calif. Civil Code §2924
4 CCP §580d

However, when the value of a mortgaged property drops below the balance owed on a *recourse debt*, the mortgage holder may elect to foreclose by judicial action. A judicial foreclosure sale allows the holder of a recourse mortgage to obtain a money judgment against the property owner for any deficiency in the value of the mortgaged property at the time of the sale to fully satisfy the recourse debt.[5]

Suing to foreclose

The first step in the judicial foreclosure process is to file a complaint in the Superior Court of the county where the property is located.

The foreclosure complaint names as defendants the original borrowers named in the mortgage as the trustors. The complaint also names anyone else holding a recorded interest in the secured property junior to the foreclosing mortgage holder's security interest in the property.

The trustee named in the mortgage is not involved in the lawsuit and is not named. A trustee under a mortgage has no interest in the property.

The mortgage holder foreclosing judicially needs to obtain a **litigation guarantee** of title insurance. The *litigation guarantee* lists all parties with a recorded interest in the property and their addresses of record. The guarantee further ensures that persons with a recorded junior interest to the foreclosing mortgage holder in the property are named and served. Thus, when noticed, their junior interest is also eliminated from title by the judicial foreclosure sale.

litigation guarantee
A title insurance policy which lists all parties with a recorded interest in a property and their addresses of record, ensuring that all persons with a recorded interest in a property are named and served in litigation.

If a person holding an interest in the property junior to the mortgage holder's trust deed is not named as a defendant, their lien or ownership interest:

- is not affected by the outcome of the foreclosure proceedings; and
- remains of record.[6]

Additionally, when the foreclosing mortgage holder intends to seek a deficiency judgment, the original borrowers need to be named as defendants, whether or not they still hold an interest in the property.[7]

lis pendens
A notice recorded for the purpose of warning all persons that the title or right to possession of the described real property is in litigation.

At the time the lawsuit is filed, the foreclosing mortgage holder records a **notice of pending action** against title to the mortgaged property, also called a **lis pendens**.

The *lis pendens* places a cloud on the title of the secured property, giving notice of the judicial foreclosure action and subjecting later acquired interests to the results of the litigation.

The foreclosure decree ends reinstatement

Until the court enters a judgment ordering the sale of the secured property, called a **foreclosure decree**, the property owner has the right to bring the delinquencies current, called **reinstatement**. A *foreclosure decree* ends the *reinstatement period*. [See Chapter 39]

5 CCP §580d
6 CCP §726(c)
7 **Hutchison** v. **Barr** (1920) 183 C 182

foreclosure decree
Decree by a court ordering the sale of mortgaged property and the payment of the debt owing to the lender out of the proceeds.

A foreclosure decree orders the sale of the real estate to satisfy:

- the outstanding debt; and
- cover foreclosure-related expenses incurred by the mortgage holder.[8]

The foreclosure decree also states whether the property owner will be held personally liable for any deficiency in the property's **fair market value (FMV)** to satisfy the debt owed.[9] Importantly, FMV is never determined by the amount of the high bid at the judicial foreclosure sale.

The notice of levy

A judicial foreclosure sale is conducted by a court-appointed receiver or sheriff, called a **levying officer**.

After the court decree authorizing the judicial foreclosure sale, the foreclosing mortgage holder is issued a **writ of sale** by the court clerk. In turn, the *writ of sale* authorizes the receiver or sheriff to record a **notice of levy**. Both describe the property to be sold and state the levy is against the security interest the mortgage holder holds in title to the property under its mortgage lien.[10]

The levying officer **records** the writ of sale and the notice of levy in the county where the property is located. They also mail the writ of sale and the notice of levy to the owner and any occupant of the property.[11]

The notice of judicial sale

Similar to the notice of trustee's sale (NOTS) recorded in a nonjudicial foreclosure, the receiver's or sheriff's **notice of judicial sale** states the necessary details of the auction, such as the:

- date;
- time; and
- location of the sale.[12]

When a deficiency judgment is sought by the foreclosing mortgage holder, the notice of judicial sale also states:

- the property is being sold subject to the property owner's right of redemption; and
- the amount of the secured debt, plus accrued interest and foreclosure-related costs.[13]

If a money judgment for any deficiency is barred, as occurs with a *nonrecourse debt*, the receiver or sheriff waits at least 120 days after service of the notice of levy before proceeding to notice the judicial sale.[14]

8 CCP § 726(a), (b)
9 CCP §726(b)
10 CCP §712.010
11 CCP §700.010
12 CCP §701.540(a)
13 CCP §729.010(b)(1)
14 CCP §701.545

Before entry of a judicial foreclosure decree, a junior trust deed holder or other mortgage holder also have the right to ***reinstate*** *the note by paying the trust deed delinquencies and foreclosure costs, bringing the trust deed note current.*

After entry of a foreclosure decree ordering the property to be sold, the junior mortgage holder has until the time the property is sold to the highest bidder at the foreclosure sale to redeem the property by paying all amounts owed on the debt and foreclosure costs. [Calif. Civil Code §2903 et seq.]

Once a property is sold at a judicial foreclosure sale, any liens subordinate to the foreclosing mortgage holder's trust deed are wiped out and eliminated from the title. [Calif. Code of Civil Procedure §§701.630; 729.080(e)]

If the junior mortgage holder does not reinstate the note or purchase the property at the judicial foreclosure sale, and the owner later ***redeems the property****, the junior mortgage holder will then be able to recover the amount of their lien, plus interest. [CCP §729.060(b)(5)]*

A creditor holding an unrecorded lien not actually known to the foreclosing lender does not need to be named or notified of the judicial foreclosure action to have the unrecorded lien extinguished on completion of a recorded mortgage holder's judicial foreclosure sale. [CCP §726(c)]

If the junior mortgage holder of record is unnamed or unserved in a judicial foreclosure action by the senior trust deed holder, the junior trust deed holder still has an enforceable trust deed after completion of a senior trust deed lender's judicial foreclosure sale.

*If the senior mortgage holder is time barred from filing another judicial foreclosure action, a junior trust deed holder of record who was not given notice of the judicial foreclosure action may initiate their own judicial or trustee's foreclosure proceedings to enforce their trust deed. The junior trust deed holder's interest is now senior to the interest of the high bidder at the first mortgage holder's judicial foreclosure sale. [****Little*** *v.* ***Community Bank*** *(1991) 234 CA3d 355]*

Consider a wiped-out junior trust deed holder whose note evidences a ***recourse debt****. The junior mortgage holder whose security interest in the property has been exhausted by a foreclosure sale on a prior mortgage sues to collect the debt from the owner who executed the note. Accordingly, the junior mortgage holder obtains a money judgment on the note since their trust deed has been eliminated and they hold no security in the property to foreclose.*

With a money judgment replacing the now unsecured note, the junior mortgage holder records an ***abstract of judgment****. The recorded abstract of the money judgment:*

- *creates an involuntary lien on all properties vested in the name of the owner; and*
- *replaces the trust deed note but evidences a different debt (the money judgment) with different rights than the prior mortgage debt.*

*If the owner redeems the property after the judicial foreclosure sale, the junior trust deed holder has a lien on the property which they can foreclose if not paid. The junior mortgage holder can also proceed with a sheriff's sale to collect on the money judgment by a foreclosure on all properties attached by the recorded abstract. [****O'Neil*** *v.* ***General Security Corporation*** *(1992) 4 CA4th 587]*

The junior mortgage holder

However, if the mortgage holder seeks a deficiency judgment on a *recourse debt*, no waiting period applies before noticing the sale. The receiver or sheriff may notice the judicial sale immediately after the clerk of the court issues the writ of sale.[15]

At least 20 days before the sale, the notice of judicial sale is:

- served on the property owner personally or by mail;[16]

15 CCP §729.010(b)(2), (3)
16 CCP §701.540(c)

- mailed to any person who has recorded a request for a notice of judicial sale;[17]
- posted in a public place in the city or judicial district where the property is located, and on the property itself; and
- published once a week for three successive weeks in a local newspaper of general circulation.[18]

Loss mitigation efforts on a consumer mortgage

When a **consumer mortgage** is being foreclosed, the mortgage holder is required to comply with federal mortgage rules under any type of foreclosure proceeding. A property owner subject to foreclosure under a consumer mortgage has the right to submit a complete **loss mitigation application** to the mortgage holder prior to 37 days before a scheduled judicial or nonjudicial foreclosure sale. On receipt of the application, the mortgage holder can't move forward with the foreclosure sale until the following criteria are met:

- the loan servicer sends the property owner a notice informing them they are not eligible for loss mitigation; and
- the property owner either is not eligible to appeal, has not requested to appeal within the time period allowed, or their appeal has been denied; or
- the property owner rejects all loss mitigation possibilities the servicers offers; or
- the property owner did not perform under an agreement on a previously agreed to loss mitigation option.[19]

Highest bidder acquires the property

The public sale held by a court-appointed receiver or sheriff is conducted as an *auction*. The property is sold to the highest bidder.[20]

The foreclosing mortgage holder is entitled to make a credit bid up to the full amount of the debt owed to acquire the property at the foreclosure sale. Payment by a successful bidder other than the mortgage holder is made at the time of the public sale:

- in cash;
- by certified check; or
- by a credit transaction as long as the amount is over $5,000, in which case the greater of $5,000 or 10% of the amount bid is due at the time of sale, with the remaining balance plus applicable costs and interest due within ten days after the sale.[21]

If the successful bidder fails to pay the amount bid, the receiver may sell the property to the highest bidder at a subsequent sale. The defaulting bidder is liable for interest, costs and legal fees for their failure to pay their bid.[22]

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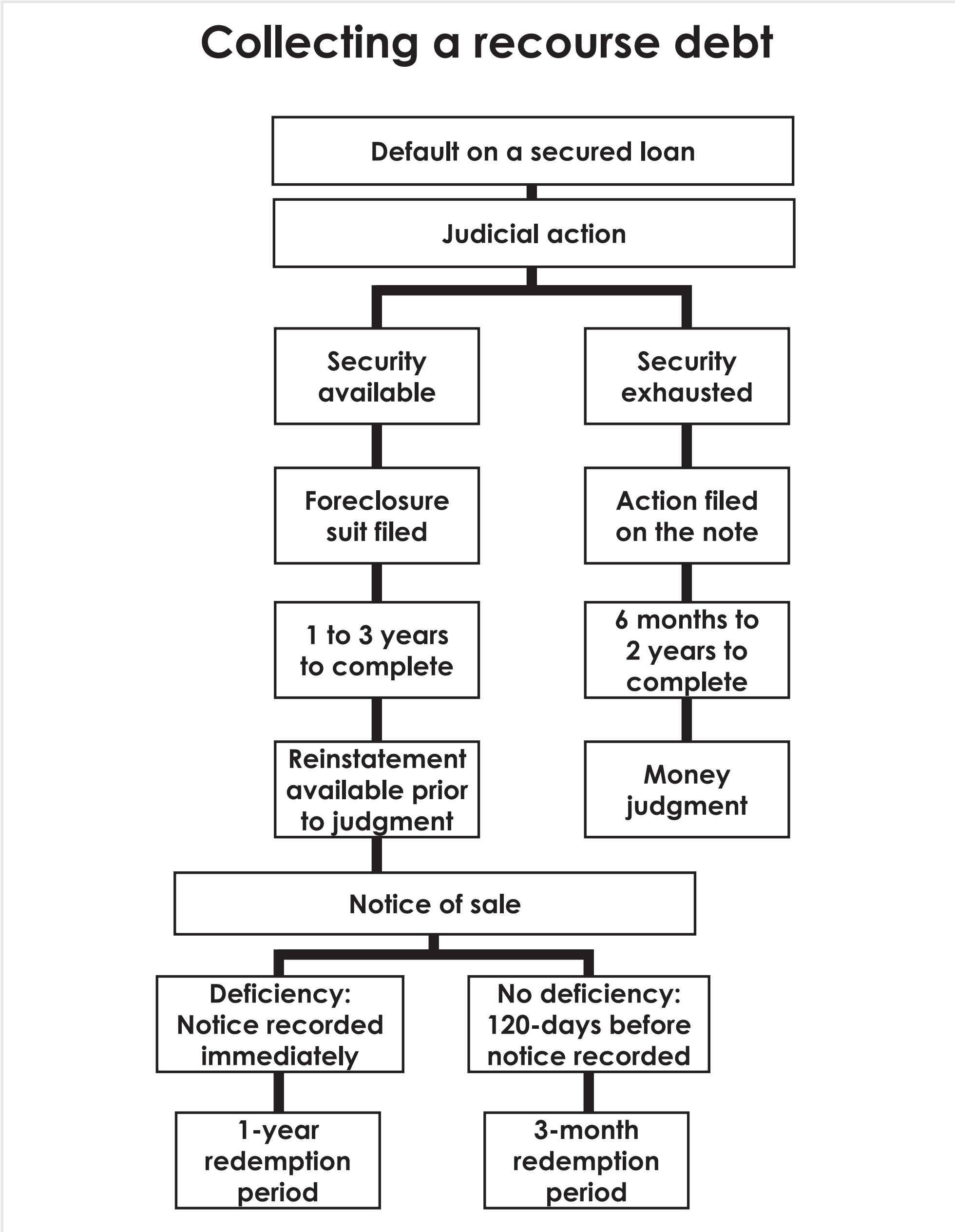
17 CCP §701.550(a)
18 CCP §701.540(g)
19 12 Code of Federal Regulations 1024.41(g)
20 CCP §701.570(b)
21 CCP §701.590(a), (c)
22 CCP §701.600

Collecting a recourse debt



The foreclosing mortgage holder is often the highest — or only — bidder at a judicial sale. When intending to seek a deficiency judgment, the mortgage holder needs to **bid no less** than an amount it believes the court will set as the *FMV* of the property. Any successful bids for less than the property's FMV on the date of the sale will generate an uncollectible loss on the mortgage holder. The loss from a **below market bid** is the spread between the high bid when the owner redeems and the greater FMV.[23]

23 **Luther Burbank Savings and Loan Association** v. **Community Construction, Inc.** (1998) 64 CA4th 652

Judicial sale completed

A **certificate of sale** is issued to the successful bidder on the completion of a judicial foreclosure sale.

Although the bidder purchased the property at the public auction, they will not become the owner of the property or be able to take possession of it until the applicable **redemption period** expires.[24] [See Chapter 39]

The *certificate of sale* reflects the owner's continuing right to redeem the property and avoid losing it to the highest bidder.[25]

The owner's redemption follows foreclosure

certificate of sale
A certificate issued to the successful bidder on the completion of a judicial sale of a property.

On a judicial foreclosure of a purchase-assist mortgage secured by a buyer-occupied one-to-four unit residential property, or a seller carryback note secured solely by the property sold no matter its use, the property owner:

- is not liable for any deficiency in the property value to fully satisfy the debt;[26] and
- has **three months** after the judicial sale to redeem the property by paying off the entire debt and costs.[27]

However, if the owner is liable on a recourse debt for a deficiency in the property's value, the owner has up to **one year** after the judicial sale to redeem the property.[28]

The property can only be redeemed by the owner or the owner's **successor-in-interest** since all junior mortgage holders are wiped out, leaving no remaining rights in the property.

Successors-in-interest to the owner include any person who acquires the owner's interest in the property by deed prior to the judicial foreclosure sale.[29]

The **redemption price** for the owner (or successor) to recover the property sold at a judicial foreclosure sale is the total of:

- the price paid for the property by the highest bidder at the judicial foreclosure sale (even if the amount is less than the property's FMV on that date);
- taxes, assessments, insurance premiums, upkeep, repair or improvements to the property paid by the successful bidder; and
- interest on the above amounts at the legal rate on money judgments (10%) from the date of the payments through the date the redemption amount is tendered in full.[30]

On redemption, the owner (or successor) is entitled to:

- an offset for any net rents collected by the mortgage holder under an *assignment of rents provision* in the mortgage; and

24 CCP §729.090
25 CCP §729.020
26 CCP §580b
27 CCP §729.030(a)
28 CCP §729.030(b)
29 CCP §729.020
30 CCP §729.060

- an offset for the rental value of the premises for any period of time the successful bidder occupied the property following the sale.[31]

If the owner or successor does not redeem the property within the redemption period, the sale is final and the high bidder is entitled to possession.[32]

Obtaining a deficiency judgment

The remaining balance owed on a mortgage may be greater than the *fair price* of the mortgage holder's security interest in the real estate. The spread when the fair price is lower than the balance due is the *deficiency* in the value of the property to cover the debt.

A money judgment for the deficiency in the property value to fully satisfy the debt is available if not barred by **anti-deficiency** statutes as a nonrecourse debt. The mortgage holder holding a recourse mortgage will be awarded a money judgment for any deficiency in value at a hearing following the foreclosure sale. At a **fair value hearing**, noticed within three months after the foreclosure sale, the amount of the deficiency is set by the court.[33]

fair value hearing
The court proceeding at which a money judgment is awarded for any deficiency in the secured property's fair market value (FMV) at the time of the judicial foreclosure sale to fully satisfy all debt obligations owed the mortgage holder.

The amount awarded as a deficiency judgment is based on the debt owed on the date of the judicial foreclosure sale, and the *greater* of:

- the FMV of the property on the date of the foreclosure sale, minus any amounts owed on liens senior to the mortgage being foreclosed, the result setting the *fair price* of the mortgage holder's security interest in the property; or
- the amount bid for the property at the judicial foreclosure sale.[34]

The mortgage holder is awarded a money judgment for the portion of the debt not covered by the fair price of the mortgage holder's secured position on title, or the price bid at the sale if it is higher.

The mortgage holder and property owner present evidence at the fair value hearing to establish the property's FMV on the date of the foreclosure sale. The court may appoint an appraiser, called a **probate referee**, to advise the court on the property's FMV.[35]

probate referee (on foreclosure)
An appraiser appointed by the court in a judicial foreclosure action to advise the court on a property's fair market value (FMV) on the date of the judicial foreclosure sale.

31 CCP §§729.060, 729.090
32 CCP §729.080
33 CCP §§580a, 726(b)
34 CCP §580a
35 CCP §§580a, 726(b)

Chapter 38 Summary

When a loan is in default, the mortgage holder's collection efforts are limited to judicial or non-judicial activities, both of which are very structured. If the note evidences a recourse debt, the mortgage holder may recover against both the property and the owner as the named borrower, but only if a judicial foreclosure sale takes place.

Trustee's sales are considerably less expensive and quicker than judicial foreclosures. Alternatively, a judicial sale requires the filing of a lawsuit, which includes:

- litigation expenses;
- appraisals; and
- attorney fees.

Similar to the notice of trustee's sale (NOTS) recorded in a nonjudicial foreclosure, the receiver's or sheriff's notice of judicial sale states the necessary details of the auction, such as the:

- date;
- time; and
- location of the sale.

When a consumer mortgage is being foreclosed, the mortgage holder is required to comply with federal mortgage rules under any type of foreclosure proceeding.

The foreclosing mortgage holder is often the highest — or only — bidder at a judicial sale. When intending to seek a deficiency judgment, the mortgage holder needs to bid no less than an amount it believes the court will set as the fair market value (FMV) of the property. Any successful bids for less than the property's FMV on the date of the sale will generate an uncollectible loss on the mortgage holder.

Although the bidder purchased the property at the public auction, they will not become the owner of the property or be able to take possession of it until the applicable redemption period expires.

The remaining balance owed on a mortgage may be greater than the fair price of the mortgage holder's security interest in the real estate. The spread when the fair price is lower than the balance due is the deficiency in the value of the property to cover the debt. A money judgment for the deficiency in the property value to fully satisfy the debt is available if not barred by anti-deficiency statutes as a nonrecourse debt.

Chapter 38 Key Terms

lis pendens .... **pg. 417**
litigation guarantee .... **pg. 417**
money judgment (on foreclosure) .... **pg. 416**
nonjudicial foreclosure .... **pg. 416**
probate referee (on foreclosure) .... **pg. 423**
recourse debt .... **pg. 416**

Notes:

Chapter 39

Reinstatement and redemption periods during foreclosure

Learning Objectives

After reading this chapter, you will be able to:

- identify the boilerplate acceleration and power-of-sale provisions in trust deeds;
- understand how a property owner or junior lienholder terminates foreclosure proceedings by reinstating or redeeming a mortgage;
- distinguish the timeframes an owner has to cure a default and reinstate a mortgage from periods for trustee's notices, postings and advertising periods;
- advise a client on their financial options when faced with a mortgage foreclosure; and
- recognize defaults curable only by redemption.

Key Terms

acceleration	**recourse debt**
future advances clause	**redemption**
nonrecourse debt	**reinstatement**
power-of-sale provision	

Nullifying the call

Trust deeds contain a boilerplate provision authorizing mortgage holders to call all amounts remaining unpaid due and payable on a material default of the mortgage, called an **acceleration clause**. In tandem, the trust deed **power-of-sale provision** authorizes the trustee to initiate a non-judicial foreclosure sale of the property on the mortgage holder's declaration of default and instructions to foreclose.

acceleration
A demand for immediate payment of all amounts remaining unpaid on a mortgage or extension of credit by a lender or carryback seller.

power-of-sale provision
A trust deed provision authorizing the trustee to initiate a non-judicial foreclosure sale of the described property on instructions from the beneficiary.

To exercise the *power-of-sale provision* and initiate the trustee's foreclosure procedures, the trustee records a *notice of default* (NOD) when so instructed by the mortgage holder. As triggered by the *acceleration clause* when an NOD is recorded, all sums remaining to be paid on the mortgage debt become due and immediately payable, subject to the owner's and junior lienholder's reinstatement rights to cure the default.

Consider a homeowner who defaults on a mortgage encumbering their property, which includes any default on the note or trust deed. To enforce collection of all sums owed, the mortgage holder hands instructions to the trustee authorizing the trustee to record an NOD to commence foreclosure proceedings.

An equity purchase (EP) investor's agent, aware of the NOD, submits an EP agreement offer to the homeowner. The homeowner accepts. The terms include the transfer of ownership to the EP investor, taking title subject to the existing mortgage debt now in foreclosure. The homeowner is to pay all delinquencies and foreclosure charges through escrow on closing using funds received on the price paid by the EP investor.

Escrow is opened after the five-day right to cancel the EP transaction has ended. Escrow sends a request for a *beneficiary statement* to the holder of the mortgage, called the **beneficiary**. The mortgage holder responds to escrow's request for a beneficiary statement by sending a **payoff demand**, not a beneficiary statement. The mortgage holder claims they are enforcing the acceleration clause in the trust deed and will only accept payment in full now that the trustee has recorded an NOD.

Itemization of delinquencies and charges

The NOD itemizes the amount of all delinquencies and related charges separately from the balance due. Thus, escrow is able to determine the amount due to cure the default. The trustee is contacted and the total of the foreclosure fees and charges incurred by the date scheduled for close of escrow are established.

On escrow's call for funds, the EP investor deposits closing funds with escrow. Escrow is closed, title is conveyed to the EP investor and the delinquencies and foreclosure costs sufficient to reinstate the mortgage debt are forwarded to the trustee, payable to the mortgage holder from funds accruing to the homeowner on closing.

reinstatement
A property owner or junior lienholder's right to reinstate a mortgage and cure any default prior to five business days before the trustee's sale by paying delinquent amounts due on the note and trust deed, plus foreclosure charges.

The mortgage holder rejects the sales proceeds, claiming the entire amount of their note is due as agreed in the trust deed provisions. Further, the mortgage holder now claims the **due-on clause** in the trust deed has been triggered by the buyer's failure to obtain the mortgage holder's consent to the sales transaction. Thus, the mortgage holder now further justifies a full payoff of the note based on a violation of the due-on clause.

Does escrow, on tendering only the amount of the delinquencies and foreclosure costs necessary to cure the default noted in the NOD, cause the mortgage debt to be reinstated as though a default had never occurred?

Yes! After an NOD is recorded and prior to five business days before the trustee's sale, the owner is able to terminate the foreclosure proceedings by paying:

- the *delinquent amounts* due on the mortgage debt as described in the NOD and foreclosure charges incurred by the trustee, called **reinstatement**;[1] or
- the *entire amount* due on the mortgage debt, plus foreclosure charges, called **redemption**.[2]

redemption
A property owner or junior lienholder's right to clear title to property of a mortgage lien prior to the completion of a trustee's sale or following a judicial foreclosure sale by paying all amounts due on the mortgage debt, including foreclosure charges.

In this instance, the call triggered by a violation of the due-on clause based on the unconsented-to transfer to the EP investor took place after the recording of the NOD. The default in payment due on the call under the due-on clause is not stated as a default in the NOD. Thus, the due-on call cannot be enforced under this NOD. Here, the mortgage holder needs to call the mortgage due when they do not intend to accept further monthly payments from the new owner, and if not paid in full, proceed anew to foreclose under a later recorded NOD.

Monetary defaults and reinstatement

A mortgage on which the trustee has recorded an NOD initiating foreclosure is *reinstated* when the mortgage holder receives:

- all amounts referenced as delinquent in the NOD, including principal, interest, taxes and insurance (collectively known as PITI), assessments and advances;
- installments that become due and remain unpaid after the recording of the NOD;
- any future advances made by the mortgage holder after the recording of the NOD to pay taxes, senior liens, assessments, insurance premiums and to eliminate any other impairment of the security; and
- costs and expenses incurred by the mortgage holder to enforce the trust deed, including statutorily limited trustees fee's (or attorney fees).[3]

After the NOD is recorded

After an NOD is recorded, an owner or junior lienholder may bring current any curable monetary default stated in the NOD prior to five business days before the trustee's sale, called the **reinstatement period**. When the sale is postponed, the *reinstatement period* is extended, ending the day before the fifth business day prior to the postponed sale date.[4] [See Figure 1]

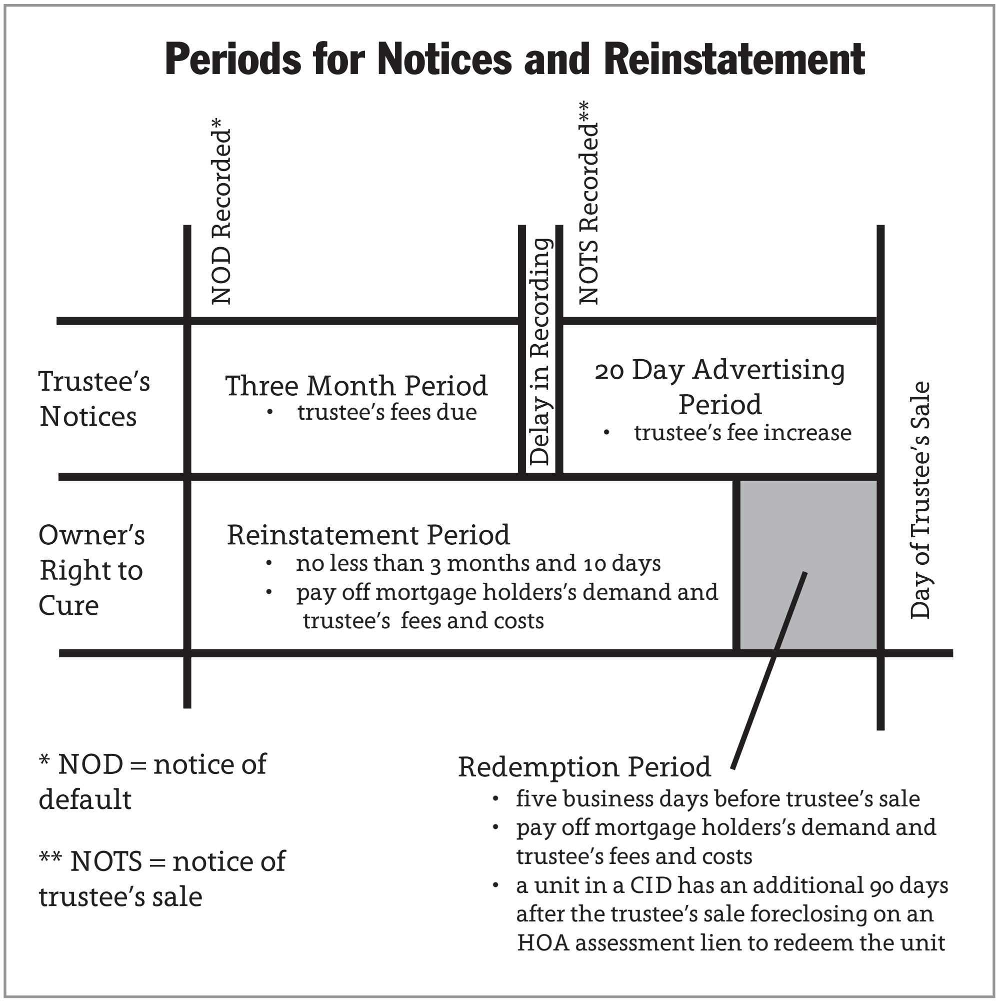
Until the trustee records an NOD, the mortgage holder is compelled to accept the tender of all delinquent amounts.

After recording the NOD, the trustee allows three months to pass before advertising and posting notice of the date of the trustee's sale.[5] [See Figure 1]

1 Calif. Civil Code §2924c
2 CC §2903
3 CC §2924c(a)(1)
4 CC §2924c(e)
5 CC §2924

Figure 1

Periods for Notice and Reinstatement



The trustee needs to begin advertising and post a **notice of trustee's sale (NOTS)** at least 20 days before the date of the sale. The trustee may sell the property no sooner than the twenty-first day after advertising begins and the posting of notice occurs.[6] [See Figure 1]

Additionally, when the billing address for the owner is different than the address of the *residential property* in foreclosure, a notice to the occupants needs to accompany the NOTS regarding their tenant rights during and after foreclosure.[7] [See **RPI** Form 573]

The owner in foreclosure is no longer allowed to delay the trustee's sale by requesting a postponement.[8]

Thus, the owner or junior lienholder has approximately 103 to 105 days after recording the NOD to cure the default and reinstate the mortgage debt. Doing so avoids a full payoff or foreclosure of the property.

6 CC §2924f(b)
7 CC §2924.8
8 CC §2924g

Reinstatement of the mortgage debt

To determine the last day for reinstatement of the mortgage debt, consider a trustee's sale scheduled for a Friday. Count back five business days beginning with the first business day prior to the scheduled Friday sale. Since weekends are not business days, the fifth day counting backward from the scheduled trustee's sale is the previous Friday (when no holidays exist).

Thus, the very last day to reinstate the mortgage is on Thursday, the day before the five business days and, in this example, eight calendar days before the trustee's sale.

The mortgage holder's failure to identify or include the dollar amount of all known defaults in the NOD does not invalidate the NOTS. Further, the mortgage holder may enforce payment of any omitted defaults by recording another, separate NOD.[9]

On reinstatement of the mortgage debt, the trustee rescinds the NOD, removing the recorded default from title to the property.[10]

Any call due to a default is eliminated when the mortgage debt is reinstated. Upon reinstatement, the owner continues their ownership of the property as though the mortgage had never been in default.

Redemption

An owner's failure to cure a default before the reinstatement period expires allows the mortgage holder to require the owner — who intends to retain ownership of the property — to *redeem* the property prior to completion of the trustee's sale by:

- paying all sums due on the mortgage debt; and
- reimbursing the costs of foreclosure.

The owner's right of redemption runs until the trustee completes the bidding and announces the property has been sold. Any owner, junior lienholder, or other person with an interest in the property (such as a tenant with a leasehold estate) may satisfy the debt and redeem the property prior to the completion of the trustee's sale.[11]

To redeem the property, the owner or junior lienholder is required to pay:

- the principal and all interest charges accrued on the principal;
- permissible penalties;
- foreclosure costs; and
- any future advances made by the foreclosing mortgage holder to protect its security interest in the property.

Unless all unpaid amounts due on the mortgage debt are paid in full during the redemption period, the owner loses ownership of the property at the trustee's foreclosure sale.

9 CC §2924
10 CC §2924c(a)(2)
11 CC §2903

The owner's alternatives

Aside from reinstatement and redemption, an owner of property has several other options when faced with losing their property through foreclosure. These options include:

1. ***Refinance** — The owner obtains a new mortgage to pay off the one in default.*
2. ***Foreclosure consultant** — The owner seeks the services of a financial advisor or investment counselor, called a foreclosure consultant. For a fee, a foreclosure consultant will:*
   - *prevent a mortgage holder from enforcing or accelerating the note;*
   - *help the owner reinstate the mortgage or receive an extension of the reinstatement period; or*
   - *arrange a mortgage or an advance of funds for the owner. [Calif. Civil Code §2945.1(a); see Chapter 35]*

   However, a property owner grappling with foreclosure may obtain similar services at no cost from a mortgage counselor subsidized by the federal government.
3. ***Deed-in-lieu** — The owner deeds the property directly to the mortgage holder in exchange for cancelling the secured debt.*
4. ***Litigate** — The owner disputes the validity of the foreclosure by filing an action, restraining and enjoining the foreclosure.*
5. ***Bankruptcy** — The owner files a petition in bankruptcy for protection. The petition automatically stays the foreclosure until the court orders a release of the stay on request from the mortgage holder. [11 United States Code §362(a)]*

   Unless the owner can make up the default or have the mortgage amount "crammed down" as part of any reorganization plan, bankruptcy only delays the inevitable foreclosure. Once the automatic stay is lifted, the foreclosure sale may take place no sooner than seven calendar days later. [CC §2924g(d)]
6. ***Sale** — The owner sells the property to a buyer before the trustee's sale. A recorded NOD states the owner has the right to sell their property while in foreclosure. [CC §2924c(b)]*

   *In an effort to protect homeowners from being unlawfully deprived of the equity in their residence, special requirements exist for purchase agreements between owners and **equity purchase investors** on owner-occupied, one-to-four unit residential property in foreclosure. [CC §1695 et seq.]*

   However, selling property in foreclosure is difficult for an owner. Time constraints imposed by reinstatement and redemption periods and the difficulty of locating a buyer-occupant or investor able to meet the financing needs to assume or pay off existing mortgages, cure defaults and correct the deferred maintenance on the property exacerbate any sales effort.
7. ***Walk away** — The owner on a default decides to vacate the property when the mortgage holder completes foreclosure, known as a strategic default.*

   A strategic default is an economically viable alternative for an owner with little or no equity remaining in the property. The strategy is particularly useful when payments saved during continued occupancy (nine months on average from default) exceed the value of the equity in the property, and specifically when the mortgage balance exceeds the property's value.

Mortgage holder remedies on a default

An owner's default on a mortgage encumbering their property may arise under a provision in either the note or trust deed.

A default on the note triggers a default on the trust deed, permitting foreclosure on the secured property. For example, when the owner fails to pay installments as they become due under the terms of the note, the owner is in default on the note. In turn, a default exists on the trust deed.

The owner's default prompts the mortgage holder to instruct the trustee to record an NOD. The recording of the NOD acts as an automatic call of all amounts due under the *acceleration clause* in the trust deed.

Additionally, when the owner fails to meet their obligations regarding the care, use and maintenance of the secured real estate, the owner is in default under the **waste provision** in the trust deed. The default on the trust deed exists even though the owner may be current on all payments called for in the note.

Other activities are considered a default on the trust deed, such as the owner's failure to pay:

- property taxes;
- hazard insurance premiums;
- assessments with priority; and
- amounts due on senior mortgages.

A mortgage holder may advance funds to cure a default on the trust deed or preserve the value of the property. The amount of the advance is added to the mortgage debt owed by authority of the trust deed's **future advances** provision. The mortgage holder may then demand the immediate repayment of the advance from the owner.

future advances clause
A trust deed provision authorizing a mortgage holder to advance funds for payment of conditions impairing the mortgage holder's security interest in the mortgaged property, such as delinquent property taxes, assessments, improvement bonds, mortgage insurance premiums or elimination of waste.

Anti-deficiency protections in California

All mortgage debt is categorized as either:

- *nonrecourse*; or
- *recourse*.

Nonrecourse debt is one of two types of mortgage debt:

- *purchase-money debt* of any priority (first, second or even third mortgages), which funds the purchase or construction of a homebuyer's one-to-four unit owner-occupied residence; or
- *seller-financed debt,* also called *installment* or *carryback paper,* on the sale of any type of real estate when the debt is secured solely by the property sold.[12]

nonrecourse debt
A debt recoverable on default solely through the value of the security interest in the secured property.

A mortgage holder of a *nonrecourse debt* may not pursue the homeowner personally to collect for a deficiency in the value of the secured property to fully pay off the nonrecourse debt following any type of foreclosure, judicial or nonjudicial.

12 Calif. Code of Civil Procedure §580b

However, the mortgage holder who underbids at the trustee's sale may pursue an owner for nonrecourse mortgage debt losses caused by the owner's **bad-faith waste** of the property, defined as reckless or malicious injury to the property, reducing its value.[13]

Additionally, while the mortgage holder may not pursue a homeowner for a deficiency in the value of the property to satisfy purchase-money paper, the *Federal Housing Administration (FHA)* or *U.S. Department of Veterans Affairs (VA)* have recourse against the homebuyer who signed an FHA or VA guarantee agreement. Practically speaking, the FHA and the VA rarely pursue collection on their indemnity rights; however they have the legal right to do so.[14]

Recourse mortgage debt collection

recourse debt
A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

Recourse debt is any mortgage debt not classified as nonrecourse debt. A mortgage holder may pursue an owner for a loss due to a deficiency in the value of the secured property on a recourse debt only through judicial foreclosure, and only if:

- the court-appraised value of the property at the time of the *judicial foreclosure sale* is less than the debt; and
- the bid is for less than the debt owed.[15]

Any mortgage securing a loan on other than a one-to-four unit buyer-occupied residential property is recourse debt. Thus, lender-funded mortgages secured by second homes, apartments (five or more units) or commercial properties are recourse debt.

Editor's note — A seller carryback mortgage debt is not included in any definition of a loan, as it is a credit sale. Carryback paper is nonrecourse debt regardless of the type of property securing the note when the debt is secured solely by the property sold.[16]

The appraisal and a consumer mortgage

A homeowner with a recourse mortgage is not necessarily destined to be hounded by the mortgage holder's debt collectors forever. One last, significant protection lies in the mortgage holder's choice of mortgage debt recovery.

In response to any owner's default, a mortgage holder must *first foreclose* on the property to satisfy the debt before attempting any other kind of collection effort, its bargain under the power of sale and put option in the trust deed.[17]

The mortgage holder's ability to seek a deficiency after foreclosure on a recourse debt depends upon their choice of foreclosure remedies:

- *judicial foreclosure*; or
- *nonjudicial foreclosure*.

13 **Cornelison** v. **Kornbluth** (1975) 15 CA3d 590
14 **Carter** v. **Derwinski** (9th Cir. 1993) 987 F2d 611
15 CCP §580a
16 CCP §580b
17 CCP §726(a); **Walker** v. **Community Bank** (1974) 10 C3d 729

A mortgage holder may only obtain a money judgment for a deficiency (and associated attorney and filing costs) when it completes a judicial foreclosure, and only if:

- the mortgage is recourse paper; and
- the property value is less than the amount of the mortgage at the time of the judicial foreclosure sale.[18]

Judicial foreclosures are lengthy and expensive procedures for mortgage holders. They also risk further decline in a property's value during the period of litigation plus the one-year redemption period after the foreclosure sale. Further, they may be unable to recover on a separate money award for the deficiency against the owner.

When a mortgage holder chooses instead to foreclose nonjudicially via a trustee's sale (and in California, most do so, suing only on any guarantee of the note they may hold), it loses its right to pursue any loss on the note. Mortgage holders trade the right to complete a judicial foreclosure for a cheaper, faster trustee's sale. Additionally, an owner's right to redeem their property by payment of the debt in full is terminated on completion of the trustee's sale.[19]

Mortgage defaults and reinstatement

A property owner's ability to **reinstate** a mortgage by curing a default depends on the trust deed provision in default.

For example, an owner of real estate encumbered by a mortgage fails to pay property taxes. The mortgage holder records an NOD, specifying the delinquent property taxes as the owner's default under the trust deed.

Is the property owner able to reinstate the mortgage and retain the property by eliminating the default?

Yes! The default is monetary, entitling the owner to reinstate the mortgage by simply paying the delinquent property taxes, and the trustee's fees and charges incurred in the foreclosure proceeding. Monthly payments on the note, payment of insurance premiums and payments on senior encumbrances are also curable defaults allowing reinstatement of the mortgage debt.

Defaults cured only by redemption

Some mortgage defaults do not allow the debt to be reinstated. Reinstatement of the mortgage on those defaults is only available when agreed to by the mortgage holder. Defaults triggering a call and requiring redemption of the property by a payoff of the entire debt without the ability to reinstate the mortgage include:

- a breach of a due-on clause;
- a breach of a waste provision; or
- a violation of law provision in the use of the property.

18 CCP §580c, 580a
19 CCP §580d

Consider real estate encumbered by a trust deed with a waste provision requiring the owner to maintain their property in good condition and repair. The owner fails to maintain the property, and the roof needs replacement.

The mortgage holder becomes concerned as the owner's activities have decreased the value of the mortgage holder's security, called **impairment**. Due to the owner's failure to maintain the property in good condition, the mortgage holder calls the mortgage. On the owner's failure to fully pay the remaining debt, a trustee on instructions from the mortgage holder records an NOD against the property.

In this instance, the owner may not cure the default in the trust deed (waste provision) by tendering less than the entire remaining balance of the debt. Thus, the owner is unable to reinstate the mortgage. As a result, the entire foreclosure period becomes the redemption period.

To retain ownership of the property, the owner needs to *redeem* the property by tendering full payment of all sums due, including foreclosure costs, prior to completion of the trustee's sale.

Alternatively, the trust deed gives the mortgage holder the authority to cure the waste and add the costs incurred to the principal balance of the note under the future advances clause.

However, when waste by the owner is committed in *bad faith*, the foreclosing mortgage holder needs to consider an underbid at the trustee's sale. The underbid will be in an amount equal to the property's reduced fair market value attributable to the waste. With an underbid, the mortgage holder may sue the owner to recover the deficiency in the property's value below the amount due on the debt when the bad faith waste caused the deficiency.[20]

20 **Cornelison** v. **Kornbluth** (1975) 15 C3d 590

Chapter 39 Summary

Trust deeds contain a boilerplate provision authorizing mortgage holders to call all amounts remaining unpaid due and payable on a material default of the mortgage, called an acceleration clause. In tandem, the trust deed power-of-sale provision authorizes the trustee to initiate a non-judicial foreclosure sale of the property on the mortgage holder's declaration of default and instructions to foreclose.

To exercise the power-of-sale provision and initiate the trustee's foreclosure procedures, the trustee records a notice of default (NOD) when so instructed by the mortgage holder. As triggered by the acceleration clause when an NOD is recorded, all sums remaining to be paid on the mortgage debt become due and immediately payable, subject to the owner's and junior lienholder's reinstatement rights to cure the default.

After an NOD is recorded, an owner or junior lienholder may bring current any curable monetary default stated in the NOD prior to five business days before the trustee's sale, called the reinstatement period. When the sale is postponed, the reinstatement period is extended, ending the day before the fifth business day prior to the postponed sale date.

Some mortgage defaults do not allow the debt to be reinstated. Reinstatement of the mortgage on those defaults is only available when agreed to by the mortgage holder. Defaults triggering a call and requiring redemption of the property by a payoff of the entire debt without the ability to reinstate the mortgage include:

- a breach of a due-on clause;
- a breach of a waste provision; or
- a violation of law provision in the use of the property.

Chapter 39 Key Terms

Notes:

Chapter 40

Business and private lender mortgages

Learning Objectives

After reading this chapter, you will be able to:

- differentiate between the allowable activities of a mortgage loan broker (MLB) and a mortgage loan originator (MLO);
- understand the activity reporting imposed on private lenders; and
- identify the activities that trigger threshold reporting.

Key Terms

business mortgage
hard money mortgage
private lender
threshold broker

Consumer and business mortgages differentiated

Up until now, the mortgage rules discussed have mainly applied to **consumer mortgages**. A *consumer mortgage* is a loan secured by one-to-four unit residential property made primarily for funding a:

- personal;
- household; or
- family use.[1]

In contrast to consumer mortgages, **business mortgages** are made for other than personal, household or family use and are secured by any type of real estate including a one-to-four unit residential property. *Business mortgages* are not regulated by federal law with the exception of due-on clause enforcement.[2]

business mortgage
A debt incurred primarily for other than personal, family or household purposes, whether secured or unsecured.

1 12 Code of Federal Regulations §1026.2
2 12 United States Code §1701j-3(e)

Business mortgages and other non-consumer mortgage related investment transactions include arrangements such as:

- hard money or private lending of business mortgages;
- mortgage-backed loans (MBLs);
- carryback financing [See Chapter 42]; and
- trust deed investments [See Chapters 47-50].

These transactions are excluded from most consumer mortgage protection requirements. However, dealing in these transactions triggers separate rules for licensing and reporting.

Conduct dictates licensing

In California, individuals or entities who engage in any of the following mortgage transactions need to hold a Department of Real Estate (DRE) broker license:

- buying eight or more trust deed notes or land sales contracts during one calendar year with the intent to resell them;
- selling or exchanging eight or more trust deed notes or land sales contracts during one calendar year;
- selling, exchanging or arranging for others the sale or exchange of fractionalized interests in trust deed notes; or
- making eight or more mortgages secured by one-to-four unit residential real estate during one calendar year from their own funds.[3]

Separate from these licensing rules, any individual or entity who acts on behalf of a client needs to hold a DRE broker license, or be a licensed sales agent employed by a broker, when they:

- solicit borrowers or lenders to arrange mortgages, collect payments, or perform services for others in connection with a mortgage, including:
  - loans collaterally secured by existing mortgages;
  - mortgage modifications;
  - mortgage discounts;
  - pre-foreclosure workouts;
  - mortgages made by persons in transactions and volumes noted above; and
  - the resale of individual mortgages; or
- charge an advance fee in connection with promoting the sale, lease, exchange or mortgaging of real estate.[4]

Real estate brokers are not limited to only making and arranging mortgages or selling notes directly secured by real estate. Brokers may make or arrange loans evidenced by a note and a collateral loan agreement which secure the debt by an existing note and trust deed held by the borrower.

3 Calif. Business and Professions Code §10131.1

4 Bus & P C §§10131, 10131.2

A loan evidenced by a note in favor of the lender, collaterally secured by a trust deed note held by the borrower, called an **MBL**, is a loan *indirectly secured* by real estate. Distinguished from the ownership of a trust deed note, the repayment of an *MBL* note is secured by a trust deed note. It is the trust deed note, not the underlying real estate, that is repossessed on a default in the MBL note. [See Chapter 48]

No endorsements for MLBs

In contrast to a mortgage loan originator (MLO) who makes or arranges consumer mortgages secured by one-to-four unit residential real estate for a fee, a mortgage loan broker (MLB) deals in the arranging or making of business mortgages and real estate related investments. MLBs who only deal in non-consumer mortgage transactions are not subject to MLO endorsement requirements. [See Chapters 1 and 2]

However, an MLB who is not endorsed as an MLO is limited to making and arranging non-consumer mortgage transactions.

An *MLB* may:

- arrange a business mortgage, negotiating the terms of a mortgage between the borrower and the lender who funds the mortgage;
- originate a mortgage using their own funds; and
- operate as a **trust deed broker** employed to negotiate the sale or purchase of an existing trust deed note.

When originating a business mortgage, the MLB may also be employed by the lender to act as a **servicing agent** or **contract collection agent** on the mortgage.[5] [See Chapter 50]

Hard money lending

An MLB may make or arrange hard money loans without an MLO endorsement. **Hard money lenders**, also known as **private lenders**, are lenders who make short-term mortgages from their own funds, called a **hard money mortgage**. *Private lenders* are not institutional lenders.

hard money mortgage
Real estate mortgages made by private lenders.

private lender
An individual or non-government organization that lends money.

A *hard money mortgage*, commonly referred to as a **bridge loan**, is a short-term business-purpose mortgage secured by real estate that typically has a mortgage term of one year or less. These short-term mortgages generally have higher interest rates and upfront costs in the form of origination or discount points since they are not based on traditional credit guidelines which institutional lenders rely on to avoid high default rates.

Hard money mortgages are commonly used to fund real estate purchases by investors who rehabilitate property for resale, called **flipping**, when the property does not qualify for traditional financing.

Most hard money mortgages are evidenced by **straight notes.** A *straight note* does not call for the property owner to make periodic payments until the property is sold or refinanced on completion of the repairs. When due, all principal plus accrued interest is paid in one lump-sum payment. [See **RPI** Form 423]

5 Bus & P C §10233

Hard money lending provides ample opportunity for DRE licensees to use their license without obtaining an MLO consumer mortgage endorsement. Consider an MLB who enters into a **listing agreement** to arrange a mortgage for an owner of commercial real estate. [See **RPI** Form 104]

The MLB then solicits a **private lender** who agrees to fund the mortgage sought by the owner. The *private lender* receives a note and a trust deed lien on real estate as security for the owner's promise to pay. The private lender handles the collection of payments on the note.

Later, the private lender wants to sell the trust deed note and contacts the MLB. The MLB knows trust deed investors willing to purchase the lender's trust deed note. The MLB, now acting under their DRE license as a trust deed broker, negotiates the sale of the trust deed note. The originating lender receives cash and the trust deed investor is assigned the note and trust deed.

Further, the MLB enters into a **loan servicing agreement** with the investor to handle collection on the trust deed note for a fee. [See **RPI** Form 237]

The owner of the real estate securing the mortgage is notified of the assignment of the trust deed note to the new mortgage holder. The property owner is also advised to make future payments to the broker under the *loan servicing agreement*.[6]

Reports required

A consumer mortgage lender licensed as a broker with sufficient volume of mortgage activity becomes a **threshold broker** and files periodic **DRE mortgage business activity reports**.

threshold broker
A private lender in the business of making mortgages, or a mortgage broker who annually negotiates or services an aggregate dollar amount of mortgages above a statutory threshold.

DRE licensees are required to submit periodic reports about their *consumer mortgage* activity and financial condition to both the DRE and the **Nationwide Mortgage Licensing System (NMLS)**.[7]

These loan activity reports are:

- the **Mortgage Loan Activity Notification**, filed with the DRE [See RE 866];[8]
- the **Mortgage Loan Business Activity Report**, filed with the DRE [See RE 881];[9]
- the **Residential Mortgage Loan Report**, filed with the DRE [See RE 857];[10] and
- the **Mortgage Call Report**, filed with the *NMLS*.[11] [See Chapter 8]

6 Calif. Civil Code §2937(a): Calif. Commercial Code §9318(3)
7 Bus & P C §§10166.07-08; 12 USC §5104(e)
8 Bus & P C §10166.02
9 Bus & PC §10166.07
10 Calif. Health and Safety Code §§35815-35816
11 12 USC §5104(e)

The business activity report

The *Mortgage Loan Business Activity Report* is filed by brokers providing mortgage services:

- under their individual broker license, as a **sole proprietorship**; or
- under a **corporate broker license.**

The employing broker, not their sales agents or broker-associates, files this report. **Reporting brokers** provide data on their individual mortgage activity along with the mortgage activity of licensees in their employ.

The business activity report provides the DRE with data about mortgage activity, in two parts:

- **Part A** collects data about consumer mortgage activity;[12] and
- **Part B** collects data from threshold brokers and multi-lender brokers.[13]

Reporting brokers file this report online with the DRE within 90 days of the end of the broker's fiscal year.[14]

This filing is completed by:

- the individual DRE broker, when the broker is a **sole proprietorship**; and
- the designated officer when the broker is a **corporation**.

Part A reporting is triggered when a DRE broker, under their DRE license, *makes, arranges or services* one or more consumer mortgages for a fee.[15]

Part B reporting is required of:

- *threshold brokers* who deal in *private lender transactions*;[16] and
- brokers engaging in *multi-lender transactions* (fractionalized trust deed originations and sales).[17]

Threshold and multi-lender transactions include both consumer mortgages and **business mortgages**.

A *business mortgage* is a debt incurred for other than personal, family or household (consumer) purposes and secured by any type of real estate.[18]

Threshold brokers

DRE classifies private lenders in the business of making mortgages as *threshold brokers*. Also, a mortgage broker is a threshold broker when they perform one or more of the following services within any successive 12-month period:

- negotiate ten or more mortgages totaling more than $1,000,000 which are:
    - secured by real property while acting as an agent for others; or

12 Bus & P C §10166.07
13 Bus & P C §10232.2
14 Bus & P C §10166.07(a)
15 Bus & P C §10166.07(a)(1)
16 Bus & P C §10232.2(a)
17 Bus & P C §10238(k)(3)
18 12 USC §1701j-3(e)

  - sales or exchanges of land sales contracts or trust deed notes secured by real estate as an agent for others or as an owner of trust deed notes; or
- collect payments for mortgage holders totaling $250,000 or more.[19]

When a mortgage broker meets the threshold reporting requirements, they are required to submit notification to the DRE using the **Threshold Notification** form.[20] [See **RPI** Form 542 (RE 853)]

For threshold brokers who handle trust funds, the following reports are also required:

- a quarterly **Trust Fund Status Report** [See **RPI** Form 544 (RE 855)];
- a **Trust Fund Bank Account Reconciliation** [See **RPI** Form 544-1 (RE 856)];
- the **Mortgage Loan Business Activity Report** [See RE 881]; and
- an annual **Trust Fund Account Review Report** to be prepared by a certified public accountant (CPA).[21] [See **RPI** Form 548 and 548-1]

When a mortgage broker does NOT handle trust funds, they are required to send a quarterly and annual **Trust Fund Non-Accountability Report** to the DRE. [See **RPI** Form 543 (RE 854)]

Loan servicing exemptions

Consider a private investor who makes three or four mortgages a year to buyers who need funds to purchase real estate. In addition to providing the mortgages, the private investor also employs staff to service the mortgage.

Does the investor need to hold a DRE broker license?

No! The investor is neither making eight or more mortgages nor servicing more than ten mortgages during a calendar year. Thus, they are exempt from holding a DRE broker license.

However, when the private investor continues to make and service three or four mortgages a year for a few years, they will have a servicing portfolio of more than ten mortgages. As soon as they are collecting payments on more than ten mortgages during a calendar year, they are required to hold a DRE broker license.[22]

An individual is exempt from being licensed when performing mortgage servicing activities when they:

- collect payments on ten or fewer mortgages in any calendar year;
- collect payments totaling $40,000 or less on mortgages in any calendar year;
- are a corporation licensed as an escrow agent; or
- are an employee of a real estate broker who is the agent of:

19 Bus & P C §10232(a)
20 Bus & P C §10232
21 Bus & P C §10232.2(a); Calif. Department of Real Estate Regulations §2846.5
22 Bus & P C §10133.1(b)(1)

- a government entity;
- banks or lenders licensed to do business in any state;
- pension trustees;
- a public company; or
- any combination of the above.[23]

23 Bus & P C §10133.1(b)

Chapter 40 Summary

In contrast to consumer mortgages, business mortgages are not regulated by federal law with the exception of due-on clause enforcement. Business mortgages and other non-consumer mortgage related investment transactions are excluded from most consumer mortgage protection requirements. However, dealing in these transactions triggers separate rules for licensing and reporting.

Real estate brokers are not limited to only making and arranging mortgages or selling notes directly secured by real estate. Brokers may make or arrange loans evidenced by a note and a collateral loan agreement which secure the debt by an existing note and trust deed held by the borrower.

Mortgage loan brokers (MLBs) who only deal in non-consumer mortgage transactions are not subject to mortgage loan originator (MLO) endorsement requirements. However, an MLB who is not endorsed as an MLO is limited to making and arranging non-consumer mortgage transactions.

An MLB may make or arrange hard money loans without an MLO endorsement. Hard money lenders, also known as private lenders, are lenders who make short-term mortgages from their own funds, called a hard money mortgage. Hard money mortgages are commonly used to fund real estate purchases by investors who rehabilitate property for resale.

A consumer mortgage lender licensed as a broker with sufficient volume of mortgage activity becomes a threshold broker and files periodic Department of Real Estate (DRE) mortgage business activity reports.

DRE licensees are required to submit periodic reports about their consumer mortgage activity and financial condition to both the DRE and the Nationwide Mortgage Licensing System (NMLS).

DRE classifies private lenders in the business of making mortgages as threshold brokers. When a mortgage broker meets the threshold reporting requirements, they are required to submit notification to the DRE using the Threshold Notification form.

Chapter 40 Key Terms

Chapter 41

Activity guidelines for a mortgage broker

Learning Objectives

After reading this chapter, you will be able to:

- identify the mortgage arranging, origination and resale activities which require an individual to hold a Department of Real Estate (DRE) broker license; and
- recognize the parameters for fees and interest rates when originating mortgages when a broker is involved.

Key Terms

collateral assignment
hypothecation
mortgage-backed loan (MBL)
small mortgage
usury

Mortgage-backed loans

When acting as a **mortgage loan broker (MLB)** in expectation of a fee, a **Department of Real Estate (DRE)**-licensed broker, may:

- arrange a loan evidenced by a note and secured by a trust deed lien on real estate, a process called mortgage origination;
- negotiate the sale of a mortgage — an existing trust deed note or land sales contract;
- arrange a **mortgage-backed loan (MBL)** evidenced by a note executed in favor of the lender and secured by the assignment of an existing note and trust deed held by the borrower, a financing activity called **hypothecation**; and
- arrange the sale of an *MBL*.

mortgage-backed loan (MBL)
A loan secured by the assignment of an existing note and trust deed.

hypothecation
The pledging of something as security without the necessity of giving up possession to it.

Editor's note – A broker who arranges a consumer mortgage for a fee is also required to obtain a mortgage loan originator (MLO) endorsement from the DRE. [See Chapter 2]

collateral assignment
An agreement providing additional, cumulative and concurrent security for a debt, in the form of personal property, to secure the property owner's performance under the debt.

Consider a seller who holds a note and trust deed they carried back on an installment sale of property. The carryback seller wants to borrow money for a short term, but does not want to sell the carryback note to obtain the needed funds. To borrow money, the seller offers to **pledge** by **collateral assignment**, not an absolute assignment as in a sale, the note and trust deed as security for the loan. [See **RPI** Form 438]

They retain an MLB to locate a private money lender willing to make an MBL. The loan will be evidenced by a collateral note and secured by the seller's existing carryback trust deed note.

The MBL made by the lender is evidenced by a new note (together with a security agreement linking the MBL to the trust deed note). Here, repayment of the MBL is secured only by the seller's carryback trust deed note. A carryback trust deed note is personal property.

Thus, on a default in the lender's MBL, the lender repossesses and becomes the owner of the trust deed note, not the underlying real estate described as security for the hypothecated trust deed note the lender holds as security.

A *DRE*-licensed broker may arrange the sale of a mortgage or a note secured by a *hypothecated* trust deed note. Thus, a broker may arrange and sell notes that are:

- *directly secured by real estate* (a trust deed or land sales contract); or
- *indirectly secured by real estate* (collateral assignment of a trust deed note).[1]

Personal property items may also be pledged as security for a debt using a Uniform Commercial Code-1 (UCC-1) financing statement in addition to a trust deed note or collateral assignment of a trust deed.[2]

Trust deed dealers

A **trust deed dealer** is in the business of buying and selling trust deed notes, MBLs and land sales contracts for their own account, sometimes called **flipping paper**. Unlike a trust deed broker, a *trust deed dealer* acts solely as a principal.

A trust deed dealer buying and selling trust deed notes is required to hold a DRE broker license when they buy, sell or exchange **eight or more** trust deed notes during a calendar year without retaining a broker to negotiate the resale.[3]

Here, the broker license is required even though they do not act as an agent for anyone.

1 Calif. Business and Professions Code §10131(d),(e)
2 Calif. Commercial Code §9102(a)(34),(44)
3 Bus & P C §10131.1

Conversely, an individual is not a trust deed dealer and need not be a licensed DRE broker when they:

- resell trust deeds to the public through a DRE-licensed broker;[4] or
- hold the paper they buy as a long-term investment.[5]

Exceptions to licensing requirements

When an individual acts as an agent for another individual in a trust deed transaction, they are not required to hold a DRE broker license if they are:

- a **trustee** named on the trust deed; or
- an **attorney** rendering legal services for a client.

An individual acting as a corporate officer, limited liability company (LLC) member or general partner may also negotiate a mortgage or trust deed transaction on behalf of their corporation, LLC or limited partnership (LP) without possessing a DRE broker license. However, the unlicensed corporate officer, general partner or LLC member may not receive any fee or bonus beyond their normal salary for services performed since the services are part of their regular employment duties.[6]

Individuals and entities that are permitted to engage in mortgage activities without a DRE license include:

- lenders and trust companies regulated by the federal government;
- federal- or state-licensed securities brokers or securities dealers; and
- a person licensed as a finance or mortgage lender under the authority of that license.[7]

Violation of licensing requirement

A **non-exempt individual** acting as an MLB or MLO without the proper license or endorsement may be:

- fined up to $20,000;
- imprisoned for up to six months; or
- both.

A **non-exempt corporation** engaging in MLB or MLO activities without the proper license or endorsement is liable for a fine of up to $60,000.[8]

Regulations, required disclosures and forms

Consider a noteholder, such as a carryback seller, who needs cash to pay off an accumulation of personal debts. The noteholder enters into a listing agreement with a trust deed broker employing them to locate an investor to purchase the trust deed note.

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4 Bus & P C §10131.1(b)(1)(B)

5 Bus & P C §10131.1(b)(1)(A)

6 Bus & P C §10133(a); **Broffman** v. **Newman** (1989) 213 CA3d 252

7 Bus & P C §10133.1

8 Bus & P C §10139

The broker presents the trust deed investment opportunity to an investor with whom they have an established business relationship. The investor makes an offer to purchase the trust deed note.

In the interest of preserving their seasoned business relationship with the investor, the broker persuades the cash-hungry noteholder to heavily discount the trust deed note to give the investor an above-market yield. The broker feels they do not need to disclose their pre-existing business relationship with the investor to the seller of the trust deed note since no written agency exists between the broker and the investor.

After escrow closes, the noteholder learns of the broker's business relationship with the investor. The noteholder claims the broker breached their fiduciary duty to the noteholder by representing both participants to the transaction without disclosing the dual agency. For their failure to disclose the dual agency, the noteholder claims they are entitled to money losses due to the excessive discount, plus a full refund of the brokerage fee.

The broker claims the mere existence of a dual agency relationship in the transaction does not constitute a breach of their fiduciary duty to the noteholder.

Is the broker liable to the seller of the note for their money losses?

Yes! The broker has an agency duty to notify the noteholder of any facts that might dissuade them from selling the trust deed note on the terms agreed to, including a dual agency.[9]

Further, an undisclosed dual agent may not keep any fees earned on the transaction since they breached their agency duty to their client.[10]

A broker is required to disclose all facts material to the sale or purchase of a trust deed note at the birth of the transaction — in the listing agreement. [See **RPI** Form 112]

Listing agreement

A **listing agreement** is an employment contract entered into by a broker and a client. The broker's client is either:

- a borrower seeking a mortgage or an MBL; or
- a noteholder seeking to sell a note directly or collaterally secured by a trust deed.

Brokers, as a practice, do not often represent trust deed investors under written listing agreements to locate borrowers or paper for sale. However, listing agreements are used when the broker's client wants to:

- **obtain a mortgage** secured by their real estate or a loan collaterally secured by their existing trust deed note [See **RPI** Form 104]; or
- **sell an existing note** directly or collaterally secured by a trust deed. [See **RPI** Form 112]

9 Bus & P C §10176(d)

10 **L. Byron Culver & Assoc.** v. **Jaoudi Industrial & Trading Corp.** (1991) 1 CA4th 300

The *listing agreement* obligates the client to pay the broker an agreed-to fee when the broker performs under the terms of the agreement.

Broker handling of funds

Brokers are required to account for all prepaid costs, fees and purchase funds by placing the prepaid amounts into a DRE-monitored trust account.[11]

Further, a broker may only accept the investor's funds when they can apply the funds to the acquisition of a specific note.[12]

Alternatively, on written request from the individual depositing the funds, the broker may place the prepaid amounts into an interest-bearing account until the note is delivered or the agreed-to prepaid services are performed.[13]

After depositing the funds into a trust account, the broker may make withdrawals from the deposit. However, a withdrawal may only be made by the broker for costs actually incurred or agreed-to fees actually earned while arranging a mortgage or negotiating the sale of a note.[14] [See Chapter 49]

Small mortgage and small MBL limitations

Fees and costs for arranging or selling a **small mortgage** or MBL secured by a one-to-four unit residential property are limited.[15]

small mortgage
A first trust deed debt not exceeding $30,000 or a junior trust deed debt not exceeding $20,000.

Small mortgages and MBLs are debts not exceeding:

- $30,000 when secured directly or collaterally by a first trust deed; or
- $20,000 when secured directly or collaterally by a junior trust deed.[16]

Further, brokerage fees are limited on small mortgages and MBLs based on the priority of the trust deed. Fee limitations on a note secured directly or collaterally by real estate are:

- for a first trust deed:
  - 5% of the principal amount for a mortgage or MBL with a term of less than three years; or
  - 10% of the principal amount for a mortgage or MBL with a term of three years or longer; and
- for a junior trust deed:
  - 5% of the principal amount for a mortgage or MBL with a term of less than 2 years;
  - 10% of the principal amount for a mortgage or MBL with a term of two years, but less than three years; or
  - 15% of the principal amount for a mortgage or MBL with a term of 3 years or longer.[17]

11 Bus & P C §§10145(a);10146
12 Bus & P C §10231
13 Bus & P C §10145(d)
14 Bus & P C §10146
15 Bus & P C §10248.1
16 Bus & P C §§10240.1; 10245
17 Bus & P C §10242(b)

The total costs (excluding title and recording costs) for originating a small mortgage or MBL may not exceed the greater of:

- $390; or
- 5% of the principal amount, up to $700.[18]

Costs that are subject to the restriction include, but are not limited to:

- credit investigation fees;
- appraisal fees;
- escrow fees;
- title charges;
- notary services; and
- recording fees.[19]

An MLB may not charge the maximum allowable fees as a matter of course. The costs need to be actually and reasonably incurred by the MLB when making or arranging the mortgage.[20]

Restrictions on mortgage provisions

An MLB arranging a small mortgage or MBL cannot include the following provisions in the note:

- *balloon payments* — A small mortgage with a maturity of six years or less, secured by an owner-occupied, one- or two-unit residential property, is limited in the amount of any installment to twice the amount of the smallest installment. This payment schedule rule also applies to small loans (other than construction loans) with a maturity of three years or less, secured by one-to-four unit residential property.[21]
- *late payment charges* — Any amount of debt secured by a one-to-four unit residential property will provide a ten-day grace period in the note before a late charge is incurred. The late charge incurred may not exceed 10% of the installment due or $5, whichever is greater.[22]
- *prepayment penalties* — Any amount of debt secured by an owner-occupied single family residence (SFR) may not call for a prepayment penalty after the first seven years. The penalty amount is limited to six months' advance interest on annual prepayments over 20% of the unpaid balance.[23]

Editor's note — For consumer mortgages, a prepayment penalty provision may only be added to a qualified mortgage (QM) with a fixed- or step-rate of interest. Here, a prepayment penalty is limited in duration to the first three years of the mortgage term and in amount by percentage caps. Additionally, a lender offering a consumer mortgage with a prepayment penalty is required to also offer the borrower an alternative consumer mortgage without a prepayment penalty.[24]

18 Bus & P C §10242(a)
19 Bus & P C §10241(a)
20 **Pacific Plan of California** v. **Fox** (1978) 84 CA3d 215
21 Bus & P C §§10244; 10244.1
22 Bus & P C §10242.5
23 Bus & P C §§10242.6;10245; Calif. Civil Code §2954.9(b)
24 12 Code of Federal Regulations §1026.43(g)

Penalties for violation of small loan and small MBL restrictions

Any broker involved in a small mortgage or MBL origination or sale who demands excessive fees is required to return all fees earned on the transaction upon demand. The overcharged persons need to act to reclaim the broker's fee within two years of the note's due date. The same loss-of-fee penalty applies to an MLB who arranges a small mortgage or MBL with prohibited terms or provisions.[25]

An MLB who collects excessive fees or late charges is liable for three times the amount of the overcharge plus legal costs. A borrower needs to act to recover the trebled overcharge from the MLB within two years of the overcharge.[26]

Thus, a borrower who is charged excessive fees or late payment penalties by an MLB has two remedies available. However, the borrower may receive either three times the overcharge or a return of the fees paid the MLB — not both.[27]

Usury

When a mortgage is originated, the lender charges the borrower **interest** for their use of the funds throughout the term of the mortgage.

However, the amount of interest a non-exempt lender may charge is regulated by statute and the California Constitution. Collectively, these are referred to as **usury laws**.[28]

usury
A limit on the lender's interest rate yield on nonexempt real estate mortgages.

Today, the remaining goal of *usury laws* is the prevention of **loan-sharking** by non-exempt lenders. *Loan-sharking* involves charging interest at a higher rate than the ceiling rate established by the usury laws — a rate that is exorbitant. These non-exempt mortgages are categorized as usurious while the same rate charged by an exempt lender is not.[29]

Two basic classifications of loan transactions exist relating to interest rates lenders may charge on real estate mortgages:

- **brokered** real estate mortgages; and
- **restricted** or **non-brokered** real estate mortgages.

Brokered real estate mortgages are exempt from usury restrictions and fall into one of two categories:

- mortgages *made* by a DRE-licensed broker *acting as a principal* for their own account as the lender who funds the mortgage; or
- mortgages *arranged* with lenders by a DRE-licensed broker acting as an agent in the mortgage transaction for compensation.

Restricted mortgages are all mortgages made by lenders that are neither made nor arranged by a broker.

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25 Bus & P C §10248.2
26 Bus & P C §10246
27 Bus & P C §10248.2(b)
28 Calif. Constitution, Article XV; CC §§1916.1-1916.5
29 CC §1916.3(b)

The most common *restricted mortgage* involves private party lenders, unlicensed and unassisted by brokers, who make secured or unsecured mortgages and loans.

Mortgages and MBLs secured directly or collaterally by real estate and made or arranged by DRE-licensed brokers are exempt from California usury laws.[30]

A broker "arranges" a mortgage when they act for compensation as the agent of another. Compensation received by the MLB is typically a money fee based on a percentage of the original mortgage amount.

A mortgage arranged by a broker who does not receive a fee is exempt from usury restrictions when the borrower uses the mortgage proceeds in connection with a transaction for which the broker has received or will receive a fee.

For example, a buyer employs a broker to help them locate a property to purchase. The broker locates a property satisfactory to the buyer and, at the buyer's request, negotiates carryback financing. The carryback note has a five-year due date and a balloon payment provision.

When the note is due, the buyer is unable to make the balloon payment. The broker, for no compensation, negotiates a private money loan for the buyer, enabling the buyer to pay off the carryback note. The new note has an interest rate of 20%.

Here, the note rate is still exempt from usury restrictions since the broker arranged the loan in connection with a past transaction for which the broker received compensation.

Also, a loan made by a broker acting as a principal is exempt from usury restrictions. However, a loan made to an individual licensed as a broker by a lender who is not a licensed broker is subject to usury restrictions, unless another broker arranges the loan.

Arranging a mortgage or a loan requires a broker to act as an agent to another. A broker, as an individual borrower, may not act as an agent for themselves and thus does not "arrange" a usury-exempt loan when they are the borrower.[31]

Further, the sale of a trust deed note is not a loan, and thus the yield to the investor buying the paper is not subject to usury restrictions.

30 CC §1916.1

31 **Winnett** v. **Roberts** (1985) 179 CA3d 909 (Disclosure: the legal editor of this publication was the attorney of record for the borrower in this case.)

Chapter 41 Summary

When acting as a mortgage loan broker (MLB) in expectation of a fee, a Department of Real Estate (DRE)-licensed broker may:

- arrange a loan evidenced by a note and secured by a trust deed lien on real estate, a process called mortgage origination;
- negotiate the sale of a mortgage — an existing trust deed note or land sales contract;
- arrange a mortgage-backed loan (MBL) evidenced by a note executed in favor of the lender and secured by the assignment of an existing note and trust deed held by the borrower, a financing activity called hypothecation; and
- arrange the sale of an MBL.

A trust deed dealer is in the business of buying and selling trust deed notes, MBLs and land sales contracts for their own account, sometimes called flipping paper. Unlike a trust deed broker, a trust deed dealer acts solely as a principal.

A trust deed dealer buying and selling trust deed notes is required to hold a DRE broker license when they buy, sell or exchange eight or more trust deed notes during a calendar year without retaining a broker to negotiate the resale.

When an individual acts as an agent for another individual in a trust deed transaction, they are not required to hold a DRE broker license if they are:

- a trustee named on the trust deed; or
- an attorney rendering legal services for a client.

Further, individuals and entities that are permitted to engage in mortgage activities without a DRE license include:

- lenders and trust companies regulated by the federal government;
- federal- or state-licensed securities brokers or securities dealers; and
- a person licensed as a finance or mortgage lender under the authority of that license.

A listing agreement is used by a broker when their client wants to:

- obtain a mortgage secured by their real estate or a loan collaterally secured by their existing trust deed note; or
- sell an existing note directly or collaterally secured by a trust deed.

The listing agreement obligates the client to pay the broker an agreed-to fee when the broker performs under the terms of the agreement.

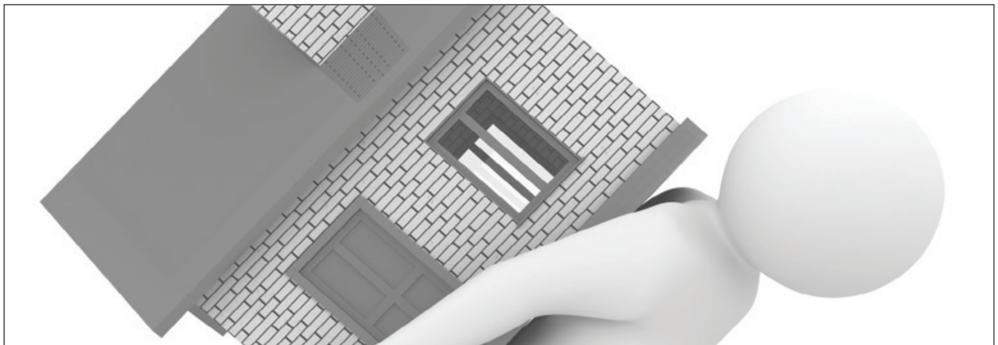
Brokers are required to account for all prepaid costs, fees and purchase funds by placing the prepaid amounts into a DRE-monitored trust account.

Fees and costs for arranging or selling a small mortgage or MBL secured by a one-to-four unit residential property are limited. Further, brokerage fees are limited on small mortgages and MBLs based on the priority of the trust deed. Any broker involved in a small mortgage or MBL origination or sale who demands excessive fees is required to return all fees earned on the transaction upon demand.

When a mortgage is originated, the lender charges the borrower interest for their use of the funds throughout the term of the mortgage. However, the amount of interest a non-exempt lender may charge is regulated by statute and the California Constitution. Collectively, these are referred to as usury laws.

Mortgages and MBLs secured directly or collaterally by real estate and made or arranged by DRE-licensed brokers are exempt from California usury laws. Also, a loan made by a broker acting as a principal is exempt from usury restrictions.

Chapter 41 Key Terms



Chapter 42

Carryback financing overview

Learning Objectives

After reading this chapter, you will be able to:

- comprehend the financial benefits afforded sellers and buyers who enter into seller carryback financing arrangements;
- identify the seller's financial risks involved in carryback financing;
- advise on the various forms of documentation used to structure seller carryback financing; and
- explain the tax advantages available to a seller for carrying back a portion of the sales price.

Key Terms

all-inclusive trust deed (AITD) note

carryback mortgage

impound account

nonrecourse debt

portfolio category income

private mortgage insurance (PMI)

Carryback financing supports the price

When mortgage money is plentiful and readily accessible, lenders are eager to make loans to nearly every buyer. This is the case no matter the type of property sought, its location or the buyer's creditworthiness.

However, when the availability of mortgages tightens, loan approvals become more elusive. Further, the definition of a "qualified buyer" becomes more restrictive. A seller hoping to locate a buyer amenable to the seller's asking price during a tight mortgage market needs to consider **carryback financing**.

carryback mortgage
A note and trust deed executed by a buyer of real estate in favor of the seller for the unpaid portion of the sales price on closing, also known as an installment sale, credit sale or seller financing.

Carryback financing is also known as:

- a carryback mortgage;

- an installment sale;
- a credit sale;
- seller financing; or
- an owner-will-carry (OWC) sale.

Carryback financing occurs when a seller carries back a note and trust deed executed by the buyer to evidence a debt owed for purchase of the seller's property. The amount of the debt is the remainder of the price due to the seller after deducting:

- the down payment; and
- the amount of any existing or new mortgage used by the buyer to pay part of the price.

Rights and obligations

On closing, the rights and obligations of real estate ownership held by the seller are shifted to the buyer. Concurrently, the seller carries back a mortgage, taking on the rights and obligations akin to that of a mortgage holder.

Editor's note — Before making, offering or negotiating consumer mortgages for compensation, California brokers and agents need to first obtain a mortgage loan originator (MLO) license endorsement on their Department of Real Estate (DRE) license.

However, a broker offering or negotiating a carryback consumer mortgage as part of a home sale to a buyer-occupant triggers the MLO license endorsement only if the broker or agent receives separate additional compensation for arranging the carryback, a fee beyond the fee collected for their role as seller's or buyer's agent in the real estate transaction.[1]

Marketing property: the seller will carry

The seller who offers a convenient and flexible financing package to prospective buyers makes their property **more marketable** and **defers the tax bite** on their profits.

Qualified buyers are willing to pay a higher price for real estate when attractive financing is available. This holds true regardless of whether financing is provided by the seller or a lender. For most buyers, the primary factors when considering their purchase of a property is:

- the amount of the down payment; and
- the monthly mortgage payments.

Seller's agents use these circumstances to inform their sellers about pricing arrangements in hyper-competitive buyer's markets.

Buyer willingness is especially apparent when the interest rate on the carryback mortgage is equal to or below the rates competitive lenders are charging on their purchase-assist loans. The lower the interest rate, the higher the price may be.

1 Calif. Business and Professions Code §10166.01(b)(1)

Flexible sales terms for the buyer

Carryback financing also provides tangible benefits for buyers. Typically, carryback financing offers a buyer:

- a moderate down payment;
- competitive interest rates;
- less stringent terms for qualification and documentation than imposed by traditional lenders; and
- no origination costs or lender processing hassle.

Lenders automatically require a minimum down payment of 20% if the buyer is to avoid **private mortgage insurance (PMI).** PMI adds about one percent in addition to the annual mortgage interest rate and reduces the maximum amount a homebuyer can borrow. Further, **Federal Housing Administration (FHA)**-insured mortgages include a **mortgage insurance premium (MIP)** regardless of the **loan-to-value ratio (LTV)**.

private mortgage insurance (PMI)
Default mortgage insurance coverage provided by private insurers for conventional loans with loan-to-value ratios (LTVs) higher than 80%.

In a carryback sale, the amount of the down payment is negotiable between the buyer and seller without the outside lender impediments a traditional mortgage broker and borrower have to contend with.

Additionally, a *price-to-interest rate tradeoff* often takes place in the carryback environment. The buyer typically negotiates a lower-than-market interest rate in exchange for agreeing to the seller's higher-than-market asking price.

Tax benefits and earnings for the seller

Taxwise, it is preferable for a seller to carry back a portion of the sales price, rather than be cashed out when taking a significant taxable profit.

The seller, with a reportable profit on a sale, is able to defer payment of a substantial portion of their profit taxes until the years in which principal is received from the buyer. When the seller avoids the entire profit tax bite in the year of the sale, the seller earns interest on the portion of the note principal that represents the tax not yet due and payable.

When the seller does not carry back a note payable in future years, they are cashed out. With no carryback, they pay significant profit taxes in the year of the sale (unless the profit is exempt or excluded from taxation, such as occurs in a §1031 transaction).

What funds the cashed-out seller has left after taxes are reinvested in some manner. These *after-tax sales proceeds* will be smaller in amount than the principal on the carryback note. Thus, the seller earns interest on the net proceeds of the carryback sale before they pay taxes on the profit allocated to the note's principal.

Tax on the interest the seller receives on their carryback mortgage is classified as **portfolio category income**. This is the case even when the property sold was in another income category (passive/business/personal).

portfolio category income
Unearned income from interest on investments in bonds, savings, income property, stocks and trust deed notes.

Proper documentation for carryback financing

On closing the sale, the carryback financing may be documented in a variety of ways. Common carryback financing arrangements include:

- land sales contracts;
- lease-option sales;
- sale-leasebacks; and
- trust deed notes, standard and all-inclusive.

Legally, the **note and trust deed** provide the most certainty. Further, they are the most universally understood of the various documents used to structure carryback financing. In this arrangement, **carryback documentation** consists of:

- a *note* executed by the buyer in favor of the seller as evidence of the portion of the price remaining to be paid for the real estate before the seller is *cashed out* [See **RPI** Form 421]; and
- a *trust deed lien* on the property sold to secure the debt owed by the buyer as evidenced by the note. [See **RPI** Form 450]

The note and trust deed are legally coupled. They are inseparable and function in tandem. The note provides evidence of the existence of the debt owed but is not filed with the County Recorder. The trust deed creates a *lien* on property as the source for repayment of the debt in the event of a default by the buyer. Together, they are referred to as a **mortgage**.

In addition, when the seller carries back a note executed by the buyer as part of the sales price for property containing one-to-four residential units, a **financial disclosure statement** needs to be prepared and handed to the buyer and seller. This statement is prepared by the broker who represents the person who first offers or counteroffers on terms calling for carryback financing.[2] [See **RPI** Form 300]

Regular and all-inclusive notes and trust deeds

The carryback note and trust deed may be structured in *regular* or *all-inclusive* terms to meet the financial needs of the buyer and seller.

For instance, when the real estate is encumbered by a mortgage which a qualified buyer may **assume** with the mortgage holder, the seller may carry back a regular note secured by a second trust deed. The note will be for the balance of the seller's equity which remains unpaid after deducting the buyer's down payment.

However, when the holder of the existing mortgage will not allow the buyer to assume the mortgage, the buyer needs to arrange a new mortgage to pay off the existing mortgage. Here, the lender of the new mortgage will need to approve of the seller carrying back a second mortgage.

Often, the seller's borrowing power is greater than the buyer's. Here, the seller may choose to refinance the existing mortgage on the property themselves and withdraw a portion of their equity by taking out a new mortgage on the property.

2 Calif. Civil Code §2956

With the property properly financed, the buyer assumes the new mortgage and the seller carries back a regular note and second trust deed for the remainder of their unpaid equity in the property.

The wraparound security device and debt relief

An alternative mortgage is available to reduce the seller's risk of loss and defer more profit taxes than a regular second carryback mortgage. This alternative is referred to as an **all-inclusive trust deed (AITD)**, also called a **wraparound mortgage** or **overriding note**.

In an *AITD* carryback arrangement, the amount owed to the seller on the carryback note is always secured by a junior trust deed (AITD) lien on the property.

However, the note secured by the AITD is for a dollar amount equal to the balance of the entire purchase price remaining unpaid after the down payment. A regular note is limited to the amount of equity remaining unpaid after the down payment.

Thus, the AITD *"wraps"* the senior mortgage by including the dollar amount of the first mortgage in the principal amount of the all-inclusive note. The buyer makes payments to the seller on the all-inclusive note.

In turn, the seller continues to remain responsible for making payments on the senior mortgage from payments received on the AITD.

all-inclusive trust deed (AITD) note
A note entered into by a buyer in favor of the seller to evidence the amount remaining due on the purchase price after deducting the down payment, an amount inclusive of any specified mortgage debts remaining of record with the seller retaining responsibility for their payment.

Carryback risks and responsibilities of the seller

A carryback seller assumes the **role of a lender** at the close of the sales escrow. This includes all the risks and obligations of a lender holding a secured position in real estate — a mortgage.

Being a mortgage holder is a fundamental real estate concept the seller's agent needs to understand when advising their seller on the nature and consequences of carrying a mortgage. Most sellers of homes are wage earners and are aware of debt obligations. However, few are aware of the management responsibilities of a person whose income is derived from the ownership of assets (the note).

Risks of loss

Above all, the seller's agent needs to confirm the seller appreciates why they are receiving a **trust deed** as a lien on the property sold. The secured property described in the trust deed serves as collateral. It is the seller's sole source of recovery to mitigate the **risk of loss** on a default by the buyer.

Another implicit risk of loss for any mortgage holder arises when a property's value declines due to deflationary future market conditions or the buyer committing **waste**. The risk of *waste*, also called **impairment of the security**, is generally overlooked during boom times due to rising property values.

However, a decline in property value during recessionary periods due to the buyer's lack of funds — the vicious part of the business cycle — poses serious consequences for the seller when the buyer defaults on the payment of taxes, insurance premiums or maintenance of the property.

Thus, costs incurred to foreclose and resell property may quickly turn a sale from a low-down payment, high-interest-rate note into a cash drain for the seller. This is a potential condition a seller's agent needs to advise their seller on, prior to the seller agreeing to carry back a mortgage.

Concerns about the buyer's default

On a default by the buyer, the carryback seller may find themselves returned to their original position — owning property they no longer want. Financially, they own it subject to a senior mortgage. In the end, the seller will incur out-of-pocket costs for:

- foreclosure;
- carrying the property (taxes, insurance, maintenance and senior mortgage payments);
- any reduction in property value;
- reassessment to current value triggered by both the sale and foreclosure;
- a modified (higher) interest rate on the senior mortgage (foreclosure also triggers the due-on clause); and
- profit taxes on any previously untaxed principal received from the down payment and in amortized monthly payments. [See **RPI** Form 303]

nonrecourse debt
A debt recoverable on default solely through the value of the security interest in the secured property.

Also, the seller needs to understand a carryback note secured solely by a trust deed lien on the property sold is a **nonrecourse debt**. Thus, the seller will be barred from obtaining a money judgment against the buyer for any part of the carryback mortgage not satisfied by the value of the property at the time of foreclosure — the unpaid and uncollectible deficiency.[3] [See Chapter 37]

However, as with any lender, when the **risk premium** built into the price, down payment, interest rate and due date on the carryback note is sufficient, the benefits of carryback financing equal or outweigh the risks of loss.

Taxes and premiums paid through the carryback seller

Consider the seller of a single family residence (SFR) who receives an offer from a buyer. Terms for payment of the purchase price include:

- a cash *down payment* of less than 20%;
- an *assumption* of the existing first mortgage (or new *purchase-assist financing*) of less than 80%; and
- a seller *carryback note* for the balance of the purchase price.

Here, the combined *LTV* of the first mortgage and the seller carryback note is more than 80% of the price paid for the property.

The seller's agent prepares and reviews a seller's **net sheet** with the seller. The seller observes the net proceeds of cash and the carryback note and their amounts. [See **RPI** Form 310]

3 Calif. Code of Civil Procedure §580b

The seller voices concern as to whether the net cash proceeds they will receive on closing will be adequate to cover out-of-pocket expenditures to foreclose if the buyer defaults on either the first or the seller's carryback mortgage. The agent prepares a foreclosure cost sheet itemizing and calculating the costs and net proceeds on a foreclosure and resale of the property and reviews it with the seller. [See **RPI** Form 303]

They determine the buyer is sufficiently creditworthy and financially capable to carry the costs of owning the property. However, any failure of the buyer to pay property taxes and insurance premiums (TI) will automatically **impair** the carryback seller's *security interest* in the property exposing the seller to some risk of loss.

When the seller pays any of these delinquencies — called a **future advance** — the amounts paid become part of the carryback mortgage principal, until reimbursed by the buyer.

To minimize the risk of the buyer defaulting, the seller wants to make a counteroffer calling for a larger down payment. In turn, that will provide more net sales proceeds (and a reduced amount of carryback note). However, the seller's agent is concerned the buyer will not agree to an increase in the down payment.

Impound account provision reduces risk

As an alternative, the seller's agent suggests the seller consider a counteroffer calling for the inclusion of an **impound account** provision in the carryback trust deed to reduce the risk of default. [See **RPI** Form 180]

impound account
A money reserve funded monthly by the property owner and maintained by the mortgage holder to pay annual recurring ownership obligations.

The *impound account* provision will call for the buyer to make monthly payments toward taxes and insurance in addition to regular principal and interest installments, commonly referred to as **PITI (principal, interest, taxes and insurance)**.

Will the seller be able to enforce an impound provision for taxes and insurance?

Yes! An impound account provision is enforceable in a consumer carryback mortgage when the combined principal of the first and carryback mortgages totals more than 80% of the property's appraised value.[4] [See Chapter 18]

An impound account provision in a mortgage on any real estate, whether mandated by law, demanded by the mortgage holder or a service requested by the property owner, calls for the property owner to make a monthly deposit with the mortgage holder to accumulate sufficient funds for the periodic payment of:

- property taxes; and
- hazard insurance premiums.[5]

4 CC §2954(a)(1)
5 CC §2954

Carryback consumer mortgage impounds

California law controls impound accounts for consumer mortgages carried back by sellers. Thus, carryback sellers need not pay interest on impound accounts established in a carryback mortgage.[6]

Surplus funds accumulated in the impound account by a carryback seller are to be refunded within 30 days of the surplus being incurred, unless the owner and the mortgage holder have agreed to apply the funds elsewhere.[7]

For example, an owner may agree in the impound account provision to either:

- credit surplus funds in the impound account toward mortgage principal; or
- retain the surplus in the impound account to cover any future deficiencies. [See **RPI** Form 455 §4]

However, a written agreement governing the use of *surplus impounded funds* (other than an immediate refund) can be rescinded by either the property owner or mortgage holder at any time.[8]

Statements and accounting for carryback consumer impounds

A seller carrying back a mortgage on one-to-four unit residential property with an impound account provision provides the buyer with an annual impound accounting within **60 days** after the end of the calendar year.[9]

The carryback seller's annual impound accounting itemizes:

- the amount received and applied to principal and interest;
- money received and disbursed from the impound account for TI obligations; and
- any late charges.[10]

A buyer of property on an impounded carryback sale is entitled to the annual impound accounting statement without charge or prior request.[11]

Impounds on AITDs

Consider a seller who will remain responsible for making payments on an underlying mortgage by carrying back an *AITD*.

The AITD will give the carryback seller additional protection against the buyer defaulting on payments on the first mortgage and the seller not learning of the default for several months.

The existing underlying mortgage contains an impound account provision for TI. The seller will continue to pay the monthly impound amount in addition to regular installments of principal and interest.

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6 CC §2954.9(b)
7 CC §2954.1(b)
8 CC §2954.1(b)
9 CC §2954.2
10 CC §2954.2(a)
11 CC §2954.2(a)

Here, the seller needs to establish an impound account payment on the AITD to collect and pass on TI payments to be made by the buyer.

Now consider a carryback seller on any type of real estate made for any purpose whose trust deed contains an impound account provision. The seller receives monthly PITI payments.

Is the seller required to maintain a separate bank account for the impounded funds?

No! Unlike trust funds, a carryback seller or lender may **commingle** the owner's impounds with its **general funds** and retain all the benefits from these funds.

However, the impounded funds have to remain in the state of California. If invested, the funds are only permitted to be invested with individual residents of the state or entities doing business in the state.[12]

On carryback transactions with no present transfer of legal title — called **land sales contracts** — the seller is required to hold the impounded funds in a **trust account**. The trust funds are only permitted to be disbursed for property taxes and insurance premiums unless the buyer and all lienholders of record agree otherwise.[13]

12 CC §2955
13 CC §2985.4

Chapter 42 Summary

Carryback financing occurs when a seller carries back a note and trust deed executed by the buyer to evidence a debt owed for purchase of the seller's property. The amount of the debt is the remainder of the price due to the seller after deducting:

- the down payment; and
- the amount of any existing or new mortgage used by the buyer to pay part of the price.

The seller who offers a convenient and flexible financing package to prospective buyers makes their property more marketable and defers the tax bite on their profits.

Qualified buyers are willing to pay a higher price for real estate when attractive financing is available.

Typically, carryback financing offers a buyer:

- a moderate down payment;
- competitive interest rates;
- less stringent terms for qualification and documentation than imposed by traditional lenders; and
- no origination costs or lender processing hassle.

On closing the sale, the carryback financing may be documented in a variety of ways. Arrangements include:

- land sales contracts;
- lease-option sales;
- sale-leasebacks; and
- trust deed notes, standard and all-inclusive.

Legally, the note and trust deed provide by far the most certainty. Further, they are the most universally understood of the various documents used to structure seller financing.

A carryback seller assumes the role of a lender at the close of the sales escrow. This includes all the risks and obligations of a lender holding a secured position in real estate.

The secured property described in the trust deed serves as collateral. It is the seller's sole source of recovery to mitigate the risk of loss on a default by the buyer.

Another implicit risk of loss for any mortgage holder arises when a property's value declines due to deflationary future market conditions or the buyer committing waste.

As with any lender, when the risk premium built into the price, down payment, interest rate and due date on the carryback note is sufficient, the benefits of carryback financing equal or outweigh the risks of loss.

Any failure of the buyer to pay property taxes and insurance premiums (TI) will automatically impair the carryback seller's security interest in the property exposing the seller to some risk of loss. An impound account provision will call for the buyer to make monthly payments toward taxes and insurance in addition to regular principal and interest installments, commonly referred to as PITI (principal, interest, taxes and insurance).

A seller carrying back a mortgage on one-to-four unit residential property with an impound account provision provides the buyer with an annual impound accounting within 60 days after the end of the calendar year.

Chapter 42 Key Terms

Chapter 43

Note and trust deed assignments

Learning Objectives

After reading this chapter, you will be able to:

- determine the various methods to invest in trust deed notes;
- identify the due diligence investigation and documentation needed for the purchase of an existing trust deed note or make a mortgage-backed loan (MBL) for a noteholder; and
- apply how to dictate escrow instructions for an assignment on the sale or hypothecation of a trust deed note.

Key Terms

allonge

anti-deficiency

collateral assignment

hypothecation

mortgage-backed loan (MBL)

nonrecourse debt

purchase money paper

recourse debt

Investing in trust deed notes

Trust deed brokers may consider soliciting individuals who now invest their money in interest-bearing opportunities to consider trust deed note investments. With higher yields and low-risk conditions, individuals do invest directly in **trust deed notes**, sometimes called **paper**, rather than buy *mortgage-backed bonds (MBBs)*.

A **trust deed investor**, acting independent of Wall Street's *MBB* market, invests in *trust deed notes*. To invest in trust deed notes, they use a trust deed broker to assist them with:

- making a loan evidenced by a note in favor of the investor and secured by a trust deed lien on real estate, a process called origination;

hypothecation
The pledging of something as security without the necessity of giving up possession to it.

- buying an existing trust deed note, called an absolute assignment; or
- making a **mortgage-backed loan (MBL)** evidenced by a note in favor of the investor and secured by an existing note and trust deed held by the borrower, called **hypothecation**.

A trust deed as collateral for an MBL

A loan evidenced by a note in favor of the lender, **collaterally secured** by a trust deed note held by the borrower, called a *mortgage-backed loan (MBL)*, is a loan indirectly secured by real estate. Thus, an MBL, collateralized by a trust deed note and in tandem secured by real estate, is a mortgage-related transaction a trust deed broker may arrange for a fee.

mortgage-backed loan (MBL)
A loan secured by the assignment of an existing note and trust deed.

Distinguished from the ownership of a trust deed note, the repayment of an MBL note is secured by a trust deed note. It is the trust deed note, not the underlying real estate, that is repossessed on a default in the MBL note.

Here, the trust deed note secured by the real estate need not also be in default for the MBL note to be in default. On repossession of the *hypothecated* trust deed note due to a delinquency in an MBL note, the MLB noteholder becomes the owner of the trust deed note in full or partial satisfaction of the MBL they made.

For example, consider a seller who holds a note and trust deed they carried back on an installment sale of property. The carryback seller wants to borrow money for a short term, but does not want to sell the carryback note to obtain the needed funds. To borrow money, the seller offers to **pledge** by **collateral assignment**, not an absolute assignment as in a sale, the note and trust deed as security for the loan. [See **RPI** Form 438]

collateral assignment
An agreement providing additional, cumulative and concurrent security for a debt, in the form of personal property, to secure the property owner's performance under the debt.

The MBL made by the lender is evidence by a new note (together with a security agreement linking the MBL to the trust deed note). Repayment of the MBL is secured only by the seller's carryback trust deed note. Thus, on a default in the lender's MBL, the lender repossesses and becomes the owner of the trust deed note — not the underlying real estate described as security for the hypothecated trust deed note. [See Figure 1]

Stages of trust deed investment

Whether an investor purchases a trust deed note or makes a loan collateralized by a trust deed note, the investor and their trust deed broker need to consider the **due diligence investigation** a prudent trust deed investor needs to undertake to purchase or lend on an existing trust deed note.

The stages of this trust deed investment include:

- due diligence investigations;
- entry into a trust deed purchase agreement or agreement to hypothecate [See **RPI** Form 241];
- loan escrow instructions, funding and closing; and
- servicing, reconveyance and foreclosure.

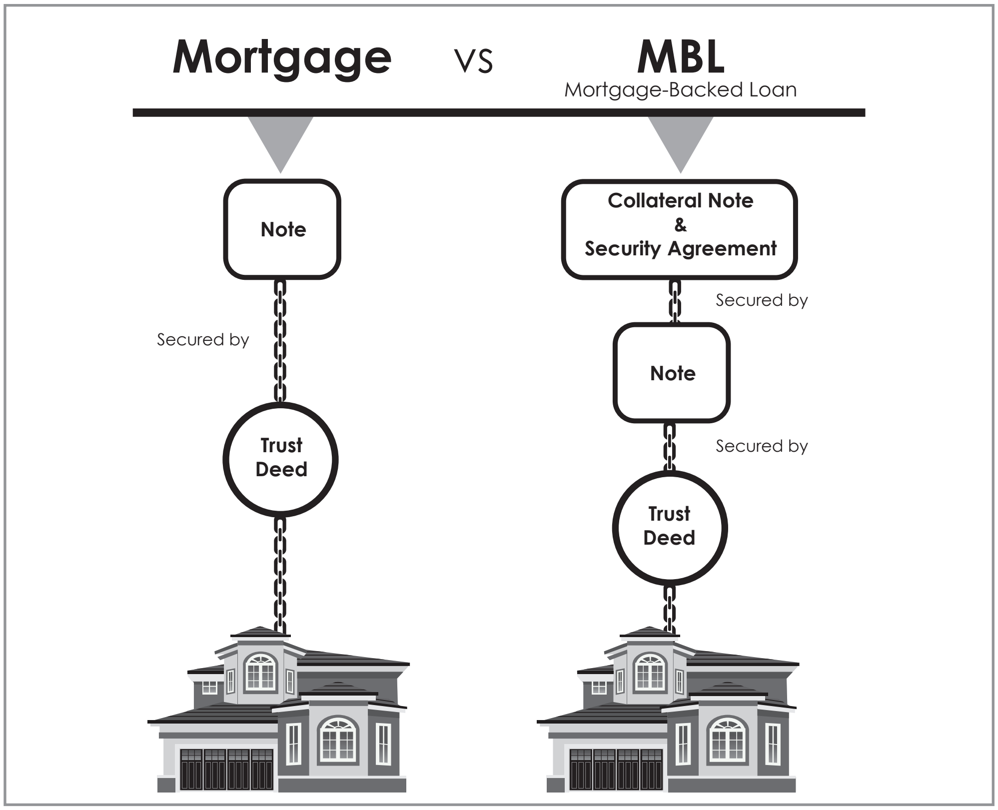

Figure 1

Mortgage vs. MBL

During the due diligence stage of a trust deed investment, the trust deed investor and their broker need to document and analyze the risks connected with:

- the payment history on the trust deed note purchased or collaterally assigned;
- the real estate (physical, title profile, income, location, value);
- the borrower's creditworthiness;
- the signatories to the note and trust deed; and
- title insurance for the assignment.

An investor's use of a trust deed broker retained under an employment agreement to assist with the due diligence process and analysis reduces the risks inherent in acquiring a trust deed note. Also, a trust deed broker typically has an inventory of trust deed note listings fully packaged under a **transmittal letter** for investors to consider. [See **RPI** Form 233]

The trust deed listing agreement

Trust deed noteholders, particularly carryback sellers, often decide to sell their trust deed notes. The task of *cashing out* a trust deed note investment requires a trust deed investor to be located who is interested in acquiring the note.

A trust deed broker employed to work diligently to locate an investor and negotiate a sale of a trust deed note for a fee needs to enter into a **trust deed**

listing agreement with the noteholder. The *listing agreement* spells out what the noteholder can expect the broker to do and provides the broker with a fee agreement. [See **RPI** Form 112]

The broker employed always has the general duty to disclose to both parties all facts and terms of the debt evidenced by the note and trust deed to be sold. The disclosures include information that may affect the willingness of the noteholder or the investor to enter into a transaction for the sale or hypothecation of the trust deed note, called **material facts**.[1]

The listing agreement calls for the noteholder's disclosure of all *material facts* regarding the trust deed note to be assigned. In turn, the broker is duty bound to disclose these facts to a prospective trust deed investor on commencement of negotiations — up front — to acquire or lend on the trust deed note.

The trust deed listing agreement discloses:

- the terms of the trust deed note, including:
    - the asking price for the trust deed note;
    - the annual yield on the asking price over the remaining life of the note;
    - the original amount, principal balance, payment terms and interest rate of the note;
    - any due-on-sale, late charge and prepayment penalty provisions in the note or trust deed; and
    - the priority of the trust deed on title to the described real estate;
- the information on the real estate securing the note;
- the amount and terms of all encumbrances on the real estate including property taxes, assessments, trust deeds and judgments; and
- any personal property included as additional security for the note. [See **RPI** Form 112]

The trust deed note as personal property

A *negotiable instrument*, such as a promissory note secured by a trust deed, contains an unconditional promise to pay a dollar amount as scheduled to the noteholder. A trust deed note, being a negotiable instrument, may be absolutely or collaterally assigned to others, such as a *trust deed investor*.

Buying a trust deed note, such as a carryback mortgage, can be a reliable and profitable investment for trust deed investors, also called **private money lenders** or **hard money lenders**. [See Chapter 40]

Comparable to a buyer of real estate entering into a purchase agreement with the *advice and assistance* of their **transaction agent (TA)**, the trust deed investor *buying* a carryback note does so with the advice and assistance of their trust deed broker. [See **RPI** Form 241]

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1 **Barry** v. **Raskov** (1991) 232 CA 3d 447

The investor's broker gathers information provided by the noteholder prior to preparing an offer to purchase a trust deed note. Relevant information to be collected and reviewed with the investor includes:

- the terms in the trust deed note;
- the existing title policy insuring the trust deed (the note is not insurable);
- the market value of the real estate securing the debt;
- a profile on the real estate that is security for the note; and
- data on the real estate's operating income and expenses when it is income-producing property.

Additional disclosures to be received and reviewed by the investor and their broker include:

- a **trustor's offset statement** from the owner of the secured property; and
- a **beneficiary statement** from each holder of trust deed notes encumbering the property. [See Chapter 46]

Prudent trust deed brokerage practice compels the investor's broker to *investigate and analyze* every document associated with the note and trust deed offered for sale.

If the mortgage being purchased is carryback paper, all the disclosures and agreements from the sale are also obtained from the seller and reviewed to determine both:

- the sufficiency of the property as security; and
- the quality of the note and trust deed.

Further, the investor and their trust deed broker review the hazard and title insurance policies which cover risks of loss and the conditions of title surrounding the trust deed. An appraisal of the property is also appropriate to ensure it functions as sufficient security, as though the investment were the origination of a mortgage.

The purchase agreement to acquire a trust deed note

At some point in the gathering and review of information on the trust deed note, property and title conditions, the broker prepares a **note and trust deed purchase agreement**. [See **RPI** Form 241]

The *note and trust deed purchase agreement* is used by the broker as a checklist of conditions when negotiating the purchase of an existing trust deed note held out for sale, to prepare the investor's offer to purchase the trust deed note. The purchase agreement states the price and terms the trust deed investor offers to purchase the trust deed note. [See **RPI** Form 241]

The note and trust deed purchase agreement contains provisions describing:

- the terms and identity of the note being purchased, such as the payment schedule and the existence of a final/balloon payment, due-on clause or prepayment penalty provision;

- any senior encumbrances of record;
- the real estate securing the debt, including its current fair market value (FMV), the type of property and whether it is owner-occupied;
- the terms of the purchase of the note, such as the purchase price;
- whether the note is to be transferred by way of an assignment or **endorsement**; and
- the brokerage fee to be paid and by whom. [See **RPI** Form 241]

Escrowing the note sale

An escrow holder is also agreed to for the assignment in the note and trust deed purchase agreement. [See **RPI** Form 241]

The trust deed note sale may be escrowed by:

- the broker involved;
- an escrow company;
- a title company; or
- an attorney.

Before preparing the escrow instructions, the person opening escrow provides the escrow officer with:

- the names of the parties to the transaction;
- the terms of the transaction;
- the trust deed involved; and
- the conditions to be met for the assignment/endorsement and funding to occur.

Further, to avoid confusion when dictating the instructions, the broker or the principals involved inform escrow of the:

- type of transaction;
- scheduled dates for the elimination of any contingencies; and
- final date for the close of escrow.

The escrow officer performs only as instructed, preparing the written instructions from oral dictation by the broker, or one or both principals involved. Some will accept a copy of the purchase agreement and figure out what they need to do to process the closing of the transaction.

Preferably, the person who dictates the instructions is the same person who collected the information the escrow officer used to prepare the instructions. They are then able to answer any question posed by the escrow officer related to the transaction.

When escrowing the transaction, the escrow officer has no obligation to notify the brokers or their principals of any suspicious fact or circumstance short of fraud detected before the close of escrow if it does not affect the closing instructions. Thus, the investor and their broker need to make sure their due diligence and investigations are completed prior to finalizing the transfer of the note and trust deed.[2]

The written escrow instructions are delivered to all persons involved in the transaction for their review, approval, and signatures. Typically, assignments and other customary documents that escrow prepares are included with the instructions to be signed by both principals.

Precision is essential

It is essential for the escrow instructions to be complete and precise. Any inconsistencies between the *note and trust deed purchase agreement* and the escrow instructions are superseded by the purchase agreement, unless the inconsistencies are stated in the instructions to be a modification.[3]

Any broker involved in the transaction is responsible for ensuring the escrow instructions, whether dictated by them or others, conform to the purchase agreement.

If the broker discovers any aspect of the escrow instructions conflict with the intentions expressed in the purchase agreement before closing, they are duty-bound to bring them to the attention of their client and the escrow holder.

On notification of an error, the close of escrow needs to be delayed by the escrow officer until the error is clarified or corrected by signed amended escrow instructions.[4]

Avoiding or assuming liability

The investor purchasing a trust deed note needs to be insured against financial loss arising out of defects in title to the secured property and from the invalidity or unenforceability of the trust deed. Thus, the investor may either:

- demand a new policy of title insurance; or
- simply accept an endorsement (an “assignee” or “104.1” endorsement) of the noteholder’s existing policy.

However, the disadvantage of obtaining an assignee endorsement is the policy provisions are not updated. An endorsed policy reflects the condition of title exactly as it was when the seller’s policy was written and does not include any junior liens that have since attached.

In addition, the investor needs to review a preliminary title report during escrow to assure the priority and title conditions of the trust deed.

Transfer of the note

On the close of escrow, the **note** is transferred from the noteholder to the investor in one of three ways:

- **assignment**;

2 **Lee** v. **Title Ins. and Trust Co.** (1968) 264 CA2d 160
3 **Karras** v. **Title Ins. and Guaranty Co.** (1953) 118 CA2d 659
4 **Diaz** v. **United California Bank** (1977) 71 CA3d 161

- **endorsement**; or
- **guarantee**.

The seller *assigns the trust deed* to the investor at the close of escrow. To assign the trust deed, the seller signs an assignment form prepared by escrow. [See **RPI** Form 445 and 446]

The completed and fully executed assignment form is forwarded by escrow to the title company insuring the trust deed. The assignment is recorded with the county recorder to give constructive notice of the assignment.

On the close of escrow, the investor receives the original note from escrow. The document assigning the trust deed (and note) is returned to the investor by the county recorder.

The sale and transfer of a trust deed note is comprised of two independent but interwoven activities:

nonrecourse debt
A debt recoverable on default solely through the value of the security interest in the secured property.

- the *assignment* or *endorsement of the promissory note*; and
- an *assignment of the trust deed.*

Editor's note — The promissory note is the primary document since it evidences the debt owed. The note on an assignment remains secured by the real estate even if the trust deed securing it is not assigned. Apart from the note, the trust deed has no value.[5]

The seller of a trust deed note avoids liability for any future default by the property owner when the transfer of the note is by an *absolute assignment of the note*, a **nonrecourse debt** situation.

recourse debt
A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

Conversely, a **recourse debt** situation occurs if the seller of a trust deed note is liable to the investor for their losses on the note when the note is transferred by:

- an endorsement of the note; or
- a guarantee of the note.

Absolute assignment

An assignment of a trust deed note to an investor divests the seller of the note of all proprietary interest in the note without guaranteeing the investor against future defaults or losses. The investor accepting a note transferred by assignment (with the trust deed) has fully *stepped into the shoes* of the seller.

purchase money paper
A nonrecourse note evidencing a debt for the purchase of a one-to-four unit residential property the buyer is going to occupy, or a seller carryback note and trust deed as an extension of credit to a buyer of any type of real estate which is secured solely by the property sold.

Consider a seller of real estate who carries back a note executed by the buyer and secured by a junior trust deed on the property sold.

An investor purchases the trust deed note by an assignment of the note and trust deed from the seller. Since the note is carryback paper secured only by the property sold, the note is **purchase-money paper.** Thus, the carryback

5 Calif. Civil Code §2936

note is subject to **anti-deficiency** rules barring recovery by way of a money judgment due to the debt against the maker of the note — the buyer of the real estate securing the note.[6]

anti-deficiency
A limitation placed on a mortgage lender's ability to recover losses on default when the secured property's value is insufficient to satisfy the mortgage debt.

Later, the senior mortgage holder forecloses on the property and wipes out the investor's junior trust deed, eliminating it from the title position which was the security for the carryback note.

The investor is now both unsecured and without *recourse* to collect on the note. The note was signed by the buyer of the real estate as part of the purchase price paid for the property.

Is the investor allowed to recover their losses from the seller who sold and assigned them the carryback note, since the investor is not able to recover from the maker of the note?

No! The seller, having assigned the note without a separate guarantee agreement, is not liable to the investor for any default on the note sold.[7]

The seller's absolute assignment of a promissory note occurs when:

- the seller signs the back of the note and add words such as *"endorsed without recourse"*;[8] or
- the note is transferred by the same form used for the assignment of the trust deed, with no notation of an assignment or endorsement on the note itself, the acceptable common method used by escrow to transfer notes and trust deeds unless advised to the contrary. [See **RPI** Form 445]

Endorsements

Now consider a seller who carries back a note and trust deed. The seller later sells the note and trust deed to an investor. To transfer the note to the investor, the seller endorses the note by placing their signature on the back of the note. Words of "*assignment*" or "*without recourse*" are not included with the endorsement.

The buyer of the real estate defaults on the note. Without first completing a foreclosure on the real estate under the trust deed, the investor makes a demand on the seller of the note to pay the full amount of the note.

The seller claims the investor needs to first foreclosure and sell the real estate before making a demand on the seller. However, the seller, as an endorser, is liable to the investor separate from any borrower liability on the note itself. The investor may recover from the endorser of the note without first foreclosing on the real estate which secured the note.[9]

In essence, the seller of the note by endorsement has agreed *to repurchase* the note on:

- a default in payments on the note; or

6 Calif. Code of Civil Procedure §580b(b)
7 Calif. Commercial Code §3415(b)
8 **Kinsel** v. **Ballou** (1907) 151 C 754
9 Kinsel, *supra*

- nonpayment on acceleration of the note based on a default in the trust deed.

Even if the note was purchased at a discount by the investor, the liability for repurchasing the note is for the full amount due on the note.

Signature without limitation

A note is endorsed whenever the holder who sells the note signs its back and delivers the note to the buyer. A signature alone, or a statement such as *"pay to the order of..."* accompanied by a signature, are effective as endorsements when placed on the back of a note — the note is transferred giving the buyer recourse to the seller of the note.

Now consider a seller of a trust deed note and a trust deed investor who orally agree to the terms for the sale of the note. Escrow is opened.

The escrow office is given no instructions on the type of transfer to be prepared. On closing, the escrow officer prepares an assignment of trust deed form. The seller signs both the:

- assignment of trust deed form, which states the note and trust deed are being assigned; and
- back of the note, as an endorsement with no words of "assignment" or "without recourse."

Later, the borrower defaults on the note, and the investor makes a demand on the seller of the note, as an endorser, to pay the full amount of the note. The carryback seller claims they are not liable to the investor since they assigned the note and trust deed and did not intend to establish any liability for the repurchase of the note.

However, when the seller of a note transfers the note by endorsement without words limiting the seller's signature on the note to an assignment of the note, the seller becomes personally liable to the investor, unless the seller can show the signature was not an endorsement.[10]

For example, consider the seller and investor who enter into an agreement for the sale of a note and trust deed. The purchase agreement for the note and trust deed states the note will be transferred to the buyer through escrow by way of an assignment.

On closing, the seller signs, upon escrow's request, both the:

- assignment of deed of trust form, assigning the note and trust deed; and
- back of the note.

Here, the seller's signature on the note is not enforceable as an endorsement. The seller can show the signature on the back of the note was not for the purpose of establishing recourse liability as an endorser of the note. The underlying purchase agreement for the note and trust deed states the seller is transferring the note by an assignment.[11]

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10 Com C §3204(a)(3)

11 Com C §3204(a)(3)

Endorser's liability

The seller of a note by endorsement is liable for the entire amount due on the note and trust deed.

The endorsements of the note need not be on the note itself. A note is also endorsed if a separate sheet of paper containing the signature and any words of endorsement is attached to the note, called an **allonge**.[12]

allonge
An attachment to a note occurring between preparation of the note and closing the transaction providing information necessary to update entries on the note at the time it becomes effective.

If the note has been transferred by endorsement several times, the present noteholder may recover only against their immediate endorser, unless prior endorsers have agreed otherwise. Endorsers may agree to endorse as joint payees, in which case both agree to be jointly liable to the noteholder.

Generally, endorsers are liable to one another in the same order in which they endorsed the note. This is presumed to be the order in which their signatures appear by endorsement on the note.[13]

Notice to borrower

Any change in the collection agent on transfer of a trust deed note secured by one-to-four residential units needs to be communicated to the borrower paying on the note. Thus, if the borrower continues to make payments to the seller of the trust deed note or their collection agent after the transfer, the borrower is not liable to the investor for payments made if they were made:

- on time, according to the payment schedule; and
- prior to receipt of the investor's transfer notice.[14]

NOD/NODq

The investor as beneficiary of the trust deed note will receive a **notice of default (NOD)** or **notice of delinquency (NODq)** from the senior mortgage holders if a request for each is recorded and served on the mortgage holders. [See **RPI** Form 412]

The noteholder's recorded right to receive an *NOD* and *NODq* is transferred to the investor on sale of the note. However, the investor needs to file renewals of each request to reflect the investor's name and address. The senior mortgage holder's charge for receiving each renewal request is $15.[15]

Any person who signs the back of the note without indicating the signature is for another purpose is considered an endorser, such as a broker who does not guarantee the note they sold for another, but assumes liability for repayment of the note by endorsing the note on its transfer.

12 Com C §3204(a)
13 Com C §3415(a)
14 CC §2937(f)
15 CC §2924e(b)

Chapter 43 Summary

With higher yields and low-risk conditions, individuals do invest directly in trust deed notes rather than buy mortgage-backed bonds (MBBs). A trust deed investor invests in a trust deed note by:

- making a loan evidenced by a note in favor of the investor and secured by a trust deed lien on real estate;
- buying an existing trust deed note; or
- making a mortgage-backed loan (MBL) evidenced by a note executed in favor of the investor and secured an existing note and trust deed held by the borrower.

A loan evidenced by a note in favor of the lender, collaterally secured by a trust deed note held by the borrower, called a MBL, is a loan indirectly secured by real estate. Distinguished from the ownership of a trust deed note, the repayment of an MBL note is secured by a trust deed note. It is the trust deed note, not the underlying real estate, that is repossessed on a default in the MBL note.

Whether an investor purchases a trust deed note or makes a loan collateralized by a trust deed note, the investor and their trust deed broker need to consider the due diligence investigation a prudent trust deed investor needs to undertake to purchase or lend on an existing trust deed note.

An investor's use of a trust deed broker retained under an employment agreement to assist with the due diligence process and analysis reduces the risks inherent in acquiring a trust deed note.

Trust deed noteholders, particularly carryback sellers, often decide to sell their trust deed note. A trust deed broker employed to work diligently to locate an investor and negotiate a sale of a trust deed note for a fee needs to enter into a trust deed listing agreement with the noteholder.

The broker employed always has the general duty to disclose to both parties all facts and terms of the debt evidenced by the note and trust deed to be sold. The disclosures include information that may affect the willingness of the noteholder or the investor to enter into a transaction for the sale or hypothecation of the trust deed note, called material facts.

The investor's broker gathers information provided by the noteholder prior to preparing an offer to purchase a trust deed note for review with the investor. After gathering and review of information on the trust deed note, property and title conditions, the broker prepares a note and trust deed purchase agreement. The purchase agreement states the price and terms the trust deed investor offers to purchase the trust deed note.

An escrow holder is also agreed to for the assignment in the note and trust deed purchase agreement.

When escrow is opened, it is essential for the escrow instructions to be complete and precise. Any inconsistencies between the note and trust deed purchase agreement and the escrow instructions are superseded by the purchase agreement, unless the inconsistencies are stated in the instructions to be a modification.

The investor purchasing a trust deed note needs to be insured against financial loss arising out of defects in title to the secured property and from the invalidity or unenforceability of the trust deed.

Chapter 43 Key Terms

Notes:

Chapter 44

Due diligence investigations into a trust deed note

Learning Objectives

After reading this chapter, you will be able to:

- describe the due diligence investigation to be conducted by a trust deed broker regarding the circumstances of a trust deed note available for purchase by a trust deed investor; and
- recognize the investor's and their broker's need to investigate and analyze conditions which affect the value of the trust deed note and the real estate securing the debt evidenced by the note.

Key Terms

beneficiary statement	**preliminary title report**
call	**promissory note**
due-on clause	**property profile**
holder in due course	**recast**
loan-to-value ratio (LTV)	**trustor's offset statement**

The history, terms and conditions of a note

A **promissory note** secured by a **trust deed**, together called a *mortgage*, contains an unconditional promise to pay the noteholder an agreed-to dollar amount as scheduled by the terms of the note. A trust deed note, being a **negotiable instrument**, may be sold and assigned to a buyer, called a *trust deed investor*.

promissory note
A document given as evidence of a debt owed by one person to another.

For a trust deed investor to *enforce collection* of principal and interest payments called for in a trust deed note they are acquiring, they need to qualify as a **holder in due course** on its assignment. Unless the investor is a *holder in due course*, they will be subjected to any personal defenses against

holder in due course
One who has taken a note, check or bill of exchange in due course.

enforcement of the note that the property owner has against the person selling the note. These defenses are more likely to arise for trust deed notes created in the context of a seller carryback sales transaction.[1]

To qualify as a holder in due course on the assignment of a trust deed note, the investor needs to acquire the note:

- for **value**;
- in **good faith**;
- without notice of **defects or defenses** to payment of the note; and
- without notice the note is **overdue**, **dishonored** or has an **uncured default**.[2]

The investor purchasing a trust deed note needs to give something of *value* to the noteholder in exchange for their assignment of the note and trust deed. The investor's payment of money or transfer of real estate to the noteholder in exchange for the noteholder assigning the trust deed note to the investor is **valuable consideration**.[3]

For the investor to acquire a note in *good faith*, the note and trust deed need to be assigned with honest intentions and in faithful adherence to the common purpose of the seller of the note and the investor acquiring the note as expressed in the agreement to purchase the note. The *assignment* of a note automatically assigns the trust deed that imposed a lien on a parcel of real estate as security for the debt owed under the note.

To be free of actual or constructive *notice of deficiencies* in the note and trust deed, the investor needs to be unaware of:

- any defect on the face of the note, such as irregularities, incompleteness or evidence of alteration or forgery;
- any misrepresentations made to the owner or buyer of the property securing the note by the person who originally received the note and trust deed; or
- any condition that gives the property owner a claim against the person — lender or carryback seller — who originally received the note and trust deed.

A **trust deed broker** representing an investor in negotiations to acquire a trust deed note initially needs to investigate the financial aspects of the note and trust deed. This review of the history of the note is part of their *agency duty of care and protection* owed to their client.

Comparable to a buyer of real estate entering into a purchase agreement with the *advice and assistance* of their transaction agent (TA), the trust deed investor buying a note agrees to purchase it based on the advice and assistance of their *trust deed broker*. [See **RPI** Form 241]

1 Calif. Commercial Code §3306
2 Com C §3302
3 Com C §3303

Prudent practice compels the trust deed broker representing the investor to *investigate and analyze* the circumstances surrounding the trust deed note offered for sale.

To investigate, the trust deed broker obtains and reviews a copy of every document associated with the trust deed note, including:

- the note and trust deed;
- the note's amortization schedule;
- the payment history on the note;
- a current property profile of the encumbered property from a title company;
- all documents recorded on title during the past 24 months;
- the seller's current title insurance policy;
- any senior notes and trust deeds;
- the property owner's hazard insurance policy; and
- the agreement and escrow documents which created the note and trust deed.

The broker needs to pay particular attention to the documents generated by the transaction which created the note and trust deed.

For instance, a title insurer issued a title insurance policy to cover the noteholder's enforceability of the trust deed for priority and foreclosure. However, holding a title policy does not mean the debt evidenced by the note and secured by the described property under the insured trust deed is enforceable. The debt, being the note, is not insured as collectible by a lender's policy of title insurance.[4]

Disclosure statement by a trust deed broker

The trust deed broker prepares and hands their investor a statement disclosing the status of the note and trust deed when submitting a trust deed investment opportunity for a trust deed investor's review and consideration. [See **RPI** Form 235-2 (DRE 851B)]

The *disclosure statement* details, among other items:

- the terms and conditions for payment of the debt evidenced by the trust deed note [See **RPI** Form 235-2 (DRE 851B) Part 3];
- any liens encumbering the property senior to the note's trust deed [See **RPI** Form 235-2 (DRE 851B) Part 9]; and
- the loan-to-value ratio (LTV) for the trust deed note and senior mortgages.[5] [See **RPI** Form 235-2 (DRE 851B) Part 10]

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4 **First American Title Insurance Company** v. **XWarehouse Lending Corporation** (2009) 177 CA4th 106

5 Calif. Business and Professions Code §10232.5

Other due diligence aspects the broker needs to investigate beyond the items noted in the disclosure statement include:

- an analysis of the value of the property securing the debt evidenced by the note; and
- the risk of default by the property owner on either the note (payments) or trust deed (use and maintenance of the property).

Notice and holder in due course issues

Consider an investor acquiring a trust deed note from a private lender who originated the note. The property owner's name is misspelled on the note and the note contains a poorly worded provision with a vague meaning. The terms of payment include an unusually high rate of interest and a short period of time before the principal is due.

Neither the investor nor their broker investigate the note or question the uncommonly high rate of interest. Their sole concern is the amount of principal, the rate of interest, the due date and the discount — the financial aspects.

When the note becomes due, the investor properly demands payment of the principal and interest. The owner refuses to pay, claiming the debt is unenforceable as stated in the note since the lender only partially funded the loan and the investor was on notice to investigate the note's validity due to irregularities on its face.

The investor claims the note is enforceable since it was purchased *for value* and in *good faith* and they had no knowledge of any defects or defenses to payment of the note.

Two questions arise:

1) Is the note negotiable and thus assignable despite its irregularities?

Yes! The note qualifies as a **negotiable instrument** and thus is assignable. It identified the owner and contained an unconditional promise to pay on the terms stated in the note.[6]

2) Is the investor a *holder in due course* by assignment and thus able to bar the owner's defenses to payment?

No! The investor did not purchase the note in *good faith*. They and their broker were on actual notice of the inconsistencies and errors on the face of the note. Thus, they are charged with the duty to further investigate the note's condition, which the investor and the trust deed broker failed to do.[7]

Here, the investor seeking to enforce payment of the note when they fail to qualify as a holder in due course is subjected to the same defenses to payment of the note's principal debt that the property owner has against the lender who made the loan evidenced by the defective note. The investor

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6 Com C §3104

7 Com C §3302

may enforce the note only to the extent it was funded by the lender, since the irregularities in the note put the investor and their broker on notice of possible defects.[8]

The **due diligence investigation** necessary to uncover defects in the note which the property owner might assert to defend against enforcement is performed by obtaining a **trustor's offset statement** from the property owner as a condition for closing escrow. [See **RPI** Form 414]

The trustor's offset statement

trustor's offset statement
Statement by owner of property or owner of lien against property setting forth the present status of liens against said property.

The *trustor's offset statement* is demanded by the investor's broker from the owner of the property described in the trust deed securing the note as a condition for their investor accepting an assignment and releasing funds to purchase the trust deed note. An offset statement uncovers defects in the note the owner of the real estate obligated to pay the debt might assert against the investor's enforcement of the note**.**

The noteholder selling the trust deed note (or their broker or an escrow officer) initially prepares the offset statement. Once prepared, it is delivered to the property owner for review of the information contained in the statement. When reviewed and signed by the property owner, with or without alteration, it is delivered to escrow for further approval by the trust deed investor prior to funding and closing escrow to acquire the trust deed note. [See **RPI** Form 414]

The trustor's offset statement signed and returned by the property owner confirms the:

- address and legal description of the property securing the mortgage [See **RPI** Form 414 §4];
- date of the note [See **RPI** Form 414 §5.1];
- original amount of the note and unpaid balance [See **RPI** Form 414 §§5.2, 5.3];
- periodic payment amount and schedule [See **RPI** Form 414 §5.4];
- interest rate on the note [See **RPI** Form 414 §5.4(a)];
- date through which interest has been paid [See **RPI** Form 414 §5.4(b)];
- date next payment is due [See **RPI** Form 414 §5.4(c)]; and
- due date of any final/balloon payment. [See **RPI** Form 414 §5.4(d)]

A property owner who receives a request for a trustor's offset statement from the noteholder has no duty to respond to a request for the statement, unless they have agreed in writing to do so.

However, regardless of the property owner's duty to respond, if the owner signs and returns the statement, the information it contains may be relied upon by the trust deed investor. When the owner does not return a signed statement, the broker and the investor need to investigate and confirm whether the property owner has a defense to payment of the note.

8 **In re Nusor** (1991) 123 BR 55

Generally, when the owner does not respond, the broker and investor need to conclude a problem exists with the repayment of the debt. Guarantees from the noteholder selling the trust deed note may be a solution when the property owner does not respond.

The trustor's offset statement is fundamental to establishing the investor's *holder in due course status*, imperative on an assignment of the note and trust deed**.** The sending of the offset statement and the owner's positive response demonstrate the investor acquired the note in *good faith* without any known defects in the debt or defenses against its enforcement the property owner may have, except as noted in the property owner's response to the offset statement.

The beneficiary statement

A **beneficiary statement** is also requested from all holders of mortgages encumbering the property. A beneficiary statement is a written disclosure made by a mortgage holder regarding the condition of a debt owed to them, usually evidenced by a trust deed note. [See **RPI** Form 415]

beneficiary statement
A written disclosure made by a mortgage holder regarding the condition of a debt owed to them, usually evidenced by a trust deed note.

A written request for a *beneficiary statement* from a mortgage holder needs to be made by an **entitled person** before the mortgage holder is required to respond. An *entitled person* includes:

- the **original borrower** (property owner signing the note) on the mortgage;
- the **successor-in-interest** (new property owner) to the original borrower;
- an **authorized agent** of either, such as a real estate broker, attorney or escrow agent; or
- any **beneficiary** holding a trust deed, subordinate lien or encumbrance of record.[9]

A complete beneficiary statement includes information and data regarding:

- the amount of the *unpaid balance*;
- the *interest rate* of the debt;
- the total of all *overdue payments* of principal and/or interest;
- the amounts of any *periodic payments*;
- the *due date* for final/balloon payoff of the debt;
- the date through which *real estate taxes* and special assessments have been paid, if known;
- the amount of *hazard insurance* and its term and premium, if known;
- any *impound* balance reserve for the payment of taxes and insurance;
- the amount of any *additional charges* incurred by the beneficiary that have become part of the mortgage; and

9 Calif. Civil Code §2943(a)(4)

- whether it is possible for the mortgage to be *assumed* by a new owner (added following federal deregulation of lenders in 1982).[10] [See **RPI** Form 415]

Delivery of a beneficiary statement

The holder of any type of mortgage is required to prepare and deliver a beneficiary statement within 21 days of the receipt of the written request from an entitled person.[11]

The mortgage holder's *intentional failure* to send the statement within 21 days of receipt of request results in the mortgage holder's forfeiture of $300 to the person making the request. Also, the mortgage holder is liable for all money losses resulting from its intentional failure to comply.[12]

The investor, upon receipt of the beneficiary statement(s), examines them to:

- analyze their risk of having to cope with a call or recast of the underlying mortgage when a due-on clause exists; and
- confirm the mortgage terms are as disclosed in the purchase agreement and the broker's financial disclosure.

The condition of title and past activity

A **property profile** obtained from a title company for a trust deed investor's review is the initial disclosure of the mortgages of record recorded prior to and after the trust deed securing the note being sold was recorded. Any recorded assignment or subordination of a mortgage is reflected, including any affecting the trust deed securing the note under consideration for purchase. However, a *property profile* is not to be relied on as a guarantee or warranty that the title is as represented.

property profile
A report from a title company providing information about a property's ownership, encumbrances, use restrictions and comparable sales data.

The property profile presents the current vesting, general and special taxes, assessments, bonds, encumbrances and liens of others recorded against title to the property. This is crucial information, sourced as coming from a title company, that the trust deed broker presents to the investor. This information is critical since the risk of the owner's default increases when the owner further encumbers the property with liens.

Also, the broker needs to order a **preliminary title report** from a title company (usually on entering into an agreement to purchase the note) to check the county recorder's general index for any judgment liens that have attached to the property title. Like a property profile, a *preliminary title report* is not a guarantee, warranty or representation that the title is subject to the liens reported or that the report includes all the liens affecting title.

preliminary title report
A report constituting a revocable offer by a title insurer to issue a policy of title insurance, used by a buyer and escrow for an initial review of the vesting and encumbrances recorded and affecting title to a property.

The trust deed broker's review of the **title insurance policy** held by the seller of the trust deed note confirms the trust deed's priority on title (but does not cover the investor if they acquire the trust deed note as they are not a named insured).

10 CC §2943(a)(2)
11 CC §§2943(b)(1)
12 CC §2943(e)(4)

due-on clause
A trust deed provision used by lenders to call the loan immediately due and payable, a right triggered by the owner's transfer of any interest in the real estate, with exceptions for intra-family transfers of their home.

While an assignment of a junior trust deed does not itself trigger a **due-on clause** in a senior mortgage, the broker needs to obtain a copy of any senior mortgage holder's trust deed from a title company. The broker reviews the trust deed to confirm the nature of the senior mortgage holder's **due-on rights** to challenge the *original creation* of the junior trust deed securing the note being purchased.

A senior mortgage holder may call their mortgage due on discovery of the junior mortgage if:

- the senior mortgage holder's trust deed contains a due-on provision; and
- the property owner did not obtain the mortgage holder's written consent for the creation of the junior trust deed.

The senior mortgage holder may also call their mortgage due if the buyer in a carryback financing arrangement did not formally assume the senior mortgage on the sale of the property. If the buyer did assume the senior mortgage and the junior trust deed was not disclosed to the senior mortgage holder, the senior mortgage holder may call the mortgage on discovery of its existence.

Here, the trust deed investor needs to resolve the due-on issue with the seller of the junior trust deed note before proceeding with their purchase of the note.

Due-on waivers

If a *due-on clause* exists in a senior mortgage, the trust deed broker ascertains whether the senior mortgage holder has either:

- consented to the recording of the junior trust deed as a *further encumbrance* on the property; or
- waived their right to call the mortgage due.

When mortgage rates rise in the future, the junior trust deed investor needs to appreciate that the due-on clause in the senior trust deed is a **time bomb**. If the property owner does anything to trigger the senior trust deed's due-on clause before or after the investor acquires the trust deed note, the senior mortgage holder may either:

call
A mortgage holder's demand for the balance of the loan to be immediately paid in full.

- **call the mortgage**, demanding the full amount remaining due to be paid immediately, also known as *acceleration*; or
- **recast the mortgage**, requiring a modification of the note's terms as a condition for the mortgage holder's consent to a transfer, called a *waiver by consent*.

recast
A mortgage holder's demand to modify the note terms and receive payment of additional fees in exchange for waiving the due-on clause in their mortgage.

Thus, the investor acquiring a note secured by a second trust deed needs to remain ready to absorb the risks of funding a payoff or negotiating a modification of the senior mortgage when the mortgage holder has not previously consented to the creation or existence of the second trust deed.

Due-on waivers from the underlying mortgage holder are required documentation to protect the trust deed investor's junior position on title to the property.

A written waiver of the senior mortgage holder's *future enforcement* of the due-on clause bars them from calling the mortgage and protects the investor while they have an interest in the property. The **waiver agreement** assures the investor they can preserve their security interest in the title without due-on interference from the senior mortgage holder. [See **RPI** Form 410]

To best protect their trust deed, the investor needs to have the senior mortgage holder waive their right to call their mortgage:

- on any conveyance and further encumbrance of the property by the owner;
- for as long a period as the investor has a secured position on title to the property; and
- on the investor's acquisition of title to the property if the investor has to complete a foreclosure on the property or accepts a deed-in-lieu of foreclosure.

The waiver needs to be in writing to be enforceable against the senior mortgage holder.[13]

Further, a due-on clause in the junior trust deed being acquired by assignment protects the investor if the property owner later sells or further encumbers the property. Without a due-on clause, the investor is forced to accept a new owner (one who is potentially less creditworthy) or a further encumbrance of the property by the owner, possibly creating an unreasonable risk of loss due to the owner's diminished equity in the property.

However, on an owner-occupied, one-to-four unit residential property, the creation of a junior mortgage when the property owner continues to occupy the property does not trigger due-on enforcement. Thus, the senior mortgage holder's due-on enforcement based on a further encumbrance of an owner-occupied, one-to-four unit residential property is not permitted, even though the owner's equity in the property is diminished. Conversely, any foreclosure sale by the junior mortgage holder triggers the senior trust deed's due-on clause.[14]

loan-to-value ratio (LTV)
A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property's fair market value (FMV).

The trust deed note's LTV

The **loan-to-value ratio (LTV)** of a trust deed note indicates the extent of the investor's risk of loss on the note. The risk arises when a deficiency exists in the secured property's value on a default.

The LTV represents the amount of the note's principal, together with amounts of any senior mortgages, stated as a percentage of the secured property's value.

13 12 Code of Federal Regulations §591.5(b)(4)

14 12 CFR §591.5(b)(1)(i)

The LTV is calculated as follows:

- add the price the investor intends to pay for the note (not the note's unpaid principal) to the total amount of principal unpaid on any senior mortgage(s) of record; and
- divide this total dollar amount of debt by the current fair market value (FMV) of the property.

For example, a second mortgage purchased for $50,000 is added to unpaid senior mortgages totaling $150,000 for a total of $200,000 in encumbrances. This total mortgage debt is then divided by the property's value of $250,000. The result is an LTV of 80%.

Trust deed brokers need to take into consideration the LTV ceilings on syndicated trust deed note investments based on:

- the type of property securing the note;
- the owner-occupancy status of the property; and
- the use of the property.[15] [See Chapter 47]

Conditions affecting property value

It is foreseeable a trust deed investor as a mortgage holder may have to foreclose and become the owner of the real estate securing the trust deed note they purchased if the owner defaults on either the note or trust deed.

Thus, a mortgage holder's interest in the real estate which secures performance of their note and trust deed is significant. The real estate interest liened by the trust deed — fee or leasehold, first or second — is the source of recovery, held as security to minimize the mortgage holder's risk of loss on a default.

An investigation into the conditions affecting the **value** of the secured property, by the trust deed investor or by their broker, is requisite to any analysis of the risk of loss the investor may be exposed to if they need to resort to the real estate to recover their investment — a foreseeable event.

The *value* of the secured real estate is reflected by:

- the physical condition of the property [See **RPI** Form 304];
- title conditions;
- the income and expenses the property produces [See **RPI** Form 352]; and
- the conditions of the location and area surrounding the property.

The investor needs to be provided with an estimate of the FMV of the property securing the note by either:

- an independent appraisal; or

15 Bus & P C §10238(h)(1)

- the trust deed broker's written estimated FMV including the objective data used to determine the FMV, if the investor has waived the requirement of an independent appraisal in writing.[16] [See **RPI** Form 318]

As always, the trust deed broker has a general duty owed to the trust deed investor to disclose any known adverse conditions of the secured property or the trust deed note which might affect the investor's decision to purchase the note.[17]

Physical condition of the property

The trust deed broker needs to encourage the trust deed investor to personally inspect the property and observe its location and improvements. Prudent practice calls for the trust deed broker to walk through the property with the investor. If the real estate securing the note is improved commercial property, the investor will usually have adequate access to the interior to view its care and maintenance while inspecting the exterior.

For residential property, the investor may, at the least, visit the property and assure themselves the exterior is being cared for and maintained.

When a trust deed investor purchases carryback paper, they know a buyer created the trust deed note to pay for the real estate securing the note. Faced with this fact, the investor and their broker automatically request:

- a copy of the **condition of property disclosure** the seller handed to the buyer [See **RPI** Form 304];
- a copy of the **annual property operating data (APOD)** for income property presented to the buyer [See **RPI** Form 352]; and
- a copy of the escrow instruction used in the sale which created the carryback mortgage.

With a quick review of these disclosures and documents, the trust deed broker can determine whether the carryback seller property represented both the physical condition and net operating income (NOI) of the property at the time of the sale. They can also determine whether irregularities on the sale may have taken place presenting the owner with a defense to payment of the carryback note.

Further, a trust deed investor needs to be wary of investing in notes secured by property located outside geographic areas they are familiar with. The investor who is not familiar with an area will find distance a barrier to thorough inspection, investigation and understanding of the value of the secured real estate.

Location and area surrounding the security

Consider the trust deed investor who investigates the conditions of the real estate securing a trust deed note offered for sale. The investor is satisfied with

16 Bus & P C §10232.5(a)(2),(3)

17 **Barry** v. **Raskov** (1991) 232 CA3d 447

the physical condition, operating data and appraised value of the secured real estate. However, the property is in a neighborhood and urban area experiencing deterioration in property resale values.

The location and economic status of the area surrounding the secured real estate materially affect the value of the investor's security. Thus, an analysis of the location of the property needs to be included in an investigation of the property.

A visual inspection of the surrounding neighborhood gives the investor an impression of the future direction of the secured property's value. As an indicator of value, the investor's observations of the location are factored into their determination of price and their decision to buy the trust deed note.

However, a trust deed broker needs to avoid inducing elements of improper discrimination when referencing the surrounding neighborhood. They are not to call attention to protected classes of people as influencing the value of the property, whether positive or negative.[18]

Further, a broker need not disclose the existence of a licensed care facility, such as a Residential Care Facilities for the Elderly (RCFE), which serves six or fewer people, operating in an SFR in the area. This too fosters unacceptable and unrealistic discrimination of a protected class of individuals.

However, the broker may choose to voluntarily disclose the location of a facility in a factual manner, without an opinion or innuendo which fosters discrimination.[19]

Licensed care facilities for six or fewer people need to be treated as any other SFRs in the area.[20]

Property income and expenses

If the trust deed note being purchased is secured by income-producing property, the investor also needs to review:

- a current income and expense data on the property [See **RPI** Form 352]; and
- the existing rental and lease agreements. [See **RPI** Form 550 – 552-5]

The investor's broker has a duty to disclose financial information affecting the property owner's ability to pay the mortgage. Income and expense information on rental properties, such as contained in an *APOD*, inherently affects the owner's ability to make mortgage payments.[21]

The trust deed broker or the investor need to request and obtain rental property operating information from the property manager, or compile the information from other sources, such as:

- the property owner's books; and
- utility companies, maintenance firms, property management and homeowners' associations.

18 Calif. Government Code §12955

19 73 Ops.Cal.Atty.Gen. 58 (1990)

20 Calif. Health and Safety Code §1566 et seq

21 Calif. Department of Real Estate Regulations §2785(b)(2)(c)

Chapter 44 Summary

A promissory note secured by a trust deed, together called a mortgage, contains an unconditional promise to pay the noteholder an agreed-to dollar amount as scheduled by the terms of the note.

For a trust deed investor to enforce collection of principal and interest payments called for in a trust deed note they are acquiring, they need to qualify as a holder in due course on its assignment.

The investor purchasing a trust deed note needs to give something of value to the noteholder in exchange for their assignment of the note and trust deed. The investor's payment of money or transfer of real estate to the noteholder in exchange for the noteholder assigning the trust deed note to the investor is valuable consideration.

A trust deed broker representing an investor in negotiations to acquire a trust deed note initially needs to investigate the financial aspects of the note and trust deed.

The trust deed broker prepares and hands their investor a statement disclosing the status of the note and trust deed when submitting a trust deed investment opportunity for a trust deed investor's review and consideration.

The due diligence investigation necessary to uncover defects in the note which the property owner might assert to defend against enforcement is performed by obtaining a trustor's offset statement from the property owner as a condition for closing escrow. The trustor's offset statement is fundamental to establishing the investor's holder in due course status, imperative on an assignment of the note and trust deed.

A beneficiary statement is also requested from all holders of mortgages encumbering the property. The holder of any type of mortgage is required to prepare and deliver a beneficiary statement within 21 days of the receipt of the written request from an entitled person.

A property profile obtained from a title company for a trust deed investor's review is the initial disclosure of the mortgages of record recorded prior to and after the trust deed securing the note being sold was recorded.

Also, the broker needs to order a preliminary title report from a title company (usually on entering into an agreement to purchase the note) to check the county recorder's general index for any judgment liens that have attached to the property title.

While an assignment of a junior trust deed does not itself trigger a due-on clause in a senior mortgage, the broker needs to obtain a copy of any senior mortgage holder's trust deed from a title company. The broker

reviews the trust deed to confirm the nature of the senior mortgage holder's due-on rights to challenge the original creation of the junior trust deed securing the note being purchased.

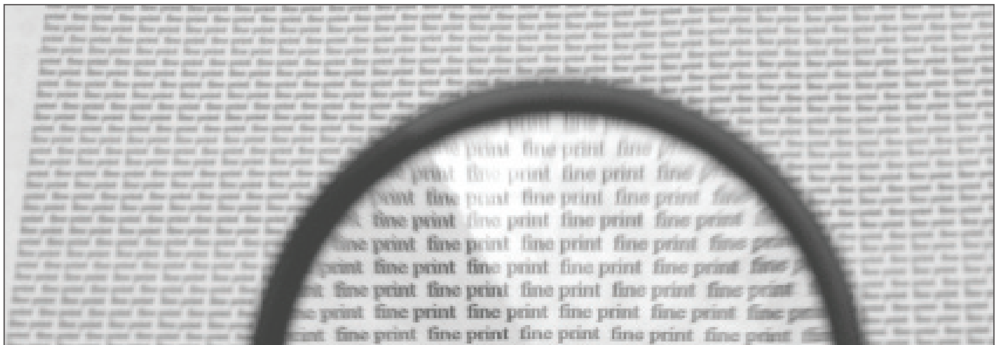
An investigation into the conditions affecting the value of the secured property, by the trust deed investor or by their broker, is requisite to any analysis of the risk of loss the investor may be exposed to if they need to resort to the real estate to recover their investment.

If the trust deed note being purchased is secured by income-producing property, the investor also needs to review:

- a current income and expense data on the property; and
- the existing rental and lease agreements.

Chapter 44 Key Terms

Chapter 45



Evaluating the carryback note

Learning Objectives

After reading this chapter, you will be able to:

- discuss the rationale underlying an investor's purchase of a trust deed note at a discount; and
- calculate the discount needed to produce the yield desired by an investor.

Key Terms

carryback mortgage	**note rate**
deficiency	**short-term rate**
long-term rate	**yield**

The financial function of a purchase discount

Consider a trust deed investor who conducts a due diligence investigation on real estate securing a trust deed note which is for sale. On determining the rate of return they need to make this investment, called the **yield**, the investor *calculates the discount* needed to establish the price they will offer to purchase the trust deed note.

Most trust deed notes offered for sale to trust deed investors are **carryback mortgages** created to finance the sale of real estate. Typically, carryback mortgages are junior in priority to an existing first mortgage.

A **discount** on the sale of a *carryback mortgage* is demanded by investors when it is necessary to deliver the investor a market-level *yield*. A discount is necessary when the carryback mortgage:

- bears interest at a rate below the private-money market rate;
- has low periodic (monthly) payments based on a long amortization period or interest only;

yield
The interest earned by an investor on an investment (or by a bank on the money it has loaned). Also, called return.

- has a medium- or long-term due date; or
- has a **loan-to-value ratio (LTV)** which presents a risk of loss due to deficient property value as security for repayment of the note.

short-term rate
A variable interest rate which changes often, driven by Federal Reserve actions to keep inflation and deflation in check.

long-term rate
An interest rate fixed for the duration of the loan.

note rate
The interest rate agreed to between the homebuyer and the lender on the promissory note. Contrast with real interest rate.

carryback mortgage
A note and trust deed executed by a buyer of real estate in favor of the seller for the unpaid portion of the sales price on closing, also known as an installment sale, credit sale or seller financing.

Also, the market rate of interest sought by investors in second mortgages is influenced by the risks of loss and management requirements of holding a junior mortgage. The **short-term rates**, used to set rates on adjustable rate mortgages (ARMs) which are influenced by the over-night rate offered by the Federal Reserve (the Fed), and **long-term rates**, used to set rates for fixed rate mortgages (FRMs) which are influenced by anticipated future inflation as perceived by bond market investors, are not the basis used for setting rates charged by trust deed investors on second mortgages. These trust deed investors are not much concerned or involved with the money markets which set the *short-term* and *long-term rates*.

Trust deed investors who invest in second mortgages demand a yield on their investment which is higher than either the current short-term or long-term rate, whether these rates are currently high, low, or have inverted.

Thus, interest rates in the second mortgage resale market are considerable higher than the interest rates on typical carryback mortgages. As a result, investors demand a higher yield than earned on the note's principal at the stated **note rate** — which leads directly to the *discount*.

The price a trust deed investor will pay for a note, called the note's **cash value**, moves contrary to the direction of the yield sought by the investor. The higher the investor's yield, the greater the discount. Thus, the lower the price paid for the note.

The discount based on uncertainties

The *cash value* paid by a trust deed investor to purchase a second mortgage is viewed as a percentage of the principal balance remaining on the note, such as 80% of its *face value*, or a 20% discount. [See Figure 1]

The present cash value an investor pays for a note is calculated based on:

- the *dollar amount* of the regularly scheduled payments;
- the *principal balance* remaining and payable as the final/balloon payment on the note's due date; and
- the *yield sought* by the investor on the amount they pay for the note.

The discount, of course, is the percentage of the note's principal balance which is not paid to buy the note, such as 20%.

deficiency
Losses experienced by a mortgage holder at a foreclosure sale due to insufficient value of the mortgaged property to satisfy the mortgage debt.

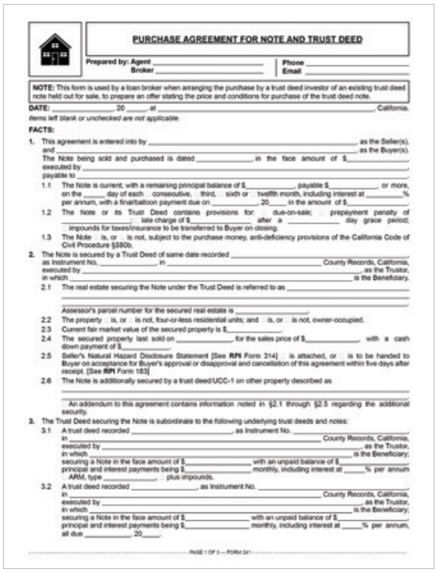
The amount of a discount is influenced by the exposure of the investor's capital to the risk of loss arising out of *uncertainties*, including:

- the inadequacy of the value of the **equity position** in the real estate to fully secure repayment of the note in the event of a default, called a **deficiency**, based on the *LTV*;
- a delinquent **payment history** on the note;

Figure 1

Form 241

Purchase Agreement for Note and Trust Deed



PURCHASE AGREEMENT FOR NOTE AND TRUST DEED

Prepared by: Agent ____________ Phone ____________
Broker ____________ Email ____________

NOTE: This form is used by a loan broker when arranging the purchase by a trust deed investor of an existing trust deed note held out for sale, to prepare an offer stating the price and conditions for purchase of the trust deed note.

DATE: ____________, 20____, at ____________, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This agreement is entered into by ____________, as the Seller(s), and ____________, as the Buyer(s). The Note being sold and purchased is dated ____________, in the face amount of $____________, executed by ____________, payable to ____________.
   1.1 The Note is current, with a remaining principal balance of $____________, payable $____________, or more, on the ____ day of each consecutive, third, sixth or twelfth month, including interest at ______% per annum, with a final/balloon payment due on ____________, 20____ in the amount of $____________.
   1.2 The Note or its Trust Deed contains provisions for: due-on-sale; prepayment penalty of ____________; late charge of $____________ after a ____________ day grace period; impounds for taxes/insurance to be transferred to Buyer on closing.
   1.3 The Note is, or is not, subject to the purchase money, anti-deficiency provisions of the California Code of Civil Procedure §580b.
2. The Note is secured by a Trust Deed of same date recorded ____________, as Instrument No. ____________, in ____________ County Records, California, executed by ____________, as the Trustor, in which ____________ is the Beneficiary.
   2.1 The real estate securing the Note under the Trust Deed is referred to as ____________. Assessor's parcel number for the secured real estate is ____________.
   2.2 The property is, or is not, four-or-less residential units; and is, or is not, owner-occupied.
   2.3 Current fair market value of the secured property is $____________.
   2.4 The secured property last sold on ____________, for the sales price of $____________, with a cash down payment of $____________.
   2.5 Seller's Natural Hazard Disclosure Statement [See **RPI** Form 314] is attached, or is to be handed to Buyer on acceptance for Buyer's approval or disapproval and cancellation of this agreement within five days after receipt. [See **RPI** Form 183]
   2.6 The Note is additionally secured by a trust deed/UCC-1 on other property described as ____________.
   An addendum to this agreement contains information noted in §2.1 through §2.5 regarding the additional security.
3. The Trust Deed securing the Note is subordinate to the following underlying trust deeds and notes:
   3.1 A trust deed recorded ____________, as Instrument No. ____________, in ____________ County Records, California, executed by ____________, as the Trustor, in which ____________ is the Beneficiary; securing a Note in the face amount of $____________ with an unpaid balance of $____________, principal and interest payments being $____________ monthly, including interest at ____% per annum ARM, type ____________, plus impounds.
   3.2 A trust deed recorded ____________, as Instrument No. ____________, in ____________ County Records, California, executed by ____________, as the Trustor, in which ____________ is the Beneficiary; securing a Note in the face amount of $____________ with an unpaid balance of $____________, principal and interest payments being $____________ monthly, including interest at ____% per annum, all due ____________, 20____.

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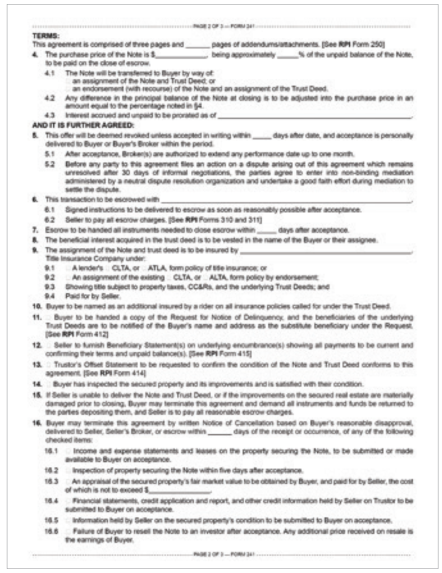

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TERMS:

This agreement is comprised of three pages and ______ pages of addendums/attachments. [See **RPI** Form 250]

4. The purchase price of the Note is $____________, being approximately _____% of the unpaid balance of the Note, to be paid on the close of escrow.
   4.1 The Note will be transferred to Buyer by way of:
   an assignment of the Note and Trust Deed; or
   an endorsement (with recourse) of the Note and an assignment of the Trust Deed.
   4.2 Any difference in the principal balance of the Note at closing is to be adjusted into the purchase price in an amount equal to the percentage noted in §4.
   4.3 Interest accrued and unpaid to be prorated as of ____________.

AND IT IS FURTHER AGREED:

5. This offer will be deemed revoked unless accepted in writing within _____ days after date, and acceptance is personally delivered to Buyer or Buyer's Broker within the period.
   5.1 After acceptance, Broker(s) are authorized to extend any performance date up to one month.
   5.2 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.
6. This transaction to be escrowed with ____________.
   6.1 Signed instructions to be delivered to escrow as soon as reasonably possible after acceptance.
   6.2 Seller to pay all escrow charges. [See **RPI** Forms 310 and 311]
7. Escrow to be handed all instruments needed to close escrow within _____ days after acceptance.
8. The beneficial interest acquired in the trust deed is to be vested in the name of the Buyer or their assignee.
9. The assignment of the Note and trust deed is to be insured by ____________, Title Insurance Company under:
   9.1 A lender's CLTA, or ATLA, form policy of title insurance; or
   9.2 An assignment of the existing CLTA, or ALTA, form policy by endorsement;
   9.3 Showing title subject to property taxes, CC&Rs, and the underlying Trust Deeds; and
   9.4 Paid for by Seller.
10. Buyer to be named as an additional insured by a rider on all insurance policies called for under the Trust Deed.
11. Buyer to be handed a copy of the Request for Notice of Delinquency, and the beneficiaries of the underlying Trust Deeds are to be notified of the Buyer's name and address as the substitute beneficiary under the Request. [See **RPI** Form 412]
12. Seller to furnish Beneficiary Statement(s) on underlying encumbrance(s) showing all payments to be current and confirming their terms and unpaid balance(s). [See **RPI** Form 415]
13. Trustor's Offset Statement to be requested to confirm the condition of the Note and Trust Deed conforms to this agreement. [See **RPI** Form 414]
14. Buyer has inspected the secured property and its improvements and is satisfied with their condition.
15. If Seller is unable to deliver the Note and Trust Deed, or if the improvements on the secured real estate are materially damaged prior to closing, Buyer may terminate this agreement and demand all instruments and funds be returned to the parties depositing them, and Seller is to pay all reasonable escrow charges.
16. Buyer may terminate this agreement by written Notice of Cancellation based on Buyer's reasonable disapproval, delivered to Seller, Seller's Broker, or escrow within ______ days of the receipt or occurrence, of any of the following checked items:
   16.1 Income and expense statements and leases on the property securing the Note, to be submitted or made available to Buyer on acceptance.
   16.2 Inspection of property securing the Note within five days after acceptance.
   16.3 An appraisal of the secured property's fair market value to be obtained by Buyer, and paid for by Seller, the cost of which is not to exceed $____________.
   16.4 Financial statements, credit application and report, and other credit information held by Seller on Trustor to be submitted to Buyer on acceptance.
   16.5 Information held by Seller on the secured property's condition to be submitted to Buyer on acceptance.
   16.6 Failure of Buyer to resell the Note to an investor after acceptance. Any additional price received on resale is the earnings of Buyer.

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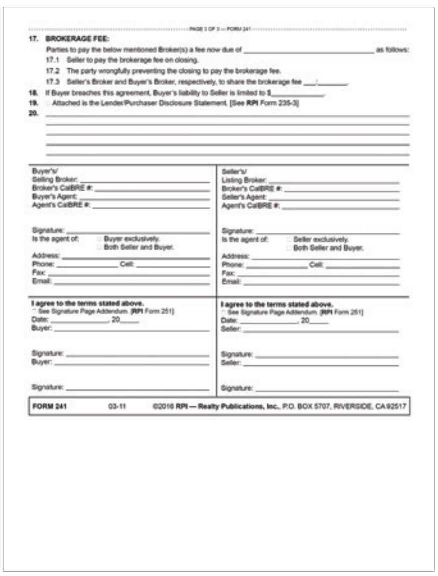

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17. BROKERAGE FEE:
   Parties to pay the below mentioned Broker(s) a fee now due of ____________ as follows:
   17.1 Seller to pay the brokerage fee on closing.
   17.2 The party wrongfully preventing the closing to pay the brokerage fee.
   17.3 Seller's Broker and Buyer's Broker, respectively, to share the brokerage fee ___:___.
18. If Buyer breaches this agreement, Buyer's liability to Seller is limited to $____________.
19. Attached is the Lender/Purchaser Disclosure Statement. [See **RPI** Form 235-3]
20. ____________

Buyer's/ Selling Broker: ____ Broker's CalBRE #: ____ Buyer's Agent: ____ Agent's CalBRE #: ____	Seller's/ Listing Broker: ____ Broker's CalBRE #: ____ Seller's Agent: ____ Agent's CalBRE #: ____
Signature: ____ Is the agent of: Buyer exclusively. Both Seller and Buyer. Address: ____ Phone: ____ Cell: ____ Fax: ____ Email: ____	Signature: ____ Is the agent of: Seller exclusively. Both Seller and Buyer. Address: ____ Phone: ____ Cell: ____ Fax: ____ Email: ____
I agree to the terms stated above. See Signature Page Addendum. [RPI Form 251] Date: ____, 20____ Buyer: ____ Signature: ____ Buyer: ____ Signature: ____	**I agree to the terms stated above.** See Signature Page Addendum. [RPI Form 251] Date: ____, 20____ Seller: ____ Signature: ____ Seller: ____ Signature: ____

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- **nonrecourse** collection enforcement limited to the property's value;
- the lack of **guarantees,** private mortgage insurance (PMI) or letters of credit;
- unusual terms of the underlying senior mortgage, taxes or bond assessments which may tend to additionally impair the second trust deed lien;
- the priority of homeowners' association (HOA) assessments;
- questionable **creditworthiness** and unverifiable **net worth** and cash reserves held by the owner of the real estate securing the mortgage; or
- the occupant's use and rental terms for the secured real estate.

Carryback economics affect discount

A seller *maximizes the sales price* of their real estate by agreeing to carry a trust deed note containing:

- a **high LTV** for the principal amount of the carryback note, usually due to a small down payment;
- a **low interest rate** which does not compensate for the risk of loss inherent in the highly leveraged junior carryback mortgage; and
- a **medium-term due date** of four to nine years, or more.

Thus, a carryback mortgage provides attractive financing for buyers. Sellers often offer carryback financing to *facilitate the sale* of their property when a buyer is unable or unwilling to borrow sufficient funds which they do not have to cash out the sale at the seller's asking price.

As for the financial benefits to a seller besides ridding themselves of their property, a carryback mortgage contains profit from the sale. As an **installment sale,** it produces the financial benefit of a deferred tax liability until the principal balance is paid, or the seller sells or **hypothecates** the note by an assignment.[1]

Taxwise, an above-market price for a parcel of real estate and a carryback note with a below-market interest rate and a long-term due date translates, respectively, into:

- *greater profit* to be reported in the future at lower capital gains rates; and
- *lesser interest income* to be reported in the future at higher standard income tax rates.

The savings in reduced overall income taxes the seller will experience by deferring the profit tax liability on an enlarged profit and reporting interest income on a below-market rate on the carryback mortgage is additional compensation for providing the financing.

Editor's note — The principal amount of the note (as reported by the seller only) is subject to reallocation to interest under Internal Revenue Service (IRS) imputed reporting rules based on the Applicable Federal Rate (AFR) for the note on the date the purchase agreement is accepted.

However, while a seller structures carryback terms in order to boost the sales price of the real estate, they are reducing the interest rate on the note. Thus, this trade off presents **drawbacks** for the carryback seller if the note is to be sold or *hypothecated*.

LTV leverage concerns

When the equity remaining in the secured property over and above the amount of the carryback note is unacceptably small — a risk-of-deficiency situation referred to as a high LTV — the note's cash value paid by a trust deed investor is adversely affected.

1 26 United States Code §453

A prudent investor interested in buying a trust deed secured by a single family residence will require the secured real estate to have at least a **20% gross equity** — over and above the secured position held by the trust deed note offered for sale.

In the event of a default on the note, a gross equity smaller than 20% of the property's value is entirely consumed (and most likely exceeded) by the:

- cost to foreclose;
- amount of cash advanced to carry the senior mortgage and pay taxes; and
- expenses incurred to resell the property . [See **RPI** Form 303]

Further, property owners with larger equities in their properties are more motivated to keep their mortgage payments current than owners with a smaller equity. Thus, an insufficient LTV for a note secured by real estate causes an investor to further discount the note to cover the additional risk of loss of the note's principal due to a *deficiency* in the property's value in the event the trust deed investor needs to foreclose.

As an alternative, a seller holding a trust deed note on a property with an LTV in excess of 80% needs to consider a **collateral loan** secured by the carryback note, rather than selling the carryback note at a drastic discount. By borrowing against the note using it as security for repayment, the discounting is entirely avoided.

Discounting the balloon payment note

The **present cash value (PV)** of a note based on the yield sought by the investor is easily established by use of a handheld financial calculator. By entering the note's current principal balance, interest rate, amount of scheduled installments and due date, an investor calculates the amount they will pay.

Consider an investor who purchases a note with a long-term due date, one beyond nine years. If the investor expects consumer inflation to rise during the long payoff period, the *real* rate of return on their invested funds falls as inflation rises. Thus, excessive inflation erodes the future **purchasing power** of the principal balance owed on the note.

Also, unforeseeable events in the future may render the secured real estate obsolete or less valuable due to changing demographics of its location or maintenance, which will impair the value of the note.

The longer the time period for payment of the note's scheduled installments before the due date for payoff of the principal balance, the greater the discount and the lower the note's present value. Thus, you have the method of accounting for the increased risk of loss due to inflation and obsolescence.

An investor wants compensation for the additional risks that may present themselves while waiting for the return of their invested cash.

Figures 2 and 3

The Balloon Payment

and

The Cash Value

The balloon payment on the note is calculated on a standard financial calculator as follows:

- *Enter the number of monthly payments [60 N].*
- *Enter the monthly interest rates [10% g i], or [10/12 i].*
- *Enter the amount of the note's remaining principal [$60,000 PV].*
- *Enter the amount of the payment [$600 CHS PMT]. This will be displayed as a negative.*
- *Request the final/balloon payment of principal due on the note [FV]. $52,256.29 is due with the 60th payment.*

Retain the entries from Figure 2 above and make the following substitutions to compute the discount necessary to receive the desired 18% yield:

- *Enter the desired yield [18% g i].*
- *Request the note's present cash value [PV]. The present cash value of the note is $45,016.45.*

Due to discounts, the actual final/balloon payment amount on a note is often greater than the note's present cash value. When the difference is significant, a carryback seller avoids a discount entirely by borrowing against the note, using it as collateral, called hypothecation. Thus, the seller retains the right to receive the final/balloon payment.

Occasionally, investors erroneously perceive a collateral loan as a purchase of the note's monthly payments, a flow of cash. This type of transaction does not occur, no matter the documentation. The holder of a note cannot sever payments from the principal of the note and separately sell payments to an investor. It is the note which the borrower assigns as collateral, not its interwoven, inseparable parts. On a default in payments, it is the principal in the note that the lender recovers, not the payments.

Before an investor calculates the discount to set the price they will pay for a note, the investor needs to:

- *calculate the amount* of the final/balloon payment due on the note; and
- *set the yield* sought on their investment in the trust deed note.

The balloon payment (Figure 2)

Consider an investor who investigates a carryback note which is offered for sale. The note has a remaining principal balance of $60,000, an interest rate of 10%, monthly payments of $600, and a final/balloon payment due in five years.

Before purchasing the note, the investor needs to establish the amount of the final/balloon payment.

The entries in Figure 2 are used to calculate the final/balloon payment. [See Figure 2]

The cash value (Figure 3)

Continuing with our previous example, the investor wants an 18% yield on their investment in the $60,000 trust deed note, not the interest rate stated on the face of the note. The entries in Figure 3 establish the cash value the investor will pay to acquire the note. [See Figure 3]

Chapter 45 Summary

Most trust deed notes offered for sale to trust deed investors are carryback mortgages created to finance the sale of real estate.

A discount on the sale of a carryback mortgage is demanded by investors when it is necessary to deliver the investor a market-level yield. The market rate of interest sought by investors in second mortgages is influenced by the risks of loss and management requirements of holding a junior mortgage.

Trust deed investors who invest in second mortgages demand a yield on their investment which is higher than either the current short- or long-term rates.

The cash value paid by a trust deed investor to purchase a second mortgage is viewed as a percentage of the principal balance remaining on the note. Thus, the amount of a discount is influenced by the exposure of the investor's capital to the risk of loss arising out of uncertainties.

As an installment sale, carryback financing produces the financial benefit of a deferred tax liability. The savings in reduced overall income taxes the seller will experience by deferring the profit tax liability on an enlarged profit and reporting interest income on a below-market rate on the carryback mortgage is additional compensation for providing the financing.

When the equity remaining in the secured property over and above the amount of the carryback note is unacceptably small, the note's cash value paid by a trust deed investor is adversely affected. Thus, an insufficient loan-to-value ratio (LTV) for a note secured by real estate causes an investor to further discount the note to cover the additional risk of loss of the note's principal due to a deficiency in the property's value in the event the trust deed investor needs to foreclose.

Chapter 45 Key Terms

Chapter 46

Beneficiary statements and payoff demands

Learning Objectives

After reading this chapter, you will be able to:

- distinguish a mortgage lender's beneficiary statement from their payoff demand;
- explain the process for requesting a beneficiary statement or payoff demand;
- understand when an error in a statement regarding the amount owed the mortgage holder becomes the unsecured debt of the named payor on the note; and
- advise property owners on the recourse versus nonrecourse nature of their mortgage obligations.

Key Terms

anti-deficiency	**novation**
beneficiary statement	**payoff demand**
entitled person	**reconveyance**
nonrecourse debt	**recourse debt**

The amount and terms of the mortgage debt

Consider a holder of a note and a **blanket trust deed** encumbering more than one parcel of real estate. The owner of the parcels has a partial release agreement with the mortgage holder for the **reconveyance** of individual parcels from the trust deed lien on the owner's payment of a portion of the debt. The agreement is not attached as an addendum to the mortgage holder's recorded trust deed. [See **RPI** Form 280]

payoff demand
A written demand, prepared by a mortgage lender, for the total dollar amount required on the date of preparation to pay off the mortgage as a requisite for recording a reconveyance of their trust deed lien on a property.

reconveyance
A document executed by a trustee named in a trust deed to release the trust deed lien from title to real estate, used when the secured debt is fully paid.

The owner of the parcels negotiates the sale of one of the properties, and a sales escrow is opened. Escrow requests a **payoff demand** from the mortgage holder on behalf of the property owner.

The mortgage holder delivers their *payoff demand* for the amount agreed to in the partial release agreement for the parcel in question. The amount is less that the full amount remaining due on the note. No notation is made on the payoff demand indicating the payment is for less than the entire amount remaining due on the mortgage debt. On the close of escrow, the mortgage holder is paid the amount stated in the payoff demand.

The title insurance company involved monitors trust deed *reconveyances* to verify title is ultimately cleared of liens paid off on properties it insures. The mortgage holder does not cause a reconveyance of the *blanket trust deed* to be recorded within 75 days of payoff.[1]

The title insurer notifies the mortgage holder of its intent to record a "**release of obligation of trust deed**" to fully reconvey the trust deed if the mortgage holder does not do so.

The mortgage holder does not respond and fails to record a partial reconveyance of the trust deed.

Finally, the title insurer records a "*release of obligation under deed of trust*" which fully reconveys the trust deed as authorized by statute. Consequently, the remaining unsold parcels are released from the trust deed lien by the action of the title company.

A demand is made

On discovery of the full reconveyance, the mortgage holder makes a demand on the title insurer for payment of the balance of the unpaid mortgage debt. The mortgage holder claims the release of the trust deed recorded by the title insurer caused them to lose their security interest in the unsold parcels and thus caused the loss.

The title insurer claims it is not liable for any amount of the unpaid balance due the mortgage holder since they were paid the amount stated in the payoff demand. The title insurer further claims it was the payment of the demand which caused the debt to become unsecured, not the reconveyance which cleared the record title.

Is the title insurer liable to the mortgage holder for the value of the security lost on the full reconveyance?

No! On the close of escrow — payment of the mortgage holder's unconditional demand and the title company's release of the trust deed lien — any sums due which the mortgage holder omitted from the payoff demand are recoverable by the mortgage holder as an unsecured debt remaining owed by the property owner as originally obligated under the note.[2]

1 Calif. Civil Code §2941(b)(3)

2 CC §2943(d)(3); **Cathay Bank** v. **Fidelity National Title Insurance Company** (1996) 46 CA4th 266

Except for the owner, no person involved in a mortgage transaction, including the owner's agents, is liable for any amounts omitted from an unconditional payoff demand.[3]

The status of the mortgage debt, on request

A mortgage holder states the amounts necessary to pay a mortgage in full by preparing and delivering either a **beneficiary statement** or a payoff demand when requested.[4]

beneficiary statement
A written disclosure made by a mortgage holder regarding the condition of a debt owed to them, usually evidenced by a trust deed note.

A request for a *beneficiary statement* is usually made by escrow on the mortgage holder of record. On receipt of the statement, it is relied upon in situations such as:

- a buyer of real estate takes title either subject to the mortgage or by an assumption, with or without a release of liability for the seller;
- a mortgage holder or other creditor receives a trust deed or other lien recorded as a junior encumbrance on the real estate; or
- a tenant acquires or encumbers a long-term leasehold interest in the real estate.

A beneficiary statement is a written disclosure made by a mortgage holder regarding the condition of a debt owed to them, usually evidenced by a note. With a mortgage, the debt is secured by a trust deed lien on the real estate described in the trust deed. [See **RPI** Form 415]

A complete beneficiary statement includes information and data regarding:

- the amount of the *unpaid balance*;
- the *interest rate* of the debt;
- the total of all *overdue payments* of principal and/or interest;
- the amounts of any *periodic payments*;
- the *due date* for final/balloon payoff of the debt;
- the date to which *real estate taxes* and special assessments have been paid, if known;
- the amount of *hazard insurance* and its term and premium, if known;
- any *impound* balance reserve for the payment of taxes and insurance;
- the amount of any *additional charges* incurred by the beneficiary that have become part of the mortgage; and
- whether it is possible for the mortgage to be *assumed* by a new owner.[5] [See **RPI** Form 415]

When delivering a beneficiary statement, the mortgage holder is to also provide a copy of the note or other evidence of the debt, including any modifications.[6]

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3 **Freedom Financial Thrift & Loan** v. **Golden Pacific Bank** (1993) 20 CA4th 1305
4 CC §2943(d)(1)
5 CC §2943(a)(2)
6 CC §2943(b)(1)

However, the statutory scheme controlling beneficiary statements does not require that a payoff demand include delivery of a copy of the note.

Statements for an ARM obligation

On **adjustable rate mortgages (ARMs)**, the beneficiary statement needs to list the note rate as adjustable, and reference the rate formula.

Formulas for ARM adjustments and payment options vary extensively from mortgage to mortgage. Thus, the seller or buyer relying on the beneficiary statement for an ARM needs greater detail than the current interest rate and payment amount. To that end, the mortgage holder *attaches a copy* of the ARM note to the beneficiary statement for full disclosure of the index used to calculate the periodic adjustments with the margin which comprises the note rate.

Requesting a statement

entitled person
The original borrower on a note and trust deed, their successor-in-interest or an authorized agent of either who may request, in writing, a beneficiary statement or payoff demand statement.

A mortgage holder need only respond when a written request for a beneficiary statement is made by an **entitled person**. An *entitled person* includes:

- the **property owner** who entered into the mortgage;
- the **successor-in-interest** (new property owner) to the person who originally entered into the mortgage;
- any junior mortgage holder; and
- the **authorized agent** of an entitled person, such as a real estate broker, attorney or escrow agent.[7]

When an entitled person does not *specifically request* a beneficiary statement, the mortgage holder need only send a payoff demand statement.[8]

The request for either statement needs to be in writing and delivered to the mortgage holder by:

- mail, at the address given in the payment notice or payment book; or
- fax.[9]

Before delivering the beneficiary statement or payoff demand, the mortgage holder may require proof the request is being made by an entitled person — proof of ownership or other authority. Thus, the written request from an escrow holder needs to be accompanied by escrow's written authorization to order a statement signed by the entitled person.[10]

Further, any **oral amendment** to either the beneficiary statement or the payoff demand statement given by the mortgage holder requires delivery of a written *amendment* by the next business day. Entitled persons may rely on an amended statement to establish, prorate and adjust payoff amounts for closing.[11]

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7 CC §2943(a)(4)
8 CC §2943(e)(1)
9 CC §§2943(a)(3), 2943(e)(5)
10 CC §2943(e)(3)
11 CC §§2943(d)(1), 2943(d)(2)

However, any error in a statement regarding the amount owed the mortgage holder becomes the **unsecured debt** of the person named in the original note once:

- escrow closes;
- title is transferred; or
- a trust deed is recorded.[12]

When the statement from a mortgage holder is amended prior to the close of escrow or a trustee's sale, the amounts listed in the amended statement control, whether the statement is a payoff demand or a beneficiary statement.[13]

An understated example

For example, an owner refinances an existing mortgage with a new lender. The payoff demand from the existing mortgage holder understates the amount due. The new lender funds the amount stated in the payoff demand and the existing mortgage is reconveyed.

Later, the paid-off mortgage holder realizes their mistake in the amount of the payoff and seeks to recover the underpayment from the new lender. The paid-off mortgage holder claims the new lender is liable for the unpaid amount since it funded the payoff which was inadequate to fully satisfy the debt.

The new lender claims the property owner who signed the note is liable for the unpaid amount since only the owner signing the note is obligated for any amount due that remains unpaid on reconveyance of the trust deed.

Is the new lender liable for the unpaid amount since it funded the payoff?

No! The mortgage holder delivering an erroneous payoff demand may only recover amounts remaining unpaid from the original signer of the note evidencing the debt. The person named in the note is the sole source of recovery for amounts understated in the payoff demand.[14]

On the sale of a property, when a prepayment penalty, late charge, attorney fees or other enforceable charges are not included in a payoff demand, the charges become unsecured obligations of the original payor on the note, not the buyer. However, collection of any underpaid amount is limited by **anti-deficiency rules** to the value of the property at the time of the payoff.[15]

anti-deficiency
A limitation placed on a mortgage lender's ability to recover losses on default when the secured property's value is insufficient to satisfy the mortgage debt.

Delivery of a beneficiary statement by the holder of any type of mortgage is to be made within 21 days of their receipt of the written request from an entitled person.[16]

The mortgage holder may not charge more than $30 for each beneficiary statement, with the exception of mortgages insured by the **Federal Housing**

12 CC §2943 (d)(3)(A)
13 CC §2943(d)(3)(B)
14 **Freedom Financial Thrift & Loan** v. **Golden Pacific Bank** (1993) 20 CA4th 1305
15 **First Nationwide Savings** v. **Perry** (1992) 11 CA4th 1657
16 CC §2943(b)(1)

Administration (FHA) or the **U.S. Department of Veterans Affairs (VA)**. Occasionally, the trust deed states a lesser amount which then controls the charge.[17]

When a request for either a beneficiary statement or a payoff demand includes a request for a copy of the trust deed, the mortgage holder needs to supply copies of the document at no extra charge.[18]

The mortgage holder's *intentional failure* to send the statement within 21 days of receipt of request results in the mortgage holder's forfeiture of $300 to the person making the request. Also, the mortgage holder is liable for all money losses resulting from its intentional failure to comply.[19]

However, the mortgage holder's failure to timely deliver the statement needs to be proven to be an intentional failure without legal excuse before the entitled person making the request may recover a penalty — a very difficult burden.

Mortgage payoff demand

A *payoff demand statement* is a written demand, typically the result of a request from escrow. It is prepared by the mortgage holder and delivered to escrow stating the amounts required as of the date of preparation to pay off the mortgage debt and reconvey the trust deed.

The statement includes information and formulas escrow is to use to calculate on a per diem basis the payoff amount after the date it is issued. The statement is effective for 30 days; less when the mortgage terms will change earlier such as on notes with adjustable interest and payments.[20]

The payoff demand, as with the beneficiary statement, is required to be delivered within 21 days of receipt by the mortgage holder on a written request from an entitled person. The charge for this service is limited to $30, unless the loan is insured by the FHA or VA.[21]

Further, intentional failure to timely reply to a request for a payoff demand also results in the mortgage holder's forfeiture of $300 and liability for any resulting money damages.[22]

Occasionally, a mortgage may be in foreclosure and the notice of sale has been published for a trustee's or judicial sale of the property. Here, a separate rule applies to requests for statements during the notice-of-sale period. The mortgage holder need not respond to requests for a payoff demand received on or after publication of the foreclosure sale.[23]

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17 CC §2943(e)(6)
18 CC §2943(e)(2)
19 CC §2943(e)(4)
20 CC §2943(a)(5)
21 CC §§2943(c), 2943(e)(6)
22 CC §2943(e)(4)
23 CC §2943(c)

Requests received during the foreclosure process

The request for a beneficiary statement or payoff demand statement may be made at any time up to two months after the recording of a **notice of default (NOD)**. During this time, the mortgage holder is obligated to respond.[24]

When the mortgage is in foreclosure, an entitled person may request a payoff demand until the publishing of:

- the **notice of trustee's sale (NOTS)** in a nonjudicial foreclosure; or
- the **notice of sale** in a judicial foreclosure.[25]

However, part of complying with the foreclosure process requires the mortgage holder to provide the owner-in-foreclosure with an accounting of the exact amount due to **reinstate** or **redeem the mortgage**.

Procedurally, the recorded *NOD* states the beneficiary will provide the owner-in-foreclosure with accurate information in response to the owner's written request to determine the exact amount to be paid to stop the foreclosure.[26]

Consider a beneficiary statement or payoff demand that is requested after an NOD is recorded, and the mortgage is not reinstated or paid in full. When an error exists in the amount requested and the property is sold at a foreclosure sale for a price based on the error, the amount of the error becomes the unsecured obligation of the payor on the note on completion of the foreclosure sale.[27]

Also, once the mortgage holder is tendered the amount demanded to pay off the debt, the omitted amounts become unsecured. The owner originally signing the note remains liable for the unpaid amount which is now unsecured and payable on the terms set forth in the note.[28]

The mortgage holder may enforce collection without first foreclosing since the security has been reconveyed.

Nonrecourse vs. recourse obligations after payoff

When a mortgage holder forecloses on a purchase-assist mortgage secured by a buyer-occupied, one-to-four unit residential property, they are barred from obtaining a judgment against the foreclosed owner for any deficiency in the value of the property to cover the amount owed. These mortgages are considered **nonrecourse debt**, also called **purchase-money** paper. Likewise, carryback notes secured only by the property sold are also *nonrecourse*, *purchase-money* paper.

Occasionally, a mistake is made by the mortgage holder in the amount of a payoff demand or beneficiary statement for a nonrecourse mortgage. Here, the mortgage holder is barred from recovering losses in excess of the property value to cover the correct amount due at the time of the erroneous payoff demand.

nonrecourse debt
A debt recoverable on default solely through the value of the security interest in the secured property.

24 CC §2943(b)(2)
25 CC §2943(c)
26 CC §2924c(b)(1)
27 CC §2943(d)(3)(B)
28 CC §2943(d)(3)

The amount of the error is an unsecured purchase-money obligation of the original buyer signing the note, but the amount remains nonrecourse debt. The character of the debt did not change — it only became unsecured.[29]

Since an error in the payoff demand on nonrecourse paper is still a nonrecourse debt, the mortgage holder is limited to a money judgment for the difference between the amount received and the value of the property at the time of the initial payoff.[30]

recourse debt
A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

Further, an error made in the beneficiary statement or payoff demand for a **recourse debt** also converts the amount of the understatement or underpayment to an unsecured debt. However, recovery on a *recourse debt* is not limited to the value of the property on the date of the payoff.[31]

The mortgage holder who demands and is paid an erroneous amount on payoff of a *recourse debt* may proceed directly to litigation for a money judgment to collect the now unsecured amount, without regard to the value of the property.

Thus, sellers are exposed to continuing liability for mortgages they owed as original or assuming buyers when the property is sold subject to the existing mortgage.

Selling property subject to a mortgage

When a buyer acquires property subject to or by assumption of an existing mortgage, the real estate remains the mortgage holder's primary source for debt recovery — the buyer becoming the primary source of payments. However, the seller is considered a guarantor — secondarily liable for payment of the mortgage — unless any assumption included a significant modification to which the seller did not consent or the seller is released of liability.[32]

When the buyer who purchases the property later resells the property and a mistake is made in the beneficiary statement prepared by the mortgage holder leading to a deficiency on payoff, then the seller, as a guarantor of payments, is liable for the error.

Thus, the seller who enters into a written assumption of the mortgage with the mortgage holder may feel compelled to condition the closing of any sale on a *release of liability* from the mortgage holder for any future errors in the beneficiary statements, called a **novation**.

novation
An agreement entered into by a mortgage holder, buyer and seller to shift responsibility for a mortgage obligation to the buyer by an assumption and release the seller of liability.

The release eliminates the seller's risk of liability for a future error by the mortgage holder in payoff demands or beneficiary statements.[33]

In a *novation*, as with an assumption, the buyer promises to perform the duties of the original owner. In addition, the mortgage holder agrees to release the seller from all liability for the debt under the novation.

29 CC §2943(d)(3)
30 **Ghirardo** v. **Antonioli** (1996) 14 CA4th 39
31 Calif. Code of Civil Procedure §726(b)
32 **Braun** v. **Crew** (1920) 183 CA 728
33 CC §1531

Chapter 46 Summary

A mortgage holder states the amounts necessary to pay a mortgage in full by preparing and delivering either a beneficiary statement or a payoff demand when requested.

Any error in a statement regarding the amount owed the mortgage holder becomes the unsecured debt of the person named in the original note. However, collection of any underpaid amount is limited by anti-deficiency rules to the value of the property at the time of the payoff.

A payoff demand statement is a written demand, typically the result of a request from escrow. It states the amounts required as of the date of preparation to pay off the mortgage debt and reconvey the trust deed.

The request for a beneficiary statement or payoff demand statement may be made at any time up to two months after the recording of a notice of default (NOD).

When an error exists in the amount requested and the property is sold at a foreclosure sale for a price based on the error, the amount of the error becomes the unsecured obligation of the payor on the note on completion of the foreclosure sale.

However, when a mortgage holder forecloses on a purchase-assist mortgage secured by a buyer-occupied, one-to-four unit residential property, they are barred from obtaining a judgment against the foreclosed owner for any deficiency in the value of the property to cover the amount owed.

In contrast, recovery on a recourse debt is not limited to the value of the property on the date of the payoff.

Chapter 46 Key Terms

Notes:

Chapter 47

Fractional trust deed investments

Learning Objectives

After reading this chapter, you will be able to:

- discuss the documentation necessary for a syndicator to publicly solicit investors to originate or purchase a mortgage; and
- understand the securities risk involved when fractionalizing trust deed investments.

Key Terms

blind pool investment **fractionalizing**

Fractionalizing a trust deed note

Consider a buyer of real estate who retains a **mortgage loan broker (MLB)** to solicit and arrange a large mortgage to be secured by real estate. The buyer and the MLB enter into a mortgage agreement contingent on the MLB locating trust deed investors with sufficient cash reserves to fund the mortgage.

To locate trust deed investors, the MLB runs advertisements soliciting private investors with modest amounts of funds to form a trust deed investment group consisting of **ten or less investors**. The mortgage is too large for any one of the investors to handle alone or prudently carry the entire risk of loss.

As investors respond to the advertisements and subscribe, their funds are placed in an independent escrow trust account. The account with an escrow company is set up specifically for this mortgage until sufficient funds accumulate to fund the transaction. When fully funded, the borrower signs and delivers the note and trust deed (documents) to the escrow. Both documents reflect the fractional ownership of the note and trust deed held by each of the numerous contributing investors, named as beneficiaries, based on their proportional investments.

The MLB concurrently enters into a **collection and servicing agreement,** signed by each of the investors, to service the mortgage as their *servicing agent*. The MLB is authorized by the agreement to:

- advance payments to the investors from the MLB's own funds to cover any delinquent installments; and
- bid on the property for the MLB's own account in the event of a foreclosure under the investors' trust deed. [See Chapter 50; see **RPI** Form 237]

Has the MLB created an *investment risk* that is regulated by California corporate securities law?

fractionalizing
Selling a share of interest in one note to multiple investors.

Yes! The MLB's singular activity of **fractionalizing** the investment in a note and trust deed among multiple private investors creates a **corporate security**.[1]

blind pool investment
An investment which involves receipt of investor contributions in a group investment program before the syndicator identifies and discloses the real estate interest the investors' funds will be used to acquire, an activity controlled by securities law.

An MLB syndicating trust deeds creates a *corporate security* when:

- they accept money from an investor or execute promissory notes *before locating* the real estate securing the trust deed, called a **blind pool investment**; or
- the trust deed is *fractionalized* among multiple investors rather than acquired by one trust deed investor for their own account.

However, an MLB may package **multiple-lender** trust deed investments and avoid securities violations, provided their conduct falls within one of two readily available exemptions from the securities law.

Securities exemptions for trust deed syndication

When fractionalizing a trust deed investment (and thus creating a securities risk), a syndicator has two options to avoid registering as a securities dealer:

- the **public offering exemption**, called the **ten-or-less trust deed investment plan**; or
- the **nonpublic offering exemption**, called the **35-or-less interrelationship rule**.

To use the *public offering exemption*, trust deed investment groups need not be limited to persons with a pre-existing relationship with the MLB. An MLB may publicly solicit trust deed investors by filing a **notice permit** with the Department of Real Estate (DRE) under this second claim of exemption option.

However, under the *nonpublic offering exemption,* the syndicator needs to have a meaningful, pre-existing business or personal relationship with the investors they privately solicit for the trust deed investment.

1 **People** v. **Schock** (1984) 152 CA3d 379

The ten-or-less rules and reporting

The ten-or-less trust deed investment scheme **(public offering exemption)** allows an MLB to publicly solicit investors to acquire a fractional interest in a trust deed note. To qualify for this ten-or-less exemption, the MLB is required to comply with the following rules and guidelines:

1. A **multi-lender transaction notice** form, also called a *notice permit or claim of exemption,* is prepared and filed with the DRE within 30 days after:
   - 1.1 the MLB **originates or sells** the first trust deed note made or acquired by ten-or-less investors they solicited from the public [See Figure 1]; or
   - 1.2 any change to the information in the original notice filed with the DRE, called an **amendment**.[2]
2. **Advertising for trust deed investors needs to:**
   - 2.1 include the **name** of the MLB and their **license identification number**;
   - 2.2 comply with §260.302 and §2848 of California Regulations, Title 10, regarding advertising criteria, wording and disclosures; and
   - 2.3 include no reference to compliance with the DRE notice permit procedure since it infers merit or approval by the DRE.[3]
3. **The trust deed securing the note needs to:**
   - 3.1 be secured by California real estate in which the MLB, directly or indirectly, has no ownership interest or right to acquire an ownership interest [See Section 5 below];
   - 3.2 have no agreement for the **future subordination** of the trust deed; and
   - 3.3 have priority as a first trust deed when it is security for a **construction loan**, with funds disbursed as construction progresses; including 10% retention until expiration of the mechanic's lien period, and covered by title insurance providing priority against mechanic's liens.[4]
4. The note cannot be a *promotional note* secured by a junior trust deed, or a trust deed subject to a future subordination agreement, executed on:
   - 4.1 lots in a subdivision;
   - 4.2 unimproved property; or
   - 4.3 newly constructed, unsold property.[5]
5. The fractional interests may be sold by a real estate broker, acting as either a **principal** or an **agent,** to finance:
   - 5.1 their acquisition of real estate at a foreclosure sale under a trust deed they are servicing or one that they originally sold to investors; or

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2 Calif. Business & Professions Code §10238(a)
3 Bus & P C §10238(c)
4 Bus & P C §10238(d)
5 Bus & P C §10238(d)

5.2 the broker's resale of real estate they acquired at a foreclosure sale under a trust deed they were servicing or originally sold to investors.[6]

6. The fractional interests are **sold to ten or less investors**.[7]

6.1 An unlimited number of persons may be publicly solicited to purchase an interest.[8]

6.2 A husband and wife, or any retirement funds or entity wholly owned by an individual and/or their spouse, that acquire a fractional interest are treated as one investor.[9]

6.3 Any organization, such as a partnership, limited liability company (LLC) or corporation that was not specifically formed for the purpose of investing in the fractional interest is treated as one investor.[10]

6.4 Each investor is to sign a statement indicating they meet minimum income or net worth standards. [See **RPI** Form 373]

6.5 In the statement, the investor needs to state that their total investment in the trust deed note from all sources (directly or through their spouse, retirement fund or controlled entity) represents:

a. 10% or less of their net worth (excluding cars, home and furnishings); or

b. 10% or less of their current or prior year's adjusted gross income (AGI) for their Internal Revenue Service (IRS) 1040 tax return.[11]

7. Each investor is given all the rights of a mortgage holder and each interest sold to the investors is on the same terms.

7.1 The investor's interest in the trust deed as a named beneficiary will be recorded before a release of the funds from escrow.[12]

8. Based on the combined principal amounts of the fractionalized note and any prior encumbrances (bonds and trust deeds), as well as the current market value of the real estate as stated in a written **opinion of value** by an appraiser or the broker, the loan-to-value ratio (LTV) may not exceed the greater of:

8.1 80% for owner-occupied, single family residences (SFRs);

8.2 75% for non-owner-occupied SFRs;

8.3 65% for commercial and income-producing property;

8.4 65% for single family, residential-zoned lots or parcels;

8.5 50% for undeveloped property zoned for commercial or residential use;

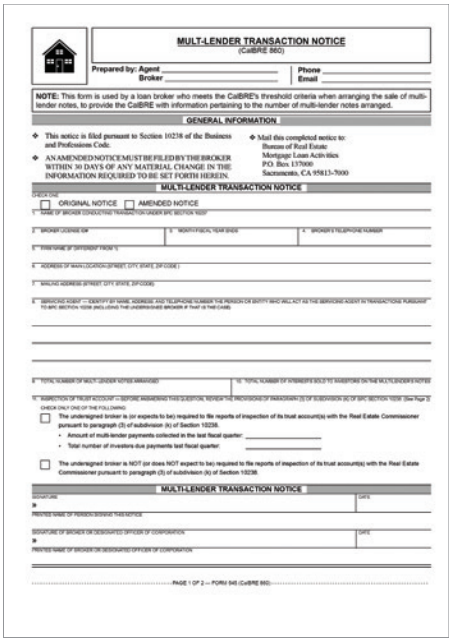
8.6 35% for other real estate; or

6 Bus & P C §10238(e)
7 Bus & P C §10238(f)
8 Bus & P C §10238(f)(2)
9 Bus & P C §10238(f)(3),(4)
10 Bus & P C §10238(f)(5),(6)
11 Bus & P C §10238(f)(1)
12 Bus & P C §10238(g)

Figure 1

Form 545

Multi-Lender Transaction Notice



MULT-LENDER TRANSACTION NOTICE
(CalBRE 860)

Prepared by: Agent ______ Phone ______
Broker ______ Email ______

NOTE: This form is used by a loan broker who meets the CalBRE's threshold criteria when arranging the sale of multi-lender notes, to provide the CalBRE with information pertaining to the number of multi-lender notes arranged.

GENERAL INFORMATION

- This notice is filed pursuant to Section 10238 of the Business and Professions Code.
- AN AMENDED NOTICE MUST BE FILED BY THE BROKER WITHIN 30 DAYS OF ANY MATERIAL CHANGE IN THE INFORMATION REQUIRED TO BE SET FORTH HEREIN.
- Mail this completed notice to:
  Bureau of Real Estate
  Mortgage Loan Activities
  P.O. Box 137000
  Sacramento, CA 95813-7000

MULTI-LENDER TRANSACTION NOTICE

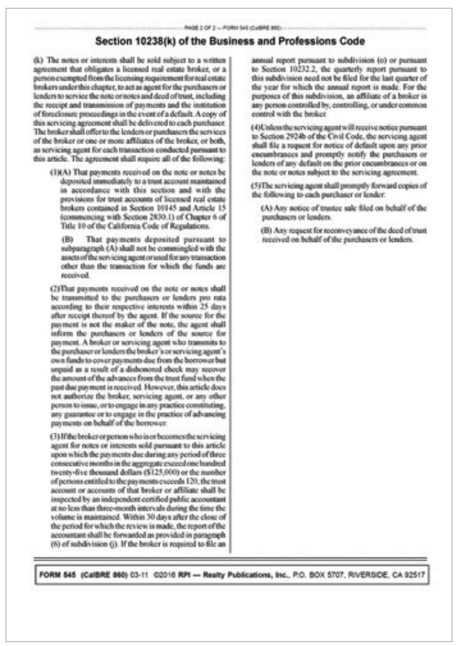
☐ ORIGINAL NOTICE ☐ AMENDED NOTICE

☐ The undersigned broker is (or expects to be) required to file reports of inspection of its trust account(s) with the Real Estate Commissioner pursuant to paragraph (3) of subdivision (k) of Section 10238.
- Amount of multi-lender payments collected in the last fiscal quarter: ______
- Total number of investors due payments last fiscal quarter: ______

☐ The undersigned broker is NOT (or does NOT expect to be) required to file reports of inspection of its trust account(s) with the Real Estate Commissioner pursuant to paragraph (3) of subdivision (k) of Section 10238.

MULTI-LENDER TRANSACTION NOTICE

For a full-size, fillable copy of this or any other form in this book that may be used in your professional practice, go to realtypublications.com/forms



Section 10238(k) of the Business and Professions Code

(k) The notes or interests shall be sold subject to a written agreement that obligates a licensed real estate broker, or a person exempted from the licensing requirement for real estate brokers under this chapter, to act as agent for the purchasers or lenders to service the note or notes and deed of trust, including the receipt and transmission of payments and the institution of foreclosure proceedings in the event of a default. A copy of this servicing agreement shall be delivered to each purchaser. The broker shall offer to the lenders or purchasers the services of the broker or one or more affiliates of the broker, or both, as servicing agent for each transaction conducted pursuant to this article. The agreement shall require all of the following:

(1)(A) That payments received on the note or notes be deposited immediately to a trust account maintained in accordance with this section and with the provisions for trust accounts of licensed real estate brokers contained in Section 10145 and Article 15 (commencing with Section 2830.1) of Chapter 6 of Title 10 of the California Code of Regulations.

(B) That payments deposited pursuant to subparagraph (A) shall not be commingled with the assets of the servicing agent or used for any transaction other than the transaction for which the funds are received.

(2)That payments received on the note or notes shall be transmitted to the purchasers or lenders pro rata according to their respective interests within 25 days after receipt thereof by the agent. If the source for the payment is not the maker of the note, the agent shall inform the purchasers or lenders of the source for payment. A broker or servicing agent who transmits to the purchaser or lenders the broker's or servicing agent's own funds to cover payments due from the borrower but unpaid as a result of a dishonored check may recover the amount of the advances from the trust fund when the past due payment is received. However, this article does not authorize the broker, servicing agent, or any other person to issue, or to engage in any practice constituting, any guarantee or to engage in the practice of advancing payments on behalf of the borrower.

(3)If the broker or person who is or becomes the servicing agent for notes or interests sold pursuant to this article upon which the payments due during any period of three consecutive months in the aggregate exceed one hundred twenty-five thousand dollars ($125,000) or the number of persons entitled to the payments exceeds 120, the trust account or accounts of that broker or affiliate shall be inspected by an independent certified public accountant at no less than three-month intervals during the time the volume is maintained. Within 30 days after the close of the period for which the review is made, the report of the accountant shall be forwarded as provided in paragraph (6) of subdivision (j). If the broker is required to file an annual report pursuant to subdivision (o) or pursuant to Section 10232.2, the quarterly report pursuant to this subdivision need not be filed for the last quarter of the year for which the annual report is made. For the purposes of this subdivision, an affiliate of a broker is any person controlled by, controlling, or under common control with the broker.

(4)Unless the servicing agent will receive notice pursuant to Section 2924b of the Civil Code, the servicing agent shall file a request for notice of default upon any prior encumbrances and promptly notify the purchasers or lenders of any default on the prior encumbrances or on the note or notes subject to the servicing agreement.

(5)The servicing agent shall promptly forward copies of the following to each purchaser or lender:

(A) Any notice of trustee sale filed on behalf of the purchasers or lenders.

(B) Any request for reconveyance of the deed of trust received on behalf of the purchasers or lenders.

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8.7 the percent of value set by any private mortgage insurance (PMI) coverage issued for the fractionalized note.[13]

Editor's note — When unique circumstances exist, the broker may exceed the statutory LTV when they are able to justify in writing their reasons for exceeding the limits. However, the LTV may never exceed 80% of improved real property or 50% of unimproved property, except for single family, residentially-zoned lots or parcels, for which the LTV may not exceed 65%.

13 Bus & P C §10238(h)(1)

The broker needs to keep the statement containing the justification for exceeding the LTV limits in their files. Also, they need to provide the investors with a copy of the LTV statement with the lender disclosure statement.[14] *[See **RPI** Form 235-1 (RE 851A)]*

9. The beneficiaries' operating agreement stipulates:
   - 9.1 a default on the note or trust deed is a default on all the investors' interests in the note; and
   - 9.2 a vote of investors holding more than 50% of the ownership interests in the note controls the action taken on a default in the trust deed and the selection of the broker, servicing agent or other persons who will act on behalf of the investors.[15]
10. The MLB needs to disclose to the investors the **identity** of the specific trust deed note they are under contract to arrange or buy, thus eliminating the formation of *blind pool trust deed investments* under the ten-or-less notice of exemption.[16]
    - 10.1 On the sale of fractional interests, the investors' funds need to be deposited in a neutral escrow and disbursed on the recording of the investors' individual interests as named beneficiaries in the trust deed and note.[17]
    - 10.2 The MLB needs to maintain records of the mortgage transaction, clearly identifying the manner of the receipt and disbursement of the investors' funds.[18]
11. A **servicing agreement** for managing the trust deed investment is entered into by the investors, in which the MLB (or other licensed person) agrees to receive payments on the note, disburse the payments received to the investors and begin foreclosure proceedings on a default in the trust deed. [See **RPI** Form 237]

    The mortgage collection agreement contains provisions for:
    - 11.1 the deposit of payments into the broker's trust account on their receipt;
    - 11.2 notice that payments deposited will not be commingled with any other funds, and will not be used for any purpose other than the servicing of the mortgage;
    - 11.3 the disbursement to the investors of their pro rata share of the payments within 25 days of receipt;
    - 11.4 notice to the investors when the source of payments is other than the borrower;
    - 11.5 no guarantee or advance of funds for payments by the broker, unless the advance is due to the borrower's check being dishonored;
    - 11.6 filing a request for a notice of default (NOD) on prior encumbrances; and

14 Bus & P C §10238(h)(2)
15 Bus & P C §10238(i)
16 Bus & P C §10238(j)
17 Bus & P C §10145(b)
18 Bus & P C §10238(j)(3)

11.7 sending investors a copy of any notice of trustee's sale (NOTS), filed on their behalf, or a request for reconveyance.[19] [See **RPI** Form 237]

12. **Material facts** will be disclosed to the investors on a DRE-designed form.

    12.1 The terms of the sale of undivided interests in the trust deed note include:

    a. the name and address of the escrow holder, date for closing and an itemized list of the costs incurred by the borrower and the investors on the origination if it is an **origination** of a mortgage [See **RPI** Form 235-1 (RE 851A];[20]

    b. its sales price, any premium or discount on the principal balance and unpaid interest, the effective rate of return, the name and address of the escrow holder and the itemized costs incurred by the seller and the investors on the sale if it is the **acquisition** of an existing mortgage [See **RPI** Form 235-2 (RE 851B)];[21] or

    c. additional disclosures of the identification and value of each parcel, the dollar amount of equity in each property after an apportionment of the amount of the trust deed note to each parcel and the resulting LTV for each parcel if the note is secured by a **blanket trust deed** as a lien on more than one parcel of real estate.[22]

13. All other relevant *material facts* affecting the sale of the trust deed note.

14. On request from an investor, the MLB needs to provide the investor the names and addresses of all other investors in the note.[23]

15. The MLB is prohibited from acquiring, directly or indirectly, an **option to buy** the interests of the investors in the note or the real estate as part of the initial transaction to acquire, originate or service a fractionalized note.

    However, the MLB, after completing the syndication of the note or entering into a service agreement, may later purchase an interest in the note or the real estate when their purchase agreement it is negotiated at the time of the acquisition.[24]

16. When the MLB sells, originates or services fractionalized notes, and the amount of payments received from all sources in any **three-month period** exceeds $125,000, or the number of all investors participating during a three-month period exceeds 120, the MLB is required to:

    16.1 have their **trust account** inspected by a certified public accountant (CPA) and forward the CPA's trust account inspection report to the DRE within 30 days after the period in review [See **RPI** Form 546 (RE 852)];[25]

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19 Bus & P C §10238(k)
20 Bus & P C §10238(l)(1)(B)
21 Bus & P C §10238(l)(1)(A)
22 Bus & P C §10238(l)(1)(C)
23 Bus & P C §10238(m)
24 Bus & P C §10238(n)
25 Bus & P C §10238(k)(3)

16.2 file an **annual report** on the status of the **trust account** with the DRE [See **RPI** Form 548];[26] and

16.3 file an **annual report** of their **trust deed sales, originations** and **servicing** with the DRE.[27] [See **RPI** Form 547 (RE 881)]

The 35-or-less interrelationship rule

The nonpublic offering exemption is the most useful exemption available to syndicators who put together an investment program which includes an activity containing a securities risk. The **nonpublic offering exemption** applies if:

- the investors do not number more than 35 (husband and wife counting as one);
- all investors have a meaningful, pre-existing business or personal relationship with the syndicator;
- the investors will not resell or distribute the interests they acquire; and
- the solicitation of investors does not involve public advertising.[28]

Thus, when an investment program contains securities risks, the syndicator does not need to be further concerned with the securities law if their program falls under the 35-or-less interrelationship rule for the nonpublic offering of a security.

No blind pools with notice permit

Consider an MLB who receives funds from investors to purchase trust deed notes the MLB will originate or select. To evidence their receipt of the funds, the MLB executes interest-bearing promissory notes in favor of the investors.

After purchasing trust deed notes with the investors' funds as agreed, the MLB collaterally assigns the notes and trust deeds to the investors to secure the amounts evidenced by the promissory notes the MLB previously executed.

An investor loses money on the scheme and demands the return of their funds, plus 10% interest from the date they delivered the funds to the MLB. The investor claims the MLB's trust deed investment program violates *securities law* since the individual promissory notes issued to evidence the receipt of funds were not registered or qualified as corporate securities.

The MLB claims no corporate securities risk exists since the notes became fully secured by the collateral assignment of the trust deeds.

Has the conduct of the MLB created a **corporate securities risk** that placed the transactions under the control of the securities law, requiring the MLB to obtain a permit or qualify for an exemption?

Yes! The MLB placed the investor's capital at risk of loss by an activity controlled by the securities law. The funds were handed to the MLB in reliance on their skill in the **later selection** and delivery of trust deed notes. The success of the investment was inextricably bound to the MLB's **managerial expertise**

26 Bus & P C §10238(o)
27 Bus & P C §10238(p)
28 Calif. Corporations Code §25102(f)

in selecting a suitable investment after the investors released their funds to the MLB without treatment as trust funds. The investor had no choice in the selection of the trust deed note acquired before their funds were put at risk.[29]

Securities risk in a trust deed investment program

The mere acquisition or origination of one trust deed note by one investor, arranged by an MLB and fully identified to the investor before they release their funds, is not conduct that creates a security, called the **California risk capital test.**

When the investor advances funds through an escrow to purchase or originate a specifically identified trust deed note, the investor receives the full value of their investment by an absolute assignment or execution of the note, secured by a trust deed on real estate of sufficient current value.

However, a trust deed investment program does contain a securities risk as a blind pool arrangement when:

- funds are handed to the MLB for release *without first identifying* the specific trust deed note and security interest to be acquired in real estate; and
- the investor relies on the *skill and judgment* of the MLB to later locate and deliver a suitable trust deed investment in exchange for the funds the investor previously placed with the MLB.

The blind pool investment lacks specificity

In a blind pool investment, the investor puts up their money before a trust deed is located for purchase. In practice, the funds are readily available to the MLB for funding the acquisition of a trust deed note when the MLB later locates one they deem to be of suitable investment quality.

The investor does not initially invest their capital in a trust deed, but in the MLB's expertise to conduct due diligence investigations and to analyze and select a future trust deed investment. The MLB is given *carte blanche* to use the investor's funds as they see fit.

The securities risk is not in a trust deed, but in the performance of the MLB's implicit promise to later select and deliver to the investor a suitable trust deed note. Thus, lacking specificity of the investment, a corporate securities risk is created in the investment program entered into by this investor.

29 **Underhill** v. **Royal** (9th Cir. 1985) 769 F2d 1426

Chapter 47 Summary

A mortgage loan broker (MLB) syndicating trust deeds creates a corporate security when:

- they accept money from an investor or execute promissory notes before locating the real estate securing the trust deed, called a blind pool investment; or
- the trust deed is fractionalized among multiple investors rather than acquired by one trust deed investor for their own account.

However, an MLB may package multiple-lender trust deed investments and avoid securities violations, provided their conduct falls within one of two readily available exemptions from the securities law:

- the nonpublic offering exemption, called the 35-or-less interrelationship rule; and
- the public offering exemption, called the ten-or-less trust deed investment plan.

The mere acquisition or origination of one trust deed note by one investor, arranged by an MLB and fully identified to the investor before they release their funds, is not conduct that creates a security, called the California risk capital test.

However, a trust deed investment program does contain a securities risk as a blind pool arrangement when:

- funds are handed to the MLB for release without first identifying the specific trust deed note and security interest to be acquired in real estate; and
- the investor relies on the skill and judgment of the MLB to later locate and deliver a suitable trust deed investment in exchange for the funds the investor previously placed with the MLB.

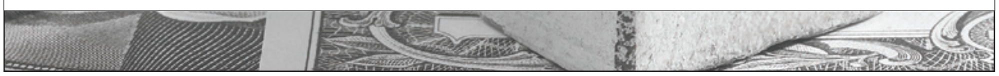
In a blind pool investment, the investor puts up their money before a trust deed is located for purchase.

The securities risk is not in a trust deed, but in the performance of the MLB's implicit promise to later select and deliver to the investor a suitable trust deed note, thus lacking specificity of the investment.

Chapter 47 Key Terms

Chapter 48

Modifying the mortgage note



Learning Objectives

After reading this chapter, you will be able to:

- distinguish between different scenarios for typical modifications of a note; and
- understand the process of modifying a note.

Key Terms

allonge
consumer mortgage
due-on clause
exculpatory clause
nonrecourse debt
novation
prepayment penalty
recourse debt
subordination

Modifying provisions in a note

During the life of a mortgage, the mortgage holder and owner of the mortgaged property may agree to **modify**, **add** or **rescind** one or more note provisions. Any change in the terms of a note requires:

- **mutual agreement** between the property owner and the mortgage holder; and
- **consideration** given in exchange for the modification, with the exception of bankruptcy. [See **RPI** Form 426]

Modifications of a mortgage usually arise out of a financial necessity experienced by the owner of the mortgaged property. Conversely, a carryback seller incurs profit taxes on receipt of a payoff of the mortgage which may prompt the seller to bargain for a modification to extend the time for payoff, and thus payment of profit taxes.

Negotiating to modify mortgage terms

The modification of a note is controlled by California **contract law**. Thus, a written contract — in this example the note evidencing a debt — is modified by:

- a *written agreement*; or
- an *oral agreement*.[1]

However, for an oral modification to be enforceable, both the mortgage holder and the property owner need to *execute* the oral agreement by taking action on it. To be certain of the terms as modified, they need to memorialize the modification in writing.

A property owner best initiates a written modification process by filling out a form submitted to the mortgage holder as an **offer to modify** the note. As with all forms, the form functions as a checklist of issues a well-informed agent considers when negotiating a modification, a malpractice risk-reduction issue.

When filled out, the agreement sets forth the terms sought by the person initiating the modification effort. A real estate agent traditionally facilitates negotiations with the mortgage holder on behalf of the owner. [See **RPI** Form 426]

Once the agreement to modify has been negotiated to set the new terms for payment and rates, the agent, broker or escrow officer prepares a **Modification of the Promissory Note** form. It is the *modification form*, a sequel to the *offer to modify* form, which actually changes the terms of the existing mortgage from those in the original note. [See **RPI** Form 425]

allonge
An attachment to a note occurring between preparation of the note and closing the transaction providing information necessary to update entries on the note at the time it becomes effective.

Provisions in the modification form:

- identify the note which is being modified;
- name the parties to the mortgage; and
- identify the trust deed and the mortgaged property involved.

To complete the paperwork called for in the agreement, the signed modification form is attached to the note as an **allonge**. The terms of the modification then become part of the original note.

Common reasons for a modification

consumer mortgage
A debt incurred primarily for personal, family, or household purposes and secured by a parcel of real estate containing one-to-four residential units.

Foreclosure prevention was one of the most common reasons for **consumer mortgage** modification during the 2000s. However, property owners and mortgage holders may agree to a mortgage modification for many reasons.

Common modifications include:

- a due date extension;
- interest rate changes;
- temporary or permanent changes in installment payment amounts or schedule;
- cash advances or accrued interest added to principal; and
- the addition of special provisions.

1 Calif. Civil Code §1698

Editor's note — Persons offering foreclosure consultant services to ***distressed homeowners*** *are subject to the federal Mortgage Assistance Relief Services (MARS) rule requiring special disclosures, advertising rules and fee restrictions.*

Very broadly, the rule only applies to mortgage brokers, real estate brokers and agents, attorneys and companies who offer consumer-mortgage relief plans, programs or services as part of their business. Mortgage holders who modify mortgages to assist struggling homeowners are not subject to the rule.[2] [See Chapter 35]

Extending the due date

Consider an owner of real estate who executes a business mortgage with a five-year due date.

Later, with the due date of the final/balloon payment approaching, the owner realizes they will be unable make the final payoff. The owner contacts the mortgage holder to negotiate a due date extension for the payoff of the mortgage.

The mortgage holder offers to extend the payoff date if the owner agrees to:

- a higher interest rate with increased monthly payments; and
- a credit check for any change in the owner's financial status since originally entering into the mortgage. [See **RPI** Form 302]

A change in the interest rates and payment terms

Consider a buyer and carryback seller who become entangled in a dispute following the close of escrow concerning the seller's **representations** of the property's condition. [See **RPI** Form 304]

The carryback seller offers to modify the mortgage, reducing the principal balance and the monthly payments to compensate the buyer for an over-valuation of the property based on undisclosed property facts. In exchange, the buyer releases the seller from any further claims concerning the condition of the property and the purchase transaction.

The buyer accepts the seller's offer to modify the mortgage and agrees to *release* the seller and *waive* the buyer's rights to any future claims. [See **RPI** Form 526]

Now consider an owner whose income-producing property is located on an earthquake fault. The existing business mortgage encumbering the property is a **recourse debt**.

recourse debt
A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

The owner is concerned about their future liability exposure in the event an earthquake renders the property valueless. If disaster reduces the property's value below the amount owed on the mortgage and the mortgage holder forecloses judicially, the owner is personally liable for the difference, called a **deficiency.** The owner wishes to eliminate this risk of loss.

2 12 Code of Federal Regulations §1015

exculpatory clause
A provision in a note secured by a trust deed which converts a recourse debt into nonrecourse debt to bar recovery by a money judgment against the borrower.

The mortgage calls for the owner to carry **earthquake insurance** which shifts the risk of loss from the owner to the insurance carrier. However, the premium for the insurance policy has become too expensive.

The owner seeks a mortgage modification with the mortgage holder, increasing the interest rate in exchange for:

- the elimination of the earthquake insurance provision; and
- a release of the owner from liability in the event circumstances beyond the owner's control impair the security, called an **exculpatory clause**.

Adding a special provision

Now consider a seller who carries back a mortgage containing a five-year due date. By its terms, the mortgage will soon be due.

However, the seller does not want the mortgage paid off at this time since *depreciation recapture* and **capital gains taxes** will be due on the profit from the final payoff. Also, the current market interest rate is much lower than the interest rate on the carryback note.

prepayment penalty
A levy charged by a mortgage holder to a borrower who pays off the outstanding principal balance on a mortgage prior to its maturity.

The seller wants to negotiate an extension of the due date and include a **prepayment penalty** provision in the note, sufficient to cover any profit taxes if the buyer pays off the mortgage early. The seller will lower the interest rate — possibly below market rates — in exchange for the buyer agreeing to the extension and *prepayment penalty* provision.

Editor's note — When the carryback mortgage in this scenario is a consumer mortgage, Regulation Z (Reg Z) rules govern the mortgage holder's ability to charge prepayment penalties.

Insuring trust deed priority

Most real estate-related debts are secured by a **lien** on title to the real estate. Such *liens* typically take the form of a recorded trust deed which describes the mortgaged property and is insured by a **title company**.

Thus, the mortgage holder needs **title insurance** to be assured of the continued **priority** of their trust deed lien relative to the junior interests on title to the real estate. Any agreement to modify the mortgage needs to be conditioned on re-insuring the trust deed by obtaining:

- an additional *title insurance policy;* or
- an *endorsement* to the mortgage holder's existing policy.

A title insurance policy is obtained or endorsed for the modification of a mortgage to assure the mortgage holder that any junior trust deed liens (such as a second mortgage) will still be considered junior to the modification. The person seeking the modification generally pays the premium charged for the title insurance policy.

In turn, the title insurance company will require any junior mortgage holder to sign a *specific subordination agreement* before re-insuring the trust deed securing the modified mortgage, even when a *future subordination agreement* exists permitting the owner to later modify the senior mortgage.

Junior lienholder is subordinated

When the modification of a senior mortgage puts a junior mortgage holder at a significantly greater risk of loss than already exists, the modified terms will not have *priority* to the pre-existing second. To avoid loss of priority on a significant modification, a junior mortgage holder needs to agree to take on the greater risk of loss, called **subordination**.

subordination
An agreement entered into by a mortgage holder to permit their security interest in title to the mortgaged property to take a junior position to another encumbrance.

Consider the holder of a first mortgage and property owner who modify the mortgage. The modification agreement:

- shortens the due date;
- raises the interest rate; and
- increases the amount of principal balance.

Later, the holder of a second mortgage secured by the property claims the first mortgage lost its priority since the modification significantly reduced the value of the second mortgage holder's security interest in the property.

The first mortgage holder claims only the modification agreement lacks priority to the second mortgage, not the mortgage's original note and trust deed, since only the modifications have the potential to impair the secured position of the second mortgage.

Here, the *modifications* to the first mortgage do not have priority over the second mortgage and thus cannot be enforced against the second mortgage holder. However, the *original terms* of the first mortgage note retain their priority. Thus, the second mortgage remains unimpaired by the modifications made to the first trust deed note and retains its original financial and legal position. The terms of the modification are essentially a third trust deed lien.[3]

Seller's breach of the due-on clause

Now consider a seller who carries back a second mortgage on the sale of their property. The property sold is subject to a first mortgage which contains a **due-on clause**. The holder of the first mortgage is not advised of the sale.

due-on clause
A trust deed provision used by lenders to call the loan immediately due and payable, a right triggered by the owner's transfer of any interest in the real estate, with exceptions for intra-family transfers of their home.

Later, the first mortgage holder learns of the sale and calls the mortgage due and immediately payable. To avoid the call, the buyer *assumes* the mortgage and modifies the note to shorten its due date.

On discovering the modifications, the carryback seller claims their second mortgage now has priority over the first since the first mortgage modification increases the risk of default, substantially impairing the seller's security interest.

In this example, the modification of the first mortgage without the junior carryback seller's consent does not result in a change in trust deed priorities.

3 **Lennar Northeast Partners** v. **Buice** (1996) 49 CA4th 1576

The mortgaged property was sold (and the seller accepted a second mortgage) without the first mortgage holder's written consent. Thus, the seller breached the *due-on clause* in the first mortgage holder's trust deed. Due to the breach, the first mortgage holder has no duty to avoid impairment of the owner's second trust deed lien.[4]

However, the modification of an *existing* junior mortgage does not trigger the due-on clause in senior trust deed liens on title to a property. Only the act of creating a *new security interest* — such as recording a mortgage — triggers the due-on clause.

The same rules apply to the modification of an existing lease on any type of property, with the exception of extensions beyond three years.

Modification to change priority

In some instances, a mortgage modification may be made to accommodate the deliberate change of lien priority.

Consider a seller who carries back a mortgage on the sale of a parcel of vacant land. Later, the buyer asks the carryback seller to *subordinate* their mortgage to a construction loan.

nonrecourse debt
A debt recoverable on default solely through the value of the security interest in the secured property.

Subordinating their mortgage lien to a construction loan with priority inherently increases the seller's risk of loss. As a result, the **nonrecourse** carryback mortgage is automatically converted to *recourse debt*.

In exchange for the seller's subordination to the construction loan, the buyer agrees to:

- modify the carryback mortgage to increase the interest rate and monthly payments;
- record a **Request for Notice of Delinquency**; and
- serve a copy of the *Request for Notice of Delinquency* on the construction lender. [See **RPI** Form 412]

Editor's note — Interest rate modifications on carryback notes are not subject to usury laws.[5]

When a modification or replacement note restructures a carryback debt and the debt remains secured solely by the property sold, the debt remains outside the usury law interest rate limits. Also, the debt retains its original nonrecourse, anti-deficiency character since the modified or replacement note evidences a continuation of the original carryback debt.[6]

4 **Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869
5 **DCM Partners** v. **Smith** (1991) 228 CA3d 729; CCP §580b
6 **Ghirardo** v. **Antonioli** (1994) 8 C4th 791; CCP §580b

Assumption

Mortgage modifications are also made when the mortgage is assumed by a buyer of the encumbered property. Here, the buyer arranges with a seller and the mortgage holder to take over the mortgage. Often on an assumption, a mortgage holder will seek a modification increasing their portfolio yield based on current factors such as:

- changes in market interest rates;
- the new owner's creditworthiness; or
- consideration for permitting the assumption.

Consider a buyer who is willing to cash out the seller's equity and assume the existing business mortgage which encumbers the property, called a **cash-to-loan (CTL)** transaction. The seller, however, is unwilling to remain liable for the recourse mortgage, even though the buyer agrees to assume it.

The seller's agent negotiates an arrangement agreeable to the mortgage holder, buyer and seller. The buyer assumes the existing mortgage and the mortgage holder releases the seller from further liability, a series of activities called a **novation**.

novation
An agreement entered into by a mortgage holder, buyer and seller to shift responsibility for a mortgage obligation to the buyer by an assumption and release the seller of liability.

The *novation agreement* is accompanied by a separate agreement to modify the mortgage. The modification is the *consideration* the mortgage holder demands for releasing the seller from liability for the mortgage. The modification agreement calls for:

- an increased interest rate and monthly payments; and
- an assumption fee paid to the mortgage holder.

Remember, special rules apply to assumptions of a *consumer mortgage*. An assumption triggers new consumer mortgage disclosures and adherence to the **ability-to-repay (ATR)** rules when:

- the mortgage is assumed by a buyer who will occupy the property as their principal residence;
- the mortgage holder expressly agrees to accept the buyer as the primary obligor; and
- the assumption agreement is in writing.

Thus, the assumption of an existing consumer mortgage on a property owner's principal residence is considered a new mortgage transaction whether or not its terms are modified.[7]

Refinancing

On a mortgage modification, the note itself is not cancelled or rewritten as it is secured by a trust deed. When a new note is executed to replace the original note, the dates of the new note and trust deed will differ, even though the debt evidenced by the new note remains the same with only a change in its terms for repayment.

7 12 CFR 1026.20(b); Official Interpretation of 1026.20(b)

Mismatched dates cause difficulty on **foreclosure** or **reconveyance** of the trust deed since the recorded trust deed refers to the secured debt as that evidenced by a note "of same date."

Additionally, on a consumer mortgage, cancelling and replacing an existing note with a new note is deemed a **refinance**, even when the new terms are substantially similar to the original terms. A *refinance* requires a Reg Z mortgage holder to provide new disclosures and apply ATR rules.[8]

A few exceptions to Reg Z exist for modifications to existing consumer mortgages. When a consumer mortgage modification meets the criteria of a refinance, it is exempt from new disclosures and ATR rules if it is:

- a *renewal* of a single-payment obligation with no change in the original terms;
- a *reduction* in the annual percentage rate (APR) with a corresponding change in the payment schedule;
- an agreement involving a *court proceeding*, such as a bankruptcy or settlement;
- a *pre-foreclosure workout* agreement (unless the interest rate or principal balance is increased); or
- a renewal of *optional insurance*, as long as required disclosures were provided at the original purchase of the optional insurance.[9]

However, the modifications above are only exempt from Reg Z disclosure requirements when undertaken by the mortgage holder who originated the mortgage. A refinancing by an assignee of the mortgage triggers new disclosures and application of the ATR rules, even when the refinancing falls into one of the exempt categories above.[10]

8 12 CFR §1026.17(a)(1)
9 12 CFR §1026.20(a)(1-5)
10 12 CFR §1026.20

Chapter 48 Summary

The modification, addition or rescission to one or more note provisions requires:

- mutual agreement between the property owner and the mortgage holder; and
- consideration given in exchange for the modification, with the exception of bankruptcy.

The modification of a note is controlled by California contract law. Thus, a note evidencing a debt is modified by a written or oral agreement. However, for an oral modification to be enforceable, both the mortgage holder and the property owner need to execute the oral agreement by taking action on it. To be certain of the terms as modified, the modification needs to be memorialized in writing.

Once the agreement to modify has been negotiated to set the new terms for payment and rates, the agent, broker or escrow officer prepares a Modification of the Promissory Note form.

The terms of the modification then become part of the original note when the signed modification form is attached to the note as an allonge.

Most real estate-related debts are secured by a lien on title to the real estate in the form of a recorded trust deed which describes the mortgaged property and is insured by a title company. Title insurance assures the mortgage holder of the continued priority of their trust deed lien relative to the junior interests on title to the real estate.

When the modification of a senior mortgage puts a junior mortgage holder at a significantly greater risk of loss than already exists, the modified terms will not have priority to the pre-existing second. To avoid loss of priority on a significant modification, a junior mortgage holder needs to agree to take on the greater risk of loss, called subordination.

In some instances, a mortgage modification may be made to accommodate the deliberate change of lien priority. Mortgage modifications are also made when the mortgage is assumed by a buyer of the encumbered property.

On a mortgage modification, the note itself is not cancelled or rewritten as it is secured by a trust deed. When a new note is executed to replace the original note, mismatched dates will cause difficulty on foreclosure or reconveyance of the trust deed since the recorded trust deed refers to the secured debt as that evidenced by a note "of same date."

Chapter 48 Key Terms

exculpatory clause .... **pg. 526**
nonrecourse debt .... **pg. 528**
novation .... **pg. 529**
prepayment penalty .... **pg. 526**
recourse debt .... **pg. 525**
subordination .... **pg. 527**

Chapter
49

Trust funds

Learning Objectives

After reading this chapter, you will be able to:

- identify the general laws and regulations governing broker-held trust funds;
- manage, receive, deposit, hold and disburse trust funds;
- obtain DRE approval and handle the receipt of advance fees; and
- understand trust fund recordkeeping and accounting procedures.

Key Terms

advance fee	**overage**
commingling	**pledge**
conversion	**subaccount ledger**
good faith deposit	**trust funds**

Introduction to trust funds

Real estate brokers and their agents often handle other people's items which have or evidence monetary value, called **funds.** *Funds* belonging to others which a broker and their agents handle when acting as agents in a transaction are called **trust funds.**

trust funds
Items which have or evidence monetary value held by a broker for a client when acting in a real estate transaction.

Trust funds include:

- rents and security deposits collected under a prope5rty management agreement [See **RPI** Form 590];
- **good faith deposits** tendered by a buyer or tenant with an offer to purchase or lease;
- fees and costs handed to the broker in advance of their performance of agreed-to services;

good faith deposit
A money deposit made by a buyer to evidence their good faith intent to buy when making an offer to acquire property. Also known as earnest money. [See RPI **Form** §1.1]

- mortgage payments and funds on contract collection and mortgage brokerage; and
- any other personal property of value.

Trusts funds are held by brokers for safekeeping and may not be treated casually. **Recordkeeping** and accounting requirements are imposed on brokers when they receive, transfer or disburse trust funds.

Identification of trust funds

Brokers, while acting on behalf of others in their capacity as agents in real estate transactions, receive funds which are not theirs and are *held in trust* for the owner of the funds. These trust funds include:

- deposits on offers to purchase and applications to rent or borrow;
- fees advanced for any brokerage services to be provided in the future, called *advance fees;*
- funds advanced for future costs;
- funds from sellers, borrowers and landlords as reserves to cover future costs;
- rental income and tenant security deposits;
- funding for a mortgage or the purchase of real estate; and
- proceeds from a sale or financing.

Trust funds are received by a broker, or by an employee acting on behalf of the broker. Employees acting on behalf of a broker include:

- sales agents;
- broker-associates;
- resident property managers; and
- office personnel.

Managing a mortgage brokerage trust account

Consider a **mortgage loan broker (MLB)** who maintains a trust account. The trust account contains mortgage payments received by the MLB while servicing mortgages on behalf of trust deed investors.

The MLB **pledges** the trust account to secure a personal loan from the same bank which holds the trust account.

pledge
To offer an asset (such as an existing carryback note) as collateral or security for another, unrelated debt.

The broker defaults on the personal loan, and the bank seizes the trust account funds.

An investor seeks to recover their trust account funds from the bank, claiming the bank's seizure of the funds is a **conversion** since trust funds cannot be taken to satisfy the broker's personal debt.

conversion
The unlawful appropriation of another's property, as in the conversion of trust funds.

The bank claims the seizure of the trust account is not a *conversion* since it exercised its right to an offset under the security agreement.

Is the investor entitled to recover their portion of the trust funds?

Yes! The trust funds belong to the investor and need to be returned. The bank's right to an offset for the broker's personal debt to the bank does not extend to seizure of funds held for others in the broker's trust account.[1]

Handling cash and checks

Funds received in the form of cash or checks made payable to the broker while acting as an agent need to be:

- deposited into the broker's trust account;
- held undeposited as instructed; or
- endorsed and handed to others entitled to the funds.

Trust funds received in the form of checks or cash may only be used for expenditures authorized and incurred for the benefit of the owner of the funds.

Further, the broker needs to regularly account to the owner on the status, expenditure and location of the negotiable trust funds, called an **owner's statement.**

Prior to the end of the *third business* day following the day the broker receives negotiable trust funds, the broker needs to deposit the funds:

- with the *person or escrow* depository entitled to the funds (as payee or by endorsement); or
- in a *trust account* maintained by the broker at a bank or other state-recognized depository.[2]

Also, when an agent of the broker accepts trust funds on behalf of the broker, the agent needs to immediately deliver the funds to the broker, unless directed by the broker to:

- deliver the trust funds to the person or the escrow entitled to the funds; or
- deposit the trust funds into the broker's trust account.[3]

Identifying the owner

A broker needs to know who owns and controls the funds held in their trust account at all times. Trust funds may only be disbursed on the authorization of the owner of the funds. **Subaccount ledgers** are set up to identify the owner of funds and the amount held for the owner.

subaccount ledger
An accounting document or file identifying the owner of trust funds and the amount held for the owner.

However, persons other than the owner of the trust funds may have an interest in the funds. If so, their authorization is also required to withdraw the funds.

1 **Chazen** v. **Centennial Bank** (1998) 61 CA4th 532

2 Calif. Business and Professions Code §10145; Calif. Department of Real Estate Regulations §2832(a)

3 Bus & P C §10145(c)

Advance fee trust fund accounting

advance fee
A fee paid in advance of any services rendered.

Broker fees deposited with the broker before they are earned are called **advance fees**. *Advance fees* will be deposited in the broker's trust account. The funds belong to the client of the broker, not the broker. The broker may not withdraw the funds before they are earned and a statement is sent to the client.

In addition to trust fund *accounting requirements*, a broker will send the client a **verified accounting for the advance fees**:

- no later than the end of each calendar quarter, and
- at the time the contract between the broker and client is fully performed.

The verified accounting for the advance fees will include:

- the name of the broker;
- the name of the client;
- a description of the services rendered or to be rendered;
- an identification of the trust fund account where the advance fee is deposited; and
- the amount of the advance fee collected.[4]

In addition, the verified accounting will include the amount disbursed for each of the following:

- costs for *agreed-to services*;
- *fees* paid to field agents and representatives; and
- *overhead costs* and *profits*.[5]

When an advance fee is disbursed from the account for advertisement, the verified accounting will include:

- a copy of the advertisement;
- the name of the publication in which the advertisement appeared; and
- the number of ads published and the dates they appeared.[6]

Further, when the advance fee is connected to a mortgage origination, the verified accounting will include a list of the names and addresses of the persons to whom the information pertaining to the loan requirements was submitted, and the dates the information was submitted.[7]

The amounts placed in the trust account may be withdrawn:

- when expended for the *benefit of the client*; or
- on the *fifth day* after the verified accounting is mailed to the client.[8]

4 DRE Regs. §2972
5 DRE Regs. §2972(f)
6 DRE Regs. §2972(g)
7 DRE Regs. §2972(h)
8 Bus & P C §10146

Approval of advance fee agreements

At least ten calendar days before a broker may solicit or agree to receive an advance fee, the broker needs to submit the advance fee agreement and any materials used with the agreement to the Commissioner of the **Department of Real Estate (DRE)** for approval.[9]

If the Commissioner, within ten calendar days of receipt, determines the material might mislead clients, the Commissioner will order the broker to refrain from using the material.[10]

To be approved by the Commissioner, the *advance fee agreement* and any materials used with the agreement will:

- contain the total amount of the advance fee and the date or event the fees will become due and payable;
- list a specific and complete description of the services to be rendered to earn the advance fee;
- give a definite date for full performance of the services described in the advance fee agreement; and
- contain no false, misleading or deceptive representations.[11]

Further, the advance fee agreement may not contain:

- a provision relieving the broker from an obligation to perform verbal agreements made by their employees or agents; or
- a guarantee the transaction involved will be completed.[12]

The withdrawal of trust funds

Checks or cash are frequently made payable and handed to a broker during a transaction. These items are trust funds since they do not belong to the broker. Rather, checks payable to the broker and cash are received "in trust" by the broker and held on behalf of the client. These funds will be deposited by the broker into a **non-interest bearing trust account**, unless endorsed and handed to others as instructed by the client.

The *trust account* opened for the deposit of cash and items payable to the broker will be in the name of the broker, as **trustee**, at a bank or a state-recognized depository.[13]

Once trust funds are deposited, they may only be withdrawn or disbursed as authorized and instructed by the owner of the funds. A third party who has an interest in the funds, such as a seller who acquires an interest in the buyer's *good faith deposit* on acceptance of a purchase agreement offer, may also need to authorize disbursement.[14]

Withdrawals or disbursements from the trust account in the name of an **individual broker** will be made under the signature of:

- the broker named as *trustee* on the account;

9 DRE Regs. §2970
10 Bus & P C §10085
11 DRE Regs. §2970(b)
12 DRE Regs. §§2970(b)(4), 2970(b)(5)
13 Bus & P C §10145
14 Bus & P C §10145(a)(1)

- a licensed broker or sales agent employed by the named broker under a broker-agent employment agreement [See **RPI** Form 505]; or
- an unlicensed employee of the named broker, provided the unlicensed employee is **bonded** for the total amount of the trust funds the employee can access.[15]

A **signer** is an employee other than the broker-employer who has written authorization from the broker to withdraw or disburse funds from the trust account. This authority is either included in an addendum to the employment agreement or provided in the agreement itself.

When the trust account is in the name of a **corporate broker** as trustee, withdrawals are made by:

- the **designated officer (DO)** who qualified the corporation as a licensed broker; or
- a licensed or unlicensed employee with the written authorization of the DO.[16]

The authorization from the corporation is made as part of the employment agreement with each signatory. [See **RPI** Form 505, 510 or 511]

However, a broker's written delegation to others who are signers on the trust account does not relieve the individual broker or the DO of a corporate broker from liability for any loss or misuse of trust funds.[17]

To help prevent an improper withdrawal by an individual signer, the broker may require two signatures on trust account withdrawals. An *insurance policy* for the brokerage business needs to include coverage for theft by employees who have direct or indirect access to trust funds.

Interest-bearing accounts

The broker may agree to place trust funds in an **interest-bearing** account when requested by the owner of the funds.

However, the broker is under no obligation to comply with the owner's request if they notify the owner they will not place the trust funds in an interest-bearing account.[18]

When the broker agrees to place the owner's trust funds in an interest-bearing trust account:

- a separate trust account will be established solely to hold the owner's trust funds;
- the trust account will be in the name of the broker as trustee, with the owner named as the specified *beneficiary*;
- the trust account will be insured by the Federal Deposit Insurance Corporation (FDIC); and

15 DRE Regs. §2834(a)
16 DRE Regs. §2834(b)
17 DRE Regs. §2834(c)
18 Bus & P C §10145(e)

- the broker and their agents may not receive any interest earned by the trust account, even if agreed to by the owner of the trust funds.[19]

Also, when trust funds are to be placed in an interest-bearing account, the broker is to first disclose:

- how interest is calculated on the account;
- who will receive the interest;
- who will pay bank service charges; and
- any penalties or notice requirements for withdrawal.[20] [See Form 535 accompanying this chapter]

Improper commingling

When a broker deposits trust funds into an account used to receive and disburse personal or business funds, the broker has improperly **commingled** the funds. Similarly, *improper commingling* occurs when the broker places or leaves personal funds in a trust account.[21]

commingling
The mixing of personal funds with client or third-party funds held in trust.

A broker is only permitted to commingle personal or business funds with trust funds in the following two DRE-authorized situations:

1. the broker may maintain a deposit of up to *$200 of their own funds* in the trust account to cover bank service charges on the account; and
2. fees or reimbursement for costs *due the broker* from the trust funds may remain in the trust account for up to 25 days before being disbursed to the broker.[22]

Except to the limited extent authorized by the DRE, commingling is improper.

The improper commingling of trust funds exposes the broker to a complaint and revocation or suspension of their license.[23]

Maintaining trust account integrity

Records maintained by the broker for their trust accounts document and track the broker's **receipt and disbursement** of trust funds. However, recordkeeping alone will not protect the broker against dishonest employees.

The assurance all trust funds are correctly deposited, credited and disbursed is best accomplished by maintaining a *written journal* or *digital accounting system*. However, even the best accounting procedures do not protect against deliberate diversion of trust funds by others.

The broker named as trustee on a trust fund account is responsible for funds held in the account. The broker is liable even when others sign on the account with authorization to make withdrawals from the account.[24]

Occasionally, it is unfeasible for the broker to personally enter and maintain each accounting transaction and conduct the reconciliation required by the

19 Bus & P C §10145(d)
20 Bus & P C §10145(d)(4)
21 **Stillman Pond, Inc.** v. **Watson** (1953) 115 CA2d 440
22 DRE Regs. §2835
23 Bus & P C §10176(e)
24 DRE Regs. §2834(c)

Form 535

Interest-Bearing Trust Account Agreement

INTEREST-BEARING TRUST ACCOUNT AGREEMENT

NOTE: This form is used by a broker or their agent when handed funds for deposit into a trust account held by the broker which account the owner requests be interest bearing, to identity the depository and terms for the interest-bearing trust account.

DATE: ________________, 20_____, at ____, California.

Items left blank or unchecked are not applicable.

This agreement regarding the handling of trust funds is between ____________________________, as the Broker, and ____, as the Depositor.

1. Depositor hearby requests Broker to hold under this agreement those trust funds in the amount of $______________ handed to Broker by Depositor on execution of this agreement.

1.1 The funds are held in trust to be disbursed for the purpose of completing Depositor's performance under an agreement entitled ____, dated __________________, 20_____, entered into by Depositor and ____________________________.

2. Broker is hearby authorized and instructed to deposit the trust funds into an interest-bearing trust account with ______________________________________, as the Depository, being a bank, thrift, credit union or industrial loan company whose accounts are insured by the Federal Deposit Insurance Company (FDIC).

The address of the branch or location of the Depository is ____.

2.1 The trust account to be in the name of Broker, as trustee for ☐ Depositor, or ☐ ________________________.

2.2 All funds in the trust account to be covered by FDIC insurance or other insurance by an agency of the United States.

2.3 The type of interest-bearing account to be ☐ passbook, ☐ time certificate, or ☐ ________________________.

2.4 The annual rate of interest accruing on the account to be ____ %. ________________________________.

2.5 Interest accruing on the deposit to be compounded ☐ daily, ☐ monthly, or ☐ quarterly.

2.6 A service charge ☐ is, or ☐ is not, imposed on the account by the Depository.

a. If a service charge is imposed, it is to be deducted and paid from interest accruing on the account.

2.7 Interest earned on the trust funds is to be paid to ☐ Depositor, or ☐ ______________________________, on (event) ____.

a. Under no circumstances may the interest be paid, directly or indirectly, to Broker or a licensed person employed by Broker.

2.8 Withdrawal of the trust funds from the account prior to __________ days after deposit with the depository, or without ______ days prior notice, shall subject the funds to a penalty of $________________ for early withdrawal.

3. The trust account shall hold no other funds belonging to Broker or held by Broker for others as trust funds.

4. The trust account number is ____________________________.

4.1 Broker is authorized and instructed to enter the account number on this agreement when it is known to Broker, and notify Depositor and other party named at §2.7 of the account number by promptly handing them a copy of this agreement containing the account number or sending a copy by regular USPS mail service.

5. Should these trust funds accepted by Broker be for use in a real estate related transaction (purchase, lease, or loan), the other parties to the transaction must consent to this agreement by signing the third party approval provision below.

I agree to the terms stated above.
Date: ______________, 20_____
Broker: ______________________________
Broker's CalBRE #: ______________________
Agent: ______________________________
Agent's CalBRE #: ______________________

Signature: ______________________________

I agree to the terms stated above.
Date: ______________, 20_____
Depositor's Name: ______________________
Social Security #: ______________________

Signature: ______________________________

I have read and approve this agreement.
Date: ______________, 20_____
Third Party's Name: ____________________

Signature: ______________________________

FORM 535 09-15

DRE. Banks and other depositories send a monthly statement of the account to each account holder for the purpose of verifying the validity of the deposits, withdrawals and charges on the account. The broker can best protect the trust funds from unauthorized withdrawals by personally receiving and reviewing bank statements before anyone else.

The broker, to maintain the integrity of the trust account, is to make sure the statement is:

- mailed to the broker's office and handed to them unopened;
- held by the bank and personally picked up by the broker; or
- sent to the broker's residence instead of the office.

When unauthorized withdrawals occur, the broker will discover them by reviewing the bank statement and the accompanying deposit tickets and paid checks before anyone else has access to the statement.

In the event the broker discovers an unauthorized withdrawal due to forgeries or improper endorsements, the broker is to notify the bank within 30 days of receiving the statement. The notice of improper payment of checks by the bank will enable the broker to recover the amount of the unauthorized payment.[25]

Any loss from the trust account not covered by the bank will be covered by the broker. Thus, to protect the broker from unrecoverable losses, business insurance is to include coverage for employee theft.

Trust account bookkeeping

The broker's bookkeeping for each trust account maintained at a bank or thrift includes entries regarding:

- the amount, date of receipt and source of all trust funds received;
- the date the trust funds were deposited in the broker's trust account;
- the date and check number for each disbursement of trust funds previously deposited in the trust account; and
- the daily balance of the trust account.[26]

Entries in the **general ledger** for the overall trust account are to be in *chronological order* of occurrences and formatted in columns. The ledgers may be maintained in either a computer program or a written journal.[27]

Editor's note — Computer programs have been developed that allow the broker to make a single entry for the receipt and disbursement of trust funds from the trust account under an account number given to the owner of the funds, called a beneficiary. On completing the entry, the program automatically generates reports for the overall trust account, each owner's subaccount and the statements to be sent to each owner of trust funds.

In addition to the *general ledger* of the entire trust account, the broker also maintains a separate *subaccount ledger* for each owner of the trust funds. The subaccount ledger lists each deposit and disbursement from the broker's trust account on behalf of each owner of the trust funds.

25 Calif. Commercial Code §4406
26 DRE Regs. §2831(a)
27 DRE Regs. §2831(c)

The subaccount ledger identifies:

- the date and amount of trust funds *deposited*;
- the date, check number and amount of each *disbursement* from the trust account;
- the date and amount of any *interest earned* on funds in the trust fund account; and
- the total amount of trust *funds remaining* after each deposit or disbursement from the trust account.[28]

Undeposited trust funds

Separate handling rules apply to funds not deposited in a trust account. Here, the broker maintains a **trust fund ledger** separate from the trust account identifying:

- the location of any trust funds received but not deposited in the trust account; and
- the date the funds were returned or forwarded, such as a check, cashier's check, cash or promissory note that is not deposited in the broker's trust account.[29]

A broker need not keep records of checks made payable to others for services, such as escrow, credit reports and appraisal services, when the total amount of all such checks for any one transaction does not exceed $1,000.[30]

However, it is best practice to make the entries since the broker is to account for the receipt and distribution of these checks on request from:

- the **DRE**; or
- the maker of the check exempt from entry in the trust fund ledger.[31]

All records of trust funds are retained by the broker for **three years** after the closing or cancellation of the transaction involving the trust funds.[32]

Lack of proper accounting records is grounds for suspension or revocation of the broker's license.[33]

Monthly reconciliation

Brokers maintaining bank trust accounts are to reconcile the general ledger for the entire trust account against the separate subaccount ledger of each person and each transaction in the subaccounts. Brokers are to reconcile these accounts at least once during each calendar month deposits or withdrawals are made.

The monthly reconciliation of the bank trust account contains:

- the name of the bank or thrift where the trust account is located and the account number;

28 DRE Regs. §2831.1
29 DRE Regs. §2831(a)(6)
30 DRE Regs. §2831(e)
31 DRE Regs. §2831(e)
32 Bus & P C §10148(a)
33 **Apollo Estates, Inc.** v. **Department of Real Estate** (1985) 174 CA3d 625

- the date of the reconciliation;
- an identification of each subaccount in the trust account documenting the deposits, withdrawals and disbursement for each person; and
- the amount of funds remaining held in trust on behalf of each person.[34]

Ownership of an unexplained overage

Occasionally due to error, the amount of all funds held in a trust account exceeds the amount of trust funds held in all the subaccounts for individuals. This condition is known as an **overage**.

overage
A surplus amount in a trust account exceeding the amount of trust funds held in all the subaccounts for individuals.

An *overage* occurs when the broker cannot determine the owner of the excess funds. The excess, however, is not the result of the broker's *commingled funds*.

The overage generally arises due to *mathematical errors*. These math errors typically occur in the entry of deposits or withdrawals, bank records or failure to identify the owner of the funds when deposited or withdrawn and entered in the trust account records.

Unexplained excess funds in a trust account are still trust funds, even though the ownership of the funds cannot be determined.

An unexplained overage may not be withdrawn for the broker's business or personal use. Further, an unexplained overage may not be used to offset shortages on individual subaccounts in the trust account.

Excess funds are not the broker's funds as the broker cannot demonstrate they have instructions to withdraw them. Unexplained trust account overages remain in the trust account, or may be placed in a separate trust fund account established to hold unexplained overages.

Ultimately, the excess funds *escheat* to the state, unless the ownership of the unexplained overage is determined within three years of the discovery of the overage.[35]

Commingling, conversion and restitution

Trust fund handling is regulated by a variety of *penalties and consequences*. A broker who misuses trust funds is subject to penalties, including:

- *civil liability* for money wrongfully converted;
- *disciplinary action* by the DRE;
- *income tax liability*; and
- *criminal sanctions* for embezzlement.

The penalty depends on the nature of the funds which the broker misuses. For example, penalties for a broker's misuse of advance fees held in trust accounts are specifically fixed by statute.

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34 DRE Regs. §2831.2

35 Calif. Code of Civil Procedure §§1500 et seq.

When the broker misuses advance fees, the owner of the funds may recover treble damages plus attorney fees from the broker. A broker who fails to account for advance fees is presumed to be guilty of **embezzlement**.[36]

However, the existence of specific statutory provisions relating to the misuse of advance fees does not mean the misuse of other types of trust funds will go unpunished. Penalties for the misuse of trust funds for other purposes fall under more general statutory schemes.

Violations subject to DRE discipline

If the DRE Commissioner determines a broker violated trust fund accounting rules, the Commissioner may obtain an injunction against the broker to stop or prevent the violation.[37]

The Commissioner may also include a claim for **restitution** on behalf of clients injured by the broker's misuse of trust funds.[38]

When the DRE conducts an audit of the broker's trust account and discovers the broker has **commingled** or **converted** more than $10,000 of trust funds, the broker's license may be suspended pending a formal hearing.

After the hearing, a *receiver* may be appointed to oversee the broker's business. The receiver is allowed to exercise any power of the broker and may file for bankruptcy on behalf of the broker.[39]

Commingling of trust funds is grounds for suspension or revocation of the broker's license.[40]

36 Bus & P C §10146
37 Bus & P C §10081.5
38 Bus & P C §10081(b)
39 Bus & P C §10081.5
40 Bus & P C §10176(e)

Chapter 49 Summary

Real estate brokers and their agents often handle other people's items which have or evidence monetary value, called funds. Funds belonging to others which a broker and their agents handle when acting as agents in a transaction are called trust funds.

Trust funds received in the form of checks or cash may only be used for expenditures authorized and incurred for the benefit of the owner of the funds.

The broker needs to regularly account to the owner on the status, expenditure and location of the negotiable trust funds, called an owner's statement.

Broker fees deposited with the broker before they are earned are called advance fees, and are deposited in the broker's trust account. The funds belong to the client of the broker, not the broker.

Before a broker may solicit or agree to receive an advance fee, the paperwork documentation needs to be submitted to the Commissioner of the Department of Real Estate (DRE) for approval.

Checks or cash are frequently made payable and handed to a broker during a transaction. These items are received "in trust" by the broker and held on behalf of the client. These funds will be deposited by the broker into a non-interest bearing trust account, unless endorsed and handed to others as instructed by the client.

Once trust funds are deposited, they may only be withdrawn or disbursed as authorized and instructed by the owner of the funds. A third party who has an interest in the funds, such as a seller who acquires an interest in the buyer's good faith deposit on acceptance of a purchase agreement offer, may also need to authorize disbursement.

The broker may agree to place trust funds in an interest-bearing account when requested by the owner of the funds. However, the broker is under no obligation to comply with the owner's request if they notify the owner they will not place the trust funds in an interest-bearing account.

When a broker deposits trust funds into an account used to receive and disburse personal or business funds, the broker has improperly commingled the funds. The improper commingling of trust funds exposes the broker to a complaint and revocation or suspension of their license.

Separate handling rules apply to funds not deposited in a trust account. Here, the broker maintains a trust fund ledger separate from the trust account.

Occasionally due to a mathematical error, the amount of all funds held in a trust account exceeds the amount of trust funds held in all the subaccounts for individuals, a condition known as an overage.

Trust fund handling is regulated by a variety of penalties and consequences. If the DRE Commissioner determines a broker violated trust fund accounting rules, the Commissioner may obtain an injunction against the broker to stop or prevent the violation.

Chapter 49 Key Terms

advance fee .... **pg. 536**
commingling .... **pg. 539**
conversion .... **pg. 534**
good faith deposit .... **pg. 534**
overage .... **pg. 543**
pledge .... **pg. 534**
subaccount ledger .... **pg. 535**
trust funds .... **pg. 533**

Contract collection services

Chapter

50

Learning Objectives

After reading this chapter, you will be able to:

- understand the licensing requirements for entering into a loan servicing agreements; and
- identify the basic services of a broker when acting as a servicing agent.

Key Terms

all-inclusive trust deed (AITD)
consumer mortgage
contract collection
hypothecation
mortgage-backed loan (MBL)

The need for contract collection agents

An agreement to act as a **servicing agent** employed by a mortgage holder to handle the *collection and accounting* for payments and *perform services* for a fee on promissory notes — secured directly or collaterally by liens on real estate — is entered into by brokers licensed by the **Department of Real Estate (DRE)**.[1]

contract collection
The collection and accounting for payments on a promissory note for a fee.

This is a professional business opportunity known as **contract collection,** and arises with:

- the creation of a carryback mortgage by a seller of real estate on credit;
- the making of a mortgage evidenced by a note executed in favor of a mortgage lender and secured by a trust deed lien on real estate, a process called *mortgage origination*;

1 Calif. Business and Professions Code §§10131(d), 10131.1

mortgage-backed loan (MBL)
A loan secured by the assignment of an existing note and trust deed.

hypothecation
The pledging of something as security without the necessity of giving up possession to it.

- the making of a **mortgage-backed loan (MBL)** evidenced by a note executed in favor of the lender and secured by the assignment of an existing note and trust deed held by the borrower, a financing activity called **hypothecation**; or
- the purchase of an existing trust deed note by a trust deed investor.

A mortgage holder may not have the time or the temperament to maintain monthly bookkeeping records and prepare notices to properly service the debt owed them on a mortgage or *MBL*.

Rather than risk accounting errors and dilatory policing of delinquencies, a mortgage holder may prefer to transfer the responsibility of servicing the mortgage to a broker.

Brokers engaged in *contract collection* use **loan servicing software.** With its use, the broker keeps a detailed accounting. Payments are broken down into principal and interest, and impounds are collected and disbursed for taxes and insurance. Further, the software's detailed statements and printouts include monthly amortization of principal over the remaining life of the mortgage, as well as the amount of the final/balloon payment when the mortgage or MBL comes due.

Loan servicing agreement

A DRE-licensed broker does not need a special endorsement or permit to perform compensable contract collection services for a noteholder.

A broker servicing a note secured directly or collaterally by real estate needs written authorization, commonly called a **loan servicing agreement**, entered into by the noteholder and the broker.[2] [See **RPI** Form 237]

When a broker arranges a mortgage or negotiates the sale of a trust deed note and further agrees to service the debt on behalf of the noteholder, they retain possession of the note on the close of the transaction. Here, the transfer and delivery of the interest the noteholder acquired is perfected, even though the broker retains possession of the note, since:

- the trust deed or assignment of the trust deed note is recorded with the county recorder; and
- the note is made payable to the noteholder, or endorsed or assigned to them.[3]

A *loan servicing agreement* contains provisions detailing:

- how the broker will receive, deposit, disburse and account for the payments received on the note;
- what activities the broker will perform on default by the property owner;
- what fee may be charged and in what amounts for the services rendered; and
- how the loan servicing agreement may be terminated. [See **RPI** Form 237]

2 Bus & P C §10233
3 Bus & P C §10233.2

The trust funds account

A DRE-licensed broker acting as a *servicing agent* for a noteholder receives funds from the property owner which are not handed directly to the noteholder. Thus, the broker deposits the funds they receive into a **trust fund account** to be held and disbursed by the broker as instructed by the noteholder.[4]

Occasionally, the noteholder requests their funds be placed in an interest-bearing account. Here, if agreeable, the broker servicing the note places the funds in an interest-bearing *trust fund account*:

- in the name of the broker as trustee for the noteholder;
- separate from the broker's own personal funds;
- covered by federal deposit insurance;
- disclosing the nature of the account:
  - how interest is calculated and paid;
  - the nature of service charges; and
  - requirements and penalties for withdrawal; and
- that does not earn interest for the direct or indirect benefit of the broker.[5] [See **RPI** Form 535]

Trust fund accounts maintained by the broker are to reflect the correct amount of funds currently held for others by the broker — no overages, no deficiencies and no commingling with the broker's personal funds.[6]

The broker keeps a separate record of all trust funds received and disbursed on each note they service under contract collection.[7]

In each record, the broker accounts for the handling of all funds deposited into the trust account, including:

- the participants in the transaction;
- the exact amount of the funds;
- the date received and deposited; and
- the amount and date of each disbursement.[8]

Typically, a broker reports to the noteholder on receipt of the monthly payment. However, a client is minimally entitled to a statement of accounting at the end of each calendar quarter (i.e., March, June, September and December).[9]

Disbursement of trust funds

The broker acting as a servicing agent disburses the net proceeds from the payments received as instructed by the noteholder. The broker's servicing fee is deducted from the funds received and paid when funds are disbursed to the noteholder.

4 Bus & P C §10145(a)
5 Bus & P C §10145(d),(e)
6 Bus & P C §10081.5
7 Calif. Department of Real Estate Regulations §2830
8 DRE Regs. §2831.1
9 Bus & P C §10146

To disburse deposited funds, the broker draws two checks on the trust account:

- one to themselves for their contract collection service fee; and
- one to the noteholder for the portion of the monthly payment remaining.

The loan servicing agreement may instruct the broker to deposit the noteholder's net proceeds from the payment directly to the noteholder's bank account to avoid processing inconveniences, delays and errors.

The brokerage fee

How much the broker charges as a service fee is a matter of negotiation between the broker and the noteholder.

The fee typically reflects:

- the direct time and money costs of administering the contract collection of the individual note;
- a share of general operating overhead; and
- a net income for the broker's efforts.

A **set-up fee** is often charged by the broker to enter into the servicing agreement and set up the accounting.

The broker's actual costs for handling the servicing of any individual account are small. After the initial set-up expenses, bookkeeping, postage and general overhead are the broker's monthly ongoing out-of-pocket operating expenses.

Servicing fees are often charged as a percentage of:

- the interest collected each month, say 6%; or
- the principal balance on the note, say 0.5%.

The broker accounts for payment of their service fee in the accounting statement sent to the noteholder.

Conversely, when the note and trust deed call for the property owner to pay the servicing agent's fee, it is charged to the property owner.

The fee paid by the property owner is an "add-on" amount due with each installment on the note. The accountings to the property owner and the noteholder each reflect the payment of the fee.

The broker and the noteholder may also agree any late charge collected will be retained by the broker for reimbursement of their further collection efforts required on delinquent payments. Occasionally, the broker also receives some or all of any prepayment penalty as compensation for premature termination of the loan servicing agreement and the resulting loss of expected future fees.

Request for notice

When agreeing to act as a servicing agent, the broker reviews the noteholder's title insurance for any other encumbrances on the secured real estate. If not already recorded, the broker, on behalf of the noteholder, prepares a **Request for Notice of Default** and a **Request for Notice of Delinquency** for each senior encumbrance, obtains signatures and records them. [See **RPI** Form 412, 412-1 and 412-2]

The broker requests that any notice of default (NOD) or notice of delinquency (NODq) be mailed directly to the noteholder. However, the property owner's consent is needed for a *Request for NODq* to be effective. Without the property owner's consent authorizing the senior mortgage holder to send an NODq to the noteholder, the senior mortgage holder need not send one. Unless a recorded Request for NODq is obtained when the trust deed note is originated, the property owner is not obligated to later consent to an NODq. [See **RPI** Form 412-2]

The broker files the *Request for NOD* and the Request for NODq with the county recorder of the county in which the property is located. The Request for NOD is filed on behalf of each noteholder named on the note being serviced.

By confirming a Request for NOD exists, or preparing and recording a Request for NOD when one does not exist, the broker ensures the noteholder will be notified when a senior mortgage holder commences foreclosure and thus threatens the noteholder's security interest in the real estate.

Further, by confirming or recording the Request for NOD, the broker handling a contract collection is relieved of the continuing duty to report to the noteholder any NODs recorded by senior mortgage holders on the property. [10]

When no Request for NOD is recorded in the noteholder's name and address, the broker is obligated to notify the noteholder of any NOD recorded by a senior mortgage holder by the later of:

- three business days of the broker's receipt of information on the recording of an NOD; or
- 15 days after recordation.[11]

Foreclosure and multiple demands for payments

The noteholder may agree the broker servicing the note is to record an NOD to commence foreclosure on behalf of the noteholder when a default in payments occurs.

When the broker records an NOD, the broker gives the noteholder a copy of the NOD within 15 days of recordation.[12]

The broker then cancels the loan servicing agreement and returns the trust deed note to the noteholder or the trustee, as instructed by the noteholder.

10 Calif. Civil Code §2924.3(b)
11 CC §2924.3(a)(2)
12 CC §2924.3(a)(1)

Under loan servicing agreements, the broker typically holds the original note. Since the noteholder presents the original note to the trustee when commencing foreclosure, the noteholder obtains the note from the broker to forward to the trustee.

When the noteholder obtains possession of the original note to commence foreclosure, the contract collection relationship is terminated as called for in the loan servicing agreement. If the servicing agreement is not cancelled, the noteholder, the trustee and the broker become involved in the accounting process during the foreclosure period, such as:

- working out a repayment plan;
- collecting late charges and any prepayment penalty;
- payment of trustee's fees and charges; and
- charging attorney fees.

It is easiest for all involved on a foreclosure when the broker removes themselves and continues any professional relationship with the noteholder on an informal basis. The broker restores their servicing relationship when the mortgage is reinstated by being ready to enter into a new servicing agreement with the noteholder.

The best solution for the servicing agent is to leave the handling of all payments submitted during foreclosure to the noteholder and the trustee. Although it may seem inefficient to cancel the agreement every time an NOD is recorded and renew it every time the default is cured, the broker avoids any confusion created by a trustee in the foreclosure accounting.

Guaranteeing the note

A real estate broker who guarantees the payments on a trust deed note is subject to corporate securities laws. Thus, a real estate broker who first obtains a **special permit** may guarantee the payments on a trust deed note. The provisions, permits, orders and conditions of securities are managed by the **Department of Financial Protection and Innovation (DFPI)**.[13]

However, application of the securities law is not triggered when the broker, as directed by the noteholder, pays noteholder obligations from the broker's own funds when the property owner, noteholder or purchaser of the note will reimburse all such costs. Broker disbursements include property taxes, payments due on senior mortgages, insurance premiums or foreclosure costs.[14]

When the broker servicing the note advances funds other than the funds received from the property owner, the broker, within ten days of advancing their own funds, gives notice to the noteholder of:

- the date and amount of the payment;
- the name of the person to whom payment was made;
- the source of the funds; and
- the reason for advancing funds.[15]

13 Calif. Corporations Code §25707
14 Bus & P C §10238(k)(2)
15 Bus & P C §10233.1

Threshold reporting

When a broker handles the collection of $250,000 or more in payments within a 12-month period on promissory notes secured directly or collaterally by real estate, the broker exceeds **revenue threshold** amounts triggering their periodic mortgage loan broker (MLB) reporting to the DRE.[16]

As a threshold MLB, the broker files an **annual report** with the DRE within 90 days after the end of the broker's fiscal year. The activity reported describes the receipt and disposition of all funds connected with their servicing of notes.[17]

The report includes:

- the number and amount of all promissory notes serviced by the broker;[18]
- the number and amount of late charges, prepayment penalties and other fees collected and retained by the broker under the loan servicing agreement;[19] and
- the defaults and foreclosures experienced by the broker in connection with the promissory notes.[20]

Threshold MLBs also file a **quarterly report** within 30 days after the end of the first three fiscal quarters on the status of their trust funds.[21]

Unlicensed contract collection agents

Individuals not licensed as real estate brokers may act as contract collection agents on notes secured directly or collaterally by real estate when:

- the volume of the collection is limited to ten or fewer notes;
- the total annual collection is $40,000 or less; or
- the collection agent is a licensed escrow corporation which deposits and maintains the property owner's mortgage payments in its trust account.[22]

Changing servicing agents

A change in servicing agent on a trust deed note encumbering one-to-four unit residential property, whether or not owner-occupied, requires both servicing agents to give notice of the change to the property owner.[23]

Specifically, the property owner obligated to pay the mortgage will receive written notice of the change in servicing agent from both:

- the prior servicing agent who has collected payments made on the note; and
- the new servicing agent who will collect future payments made on the note.

16 Bus & P C §10232(a)(2),(3)
17 Bus & P C §10232.2(a)(2)
18 Bus & P C §10232.2(c)(2)
19 Bus & P C §10232.2(c)(3)
20 Bus & P C §10232.2(c)(4)
21 Bus & P C §10232.25
22 Bus & P C §10133.1(b)
23 CC §2937(b)

Editor's note — When an NOD has been recorded or a judicial foreclosure action initiated, the trustee or attorney conducting the foreclosure is to also receive written notice of the change in collection agents.[24]

Further, the owner of a one-to-four unit residential property encumbered by a trust deed note is also entitled to written notice when the noteholder:

- no longer collects payments on the note themselves and employs a servicing agent;
- changes servicing agents; or
- sells or collaterally assigns the note and trust deed to another person who will collect payments themselves or employ a different servicing agent. [25]

For purposes of giving notice to the property owner, a trustee foreclosing under a **power of sale** provision in the trust deed securing the note is not deemed a servicing agent.[26]

Written notice required

Recording the noteholder's assignment of a note and trust deed puts anyone who later acquires an interest in the property on constructive notice of the prior assignment.[27]

However, recording an assignment does not put the owner of the secured real estate on notice that an assignment occurred. Further, recording is not notice to a property owner to re-direct payments to another person.[28]

Consider a broker who collects payments from the property owner on a trust deed note encumbering a one-to-four unit residential property. The noteholder sells and assigns the note and trust deed to a trust deed investor. The investor employs another person to collect payments on the note.

Since the broker's servicing agreement has been terminated, the broker gives the property owner a written notice stating the collection of payments will be handled by a new servicing agent.[29]

The notice of transfer of loan servicing

On mortgages secured by one-to-four unit residential property, the written notice is sent by both the prior and the new servicing agent or noteholder. The notice advises the property owner to make payments to a new servicing agent or noteholder and includes:

- the *name and address* of:
  - the noteholder when they collect payments themselves; or
  - the servicing agent who collects payments for the new noteholder;

24 CC §2937(c)
25 CC §2937(b)
26 CC §2937(h)
27 CC §2934
28 CC §2935
29 CC §2937(b)

- the *date the collection of payments will be transferred* to the new servicing agent or noteholder; and
- the *address where all future payments* are to be sent.[30] [See **RPI** Form 238]

Also, the **due date** of the next payment is included in the copies of the transfer notice sent by the new noteholder or servicing agent.[31]

The notice of transfer of loan servicing is delivered by first-class mail, postage-prepaid to:

- the property owner's billing address; or
- the buyer's address on file with the escrow agent for the newly opened escrow.[32]

Real estate other than one-to-four unit residential property

When real estate other than one-to-four unit residential property is encumbered with a trust deed note, the holder assigning the note need not give notice to the property owner of a transfer of loan servicing.

Again, recording the assignment of a note and trust deed does not put the owner of any type of secured real estate on notice that payments are to be directed to another person.

Thus, to prevent the property owner from sending payments to the prior servicing agent when assigning a note and trust deed which encumbers other than one-to-four unit residential property, both the prior and new noteholders need to give notice when a change of servicing agents occurs.

For example, a property owner only receives a notice of transfer of loan servicing from the investor who purchased the note which encumbers their property.

Without receiving notice from the prior servicing agent or noteholder, the property owner cannot be certain the notice of transfer of loan servicing received from the new noteholder or servicing agent is valid. Thus, without notice from the prior servicing agent or noteholder, the property owner may ignore the notice from the new servicing agent and continue making payments to the prior servicing agent.

A RESPA transfer notice

A written notice to the property owner is required on the transfer of servicing for **consumer mortgages**. [See **RPI** Form 238-1]

Editor's note — Virtually every federally-related mortgage under (RESPA) is also a consumer mortgage under the Truth in Lending Act (TILA). Thus, they are used interchangeably here.

Business mortgages, unlike consumer mortgages, are not controlled by either RESPA or the state law requiring a notice of change of servicing agents.

consumer mortgage
A debt incurred primarily for personal, family, or household purposes and secured by a parcel of real estate containing one-to-four residential units.

30 CC §2937(e)
31 CC §2937(f)
32 CC §2937(e)

Since most brokers acting as servicing agents are employed by private lenders or investors, a broker will not use a RESPA transfer-of-service notice — unless the private lender or the investor holding a consumer mortgage originates or buys more than $1,000,000 each year in consumer mortgages.[33]

Both the previous and new servicing agents on consumer mortgages deliver the RESPA written transfer notice to the property owner. [See **RPI** Form 238-1]

However, RESPA allows the two separate notices to be combined by both agents into one notice, when the notice is delivered at least 15 days before the due date of the first installment to be collected by the new servicing agent.[34]

Failure to give RESPA notice on consumer mortgages

When an agent servicing a *consumer mortgage* violates the RESPA requirements for the notice of transfer in any way, the servicing agent is liable to the property owner for:

- an amount equal to the sum of any actual money losses sustained by the property owner; and
- costs and reasonable attorney fees.[35]

Further, when the servicing agent on a consumer mortgage has a pattern of noncompliance with RESPA notice requirements, the servicing agent will be liable for additional damages no greater than $2,000.[36]

However, on any type of mortgage secured by a one-to-four unit residential property, the owner who receives both written notices of the change in servicing agents is obligated to make payments to a new noteholder or servicing agent.[37]

When the owner of a one-to-four unit residential property makes timely payments on their mortgage to the prior noteholder or servicing agent before receiving written notice, the owner is not liable for the misdirected payments or any late fees.[38]

AITD payments and contract collection

In a typical **all-inclusive trust deed (AITD)** carryback sales transaction, the buyer makes installment payments on the *AITD* directly to a seller who carried back the AITD. In turn, the seller makes the scheduled payments owed to the underlying senior mortgage holder. The seller retains the difference as their net cash flow on the AITD. [See **RPI** Form 442 §1.3]

The seller may enter into contract collection with a servicing agent to receive payments and make disbursements to the underlying mortgage holder. Collection and disbursement of the monthly payments called for in the AITD may be made under contract collection by:

- a bank;

33 12 Code of Federal Regulations §§1024.33(b), 1024.2
34 12 CFR §1024.33 (b)(3)(i)
35 12 United States Code §2605(f)
36 12 USC §2605(f)(1)(B)
37 CC §2937(f)
38 CC §2937(g)

- a credit union;
- an escrow company; or
- a real estate broker. [See **RPI** Form 237]

Contract collection is convenient for the seller. However, when the seller and the buyer *mutually agree* that the seller will place the AITD on contract collection, the agreement severely reduces the amount of profit tax deferred on the installment sale. Here, the collection agent is deemed to be the agent of the buyer when agreed to by both the buyer and the seller. When payments are made by a broker designated as the buyer's agent, the payments on the underlying mortgage are the buyer's responsibility.

all-inclusive trust deed (AITD)
A note entered into by a buyer in favor of the seller to evidence the amount remaining due on the purchase price after deducting the down payment, an amount inclusive of any specified mortgage debts remaining of record with the seller retaining responsibility for their payment.

Due to the shift in responsibility created by a mutually agreed to contract collection account, the seller has **debt relief**, increasing the profit-to-equity ratio on the installment sale and increasing the percentage of down payment and principal payments reported annually as profit.[39]

39 **Goodman** v. **Commissioner of Internal Revenue** (1980) 74 TC 684

Chapter 50 Summary

An agreement to act as a servicing agent to handle the collection and accounting for payments and perform services for a fee on promissory notes — secured directly or collaterally by liens on real estate — is entered into by brokers licensed by the Department of Real Estate (DRE). This professional business opportunity is known as contract collection.

A broker servicing a note secured directly or collaterally by real estate needs written authorization, commonly called a loan servicing agreement, entered into by the noteholder and the broker.

The broker keeps a separate record of all trust funds received and disbursed on each note they service under contract collection.

The broker is paid for their services as a servicing agent on a note by disbursing their "service fees" from each payment received and deposited into their trust account.

When agreeing to act as a servicing agent, the broker reviews the noteholder's title insurance for any other encumbrances on the secured real estate. If not already recorded, the broker, on behalf of the noteholder, prepares a Request for Notice of Default and a Request for Notice of Delinquency for each senior encumbrance, obtains signatures and records them.

The noteholder may agree the broker servicing the note is to record an notice of default (NOD) to commence foreclosure on behalf of the noteholder when a default in payments occurs.

A real estate broker who guarantees the payments on a trust deed note is subject to corporate securities laws and is required to first obtain a special permit.

A change in servicing agent on a note and trust deed encumbering one-to-four unit residential property, whether or not owner-occupied, requires both servicing agents to give notice of the change to the property owner. When real estate other than one-to-four unit residential property is encumbered with a trust deed note, the holder assigning the note need not give notice to the property owner of a transfer of loan servicing.

A written notice to the property owner is required on the transfer of servicing for consumer mortgages under the Real Estate Settlement Procedures Act (RESPA).

Chapter 50 Key Terms

Chapter 51

Checklist for packaging a consumer- or business-purpose mortgage

Documentation, disclosures and mortgage packaging activities

The following is a checklist of activities to be considered by a mortgage broker and lender when packaging a **mortgage application** for funding the purchase or refinance of any type of real estate.

Editor's note — None of the material in this chapter will be covered in the quizzes or final exam for this course.

The documentation and disclosures carried out when packaging a mortgage are essentially the same when the mortgage is secured by a one-to-four unit residential property. This is the case whether or not the property is owner-occupied, and whether the mortgage is for a consumer or business purpose.

However, most of these disclosures are mandated for consumer-purpose mortgages without a parallel but necessary legislated mandate for business-purpose mortgages. As a matter of good practice, the same checklist is used as steps to be taken when originating mortgages for any purpose on any type of real estate.

Also, the broker and their agent arranging a consumer mortgage is required to hold a **mortgage loan originator (MLO)** endorsement from the **Department of Real Estate (DRE)**. Conversely, a lender or broker, making or arranging business mortgages exclusive of any consumer mortgages, does not need to hold an MLO endorsement. However, when making more than seven mortgages of any type in a calendar year, the private mortgage lender is required to also hold a DRE broker license.[1]

1 Calif. Business and Professions Code §10131.1

Prohibited kickbacks and fees

To avoid overcharging, the **transaction agent (TA)** (but not their broker or another agent) handling the sales transaction which calls for a purchase-assist consumer mortgage may not receive additional fees (**kickbacks**) for services rendered to originate the consumer mortgage — unless the fee is paid by someone other than the homebuyer. When paid by a person other than the homebuyer, the *TA* needs to perform a significant portion of the service provided by the other person to be entitled to receive any fee beyond the fee for TA services in the real estate sales transaction.

A referral is never a compensable service for a TA.[2] [See Chapter 29]

The stack sheet: a documentation and activity checklist

A **stack sheet** is used by a mortgage broker or lender when setting up a file for making or arranging a mortgage. It is the control worksheet placed in the mortgage packaging file which serves as a checklist of documentation considered and noted for completion by the mortgage broker or lender before funding. [See **RPI** Form 201]

At commencement of the application process, the mortgage broker or lender provides the borrower with a checklist of information and documents needed to process the mortgage application. When a co-borrower is considered for mortgage qualification purposes, the same information and documents will be gathered from them as well. [See **RPI** Form 209 and 209-1; see Chapter 9]

Pre-application information gathering

Applicable information and documentation to be supplied by the borrower to the mortgage broker or lender varies depending on the:

- *type of mortgage* sought (consumer- or business-purpose);
- *position of the mortgage* (junior or senior);
- *type of property* (residential or nonresidential); and
- *borrower's income source* (wage earner or self-employed).

Initially, the mortgage broker or lender conducts a **pre-application interview** with the borrower to determine the borrower's intentions for their use of the mortgage funds. This interview is best conducted with the TA when funding the purchase of property. Once the borrower's intentions are determined, the mortgage broker or lender prepares the *stack sheet* checklist noting the documentation needed to process the type of mortgage involved. [See **RPI** Form 201]

Documentation to be gathered

Documentation to be gathered by the mortgage broker or lender includes:

- copies of the borrower's two most recent *pay-stubs*;
- when the pay-stubs are not computer-generated, a *letter from the borrower's employer(s)* stating their year-to-date (YTD) income;
- copies of the borrower's *W-2s* and *federal tax returns* for the last two years;

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2 Official Interpretation of 12 Code of Federal Regulations §1026.36(d)(1); CFPB 2013 Loan Originator Rule Small Entity Compliance Guide — January 13, 2014

Editor's note — Employment is verified for the last two years. In addition, the borrower needs to provide explanations for any gaps in employment of one month or longer.

- copies of the borrower's *1099s* for the last two years when self-employed;
- copies of the borrower's *bank statements* for all checking and savings accounts for the last three months;
- a *YTD Profit and Loss Statement* when the borrower is self-employed [See **RPI** Form 209-2 (FNMA 1020)];
- a *Balance Sheet Financial Statement* showing the borrower's net worth [See **RPI** Form 209-3];
- a *schedule of additional real estate owned* by the borrower;
- copies of *rental* and *lease agreements* for rental properties owned by the borrower;
- copies of each borrower's *driver license* and *Social Security card*;
- a copy of the borrower's *military ID card* when applicable;
- a copy of the borrower's *alien registration card* when applicable;
- when the property is part of a common interest development (CID), the project name, address, telephone and fax numbers of the *homeowners' association's (HOA's)* management company;
- a copy of any *bankruptcy discharge papers* including a *written explanation* for petitioning for bankruptcy protection when applicable;
- a copy of any *decree for dissolution of marriage* when applicable;
- when the application is for a home equity (second) mortgage:
  - copies of all *notes* for debts secured by trust deeds on the property; and
  - copies of any *mortgage statements or payment coupons* identifying the mortgage and showing information on the senior mortgage holder; and
- a copy of the *homeowner's insurance policy declaration page* and *property tax bill* when the application is for a home equity mortgage or refinance.

Taking the application

Upon receipt of the borrower's documentation, the lender or mortgage broker prepares forms to be signed by the borrowers (and any co-borrowers) to complete the **mortgage package**.

These mortgage forms include:

- the *Uniform Residential Loan Application* (URLA) for one-to-four unit residential property (to be used on any type of mortgage or property acquisition [See **RPI** Form 202 (FNMA 1003); see Chapter 15];
- the *Acknowledgement of Changing Conditions* to disclose to the borrower that conditions to close the mortgage may change or affect the lender's funding of the mortgage [See **RPI** Form 202-1];

- the *Loan Purpose Statement – For Reg Z Analysis* to determine the use of mortgage funds either for consumer purposes or for business, investment or agricultural purposes [See **RPI** Form 202-2];
- the *Authorization for Lender Verification of Information* [See **RPI** Form 216];
- the *Fair Credit Reporting Act* disclosure [See **RPI** Form 216-1];[3]
- the *Equal Credit Opportunity Act* disclosure [See **RPI** Form 216-2];[4]
- the *Anti-Steering Disclosure* for consumer-purpose mortgages stating the mortgage broker needs to offer mortgage options from a significant number of lenders with which the mortgage broker regularly does business [See **RPI** Form 208];[5]
- the *Advance Fee Disclosure* for consumer-purpose mortgages stating that no fees may be collected other than those used to obtain the borrower's credit history prior to receiving an initial Loan Estimate from the mortgage broker or lender [See **RPI** Form 208];[6]
- the *Notice to Applicant of Right to Receive Copy of Appraisal Report* to be provided to the borrower within three business days after the mortgage broker or lender's receipt of the borrower's mortgage application [See **RPI** Form 206];[7]
- the *Fair Lending Disclosure* to notify the borrower of prohibitions against discriminatory lending [See **RPI** Form 203 (RE 867)];[8]
- the *Credit Score Disclosure Exemption Notice* to notify the borrower of the originator's obligation to disclose to the borrower their credit scores and the credit bureaus used to obtain them [See **RPI** Form 217];[9]
- the *RESPA Servicing Disclosure Statement* [See **RPI** Form 238-2];[10]
- the *Notice of Right to Rescind – Borrower's Right to Cancel* which notifies the borrower of their right to cancel the transaction on an equity mortgage or refinance on their principal residence within three business days of receiving federally mandated consumer mortgage disclosures [See **RPI** Form 222];
- the *IRS Form 4506* or *4506-T* to request a copy of the borrower's income tax return or a transcript of the income tax return from the Internal Revenue Service (IRS) [See **RPI** Form 215 and 215-1];
- a *Loan Estimate* of all mortgage terms quoted by the mortgage broker or lender within three business days of the mortgage broker's or lender's receipt of the borrower's mortgage application [See **RPI** Form 204-5];[11]
- a special *information booklet* published by the Consumer Financial Protection Bureau (CFPB) to help the borrower understand the nature and scope of real estate settlement costs within three business days after the mortgage broker's or lender's receipt of the borrower's application;[12]

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3 12 CFR §1022 et. seq.
4 12 CFR §1002 et. seq.
5 12 CFR §1026.36(e)
6 12 CFR §1026.19(a)(1)(ii)
7 12 CFR §1002.14(a)(2)
8 21 Calif. Code of Regulations §7114
9 12 CFR §1022.74(d)(1); Calif. Civil Code §1785.20.2
10 12 CFR §1024.33(a)
11 12 CFR §1026.37
12 12 CFR §1026.19(g)

- a *Closing Disclosure*, which summarizes the "final" mortgage terms and details, provided by the mortgage broker or lender at least three days before the borrower closes on the mortgage;[13]
- a list of *homeownership counseling organizations*; and
- the *Mortgage Loan Disclosure Statement* when the originator is a mortgage broker.[14] [See **RPI** Form 204 and 204-2 (RE 882 and 885)]

Editor's note — A list of homeownership counseling organizations approved by HUD can be found at the CFPB's website at http://www.consumerfinance.gov.

When the buyer arranges consumer financing through a mortgage broker, then the broker, not the lender, provides a copy of the special information booklet to the buyer.[15]

However, the booklet does not need to be given to the borrower when the mortgage funds:

- the refinance of an existing mortgage;
- a closed-end mortgage secured by a second mortgage;
- a reverse mortgage; or
- the purchase of other than a one-to-four unit residential property.[16]

Collecting other vital information

In addition to the above documentation, the mortgage broker or lender requests and gathers reports, contracts and other vital information regarding the transaction and property condition.

This supplementary mortgage origination information includes:

- the *Residential Appraisal Report – Detached Single Family Unit or PUD* [See **RPI** Form 207 and 200 (HUD 1004)];[17]

  Editor's note — The appraisal report for an income-producing property will also include a rent survey reflecting the rental rates commanded by comparable local rental properties.

- a *tri-merge credit report* (which includes reports by Experian, Trans Union and Equifax);

  *Editor's note — When the borrower is given a negative credit score usage notice in response to their application for a mortgage on one-to-four unit residential property, the mortgage broker or lender is required to provide the borrower with an explanation of the derogatory items on the borrower's credit report. In addition, the mortgage broker or lender also needs to inform the borrower of any adverse action taken on their application.[18] [See **RPI** Form 217-1 and 219]*

- a *Verification of Employment* for a present or prior employer, or both [See **RPI** Form 210 and 210-1];

13 12 CFR §1026.19(f)(ii)
14 Bus & P C §10240
15 12 CFR §1024.6(a)(1)
16 12 CFR §1024.6(a)(3)
17 Bus & P C §11321
18 CC §1785.20; 12 CFR §202.9; 15 United States Code §1681m

- a *Verification of Deposit* to verify the borrower's recent activity and balances of their bank accounts [See **RPI** Form 211];
- a *Verification of Rent* to verify the borrower's payment history and their conduct as a tenant [See **RPI** Form 212];
- a *Verification of Mortgage* to verify the payment history and terms of the borrower's existing mortgage [See **RPI** Form 212-1];
- a *Verification of Account* to confirm the payment history and terms of the borrower's existing credit account [See **RPI** Form 213]; and
- a *Verification of Homeowners Insurance* to verify information regarding the borrower's existing homeowners insurance policy. [See **RPI** Form 214]
- a copy of the *purchase agreement* for a purchase-assist mortgage [See **RPI** Form 150];
- a copy of the *escrow instructions* [See **RPI** Form 232 and 401];
- a copy of the seller's *Condition of Property Disclosure – Transfer Disclosure Statement (TDS)*, any *home inspection report* and any other reports on components of the property and its improvements (for a purchase-assist mortgage) [See **RPI** Form 304]; and
- a copy of the *preliminary title report*.

Additional items the mortgage broker or lender may require for a mortgage secured by income-producing property include:

- an Annual Property Operating Data (APOD) worksheet [See **RPI** Form 352]; and
- a Rental Income Rent Roll. [See **RPI** Form 352-1]

Editor's note – See the ***(RPI) Realty Publications, Inc. Income Property Brokerage (IPB)*** *suite of forms.*

Underwriting and loan package transmittal

Once the mortgage package is complete, it is ready for an underwriting review for approval and funding.

Additional documents to be included to initiate the underwriting review are:

- the *Loan Transmittal Summary – Preliminary Submission to Lender* prepared by a broker arranging a mortgage to solicit a lender for funding the mortgage as a summary of information regarding the borrower and the property to be mortgaged [See **RPI** Form 233];
- the *Credit Analysis Worksheet – LTV and Income Ratios* to show the calculations of the borrower's front and back end debt-to-income ratios (DTI) and the loan-to-value ratio (LTV) [See **RPI** Form 230 (HUD-92900-WS)]; and
- the *Lender/Purchaser Disclosure Statement – Loan Origination* to disclose to the lender information regarding the mortgage terms and servicing arrangements made by the mortgage broker. [See **RPI** Form 235-1 (RE 851A)]

Glossary

A

ability-to-repay (ATR) rules **98**
A federal standard for determining an applicant's ability to repay a consumer mortgage.

acceleration **386, 428**
A demand for immediate payment of all amounts remaining unpaid on a mortgage or extension of credit by a lender or carryback seller.

active license **32**
A license status which allows an individual Department of Real Estate (DRE) licensee to perform mortgage loan originator (MLO) services as an employee of a Department of Financial Protection and Innovation (DFPI) MLO.

adjustable rate mortgage (ARM) **202**
A variable interest rate note, often starting out with an introductory teaser rate which resets in a few months or years based on a particular index.

advance fee **56, 536**
A fee paid in advance of any services rendered.

adverse action notice **340**
A disclosure notifying the applicant a negative action has been taken on their consumer mortgage application due to an unfavorable credit history, as required by the Fair Credit Reporting Act (FCRA).

affiliated business arrangement **329**
A business arrangement in which a broker may lawfully profit from referring a client to a service provider the broker owns; requires the broker to make a disclosure of their ownership interest to the client.

all-inclusive trust deed (AITD) **461, 557**
A note entered into by a buyer in favor of the seller to evidence the amount remaining due on the purchase price after deducting the down payment, an amount inclusive of any specified mortgage debts remaining of record with the seller retaining responsibility for their payment.

allonge **477, 524**
An attachment to a note occurring between preparation of the note and closing the transaction providing information necessary to update entries on the note at the time it becomes effective.

anti-deficiency **475, 507**
A limitation placed on a mortgage lender's ability to recover losses on default when the secured property's value is insufficient to satisfy the mortgage debt.

Articles of Incorporation **62**
An instrument setting forth the basic rules and purposes under which a private corporation is formed.

appraisal **136**
An appraiser's opinion or estimate of a property's value on a specific date, reduced to writing in an appraisal report.

appraisal report **142**
Documentation of an appraiser's findings, including the purpose and scope of the appraisal.

appraised value 136
The fair market value (FMV) arrived at by an appraiser.

B

back-end debt-to-income ratio (DTI) 92, 226
The percentage of monthly gross income that goes towards paying non-mortgage debt.

balance sheet...153
An itemized, dollar-value presentation for setting an individual's net worth by subtracting debt obligations (liabilities) from asset values.

balloon payment...106
Any final payment on a note which is greater than twice the amount of any regularly scheduled payments.

balloon-payment qualified mortgage 106
A type of qualified mortgage which allows small lenders to include a balloon feature.

beneficiary statement...486, 505
A written disclosure made by a mortgage holder regarding the condition of a debt owed to them, usually evidenced by a trust deed note.

blind pool investment 514
An investment which involves receipt of investor contributions in a group investment program before the syndicator identifies and discloses the real estate interest the investors' funds will be used to acquire, an activity controlled by securities law.

bona fide purchaser (BFP)..412
A buyer who purchases a property for valuable consideration in good faith without notice or knowledge of pre-existing encumbrances or conditions affecting their right to full ownership.

broker-associate..21
A Department of Real Estate (DRE)-licensed broker who works in the employment of another DRE broker.

business activity report..76
A report notifying the Department of Real Estate (DRE) of an employing broker's mortgage activities during the fiscal year.

business mortgage 40, 98, 439
A debt incurred primarily for other than personal, family or household purposes, whether secured or unsecured.

buyer mortgage capacity..158
A buyer's ability to make mortgage payments based on their debt-to-income ratios (DTI).

C

call 488
A mortgage holder's demand for the balance of the loan to be immediately paid in full.

capitalization approach...141
An appraisal method used by an appraiser to arrive at a property's value based on the present worth of a property's future net operating income.

carryback mortgage 43, 457, 496
A note and trust deed executed by a buyer of real estate in favor of the seller for the unpaid portion of the sales price on closing, also known as an installment sale, credit sale or seller financing.

certificate of sale **422**
A certificate issued to the successful bidder on the completion of a judicial sale of a property.

changed circumstance **308**
Extraordinary events defined by federal mortgage law which may be the basis for the costs provided in the Loan Estimate.

closed-end mortgage **288**
A mortgage in which the funds are disbursed once and paid off over time.

Closing Disclosure **199, 302**
A disclosure of the buyer's final settlement charges and mortgage terms handed to the buyer on a standard form within three business days before mortgage closing.

collateral assignment **448, 468**
An agreement providing additional, cumulative and concurrent security for a debt, in the form of personal property, to secure the property owner's performance under the debt.

commercial communication **374**
Anything written or spoken used to attract homeowners to a service.

commingling **539**
The mixing of personal funds with client or third-party funds held in trust.

comparable property **143**
A recently sold or listed property which has characteristics similar to the subject property being evaluated.

comparative market approach **140**
An appraisal method used by an appraiser to arrive at a property's value based on the current selling prices of similar properties.

compensating factors **92**
Positive factors which compensate for a high debt load.

computation period **185**
For impound account analysis, the 12-month period beginning on the date of the initial impound deposit during which monthly deposits, disbursements and any applicable interest occur.

conforming mortgage **196**
A conventional mortgage with terms, conditions and a maximum principal amount set by Fannie Mae and Freddie Mac.

consumer mortgage **5, 39, 98, 524, 555**
A debt incurred primarily for personal, family, or household purposes and secured by a parcel of real estate containing one-to-four residential units.

consumer mortgage application **6**
A consumer mortgage application is a request for an offer of consumer mortgage terms.

consumer purpose **5**
A primarily personal, family or household use.

consumer reporting agency **127**
Companies that compile debt information from credit bureaus and other credit sources and sell credit reports to consumers or lenders.

contract collection **547**
The collection and accounting for payments on a promissory note for a fee.

conventional mortgage **194**
A mortgage that is not made, insured or guaranteed by the federal government.

conversion **534**
The unlawful appropriation of another's property, as in the conversion of trust funds.

conversion adjustable rate mortgage (ARM) **209**
An adjustable rate mortgage (ARM) which may be converted to a fixed rate mortgage (FRM) during the mortgage term.

cost approach **140**
An appraisal method used by an appraiser to arrive at a property's value based on the present cost of constructing the present improvements and acquisition of the land.

credit repair **119**
A service purporting to raise credit scores and remove bad credit.

credit repair organization **120**
A person or company that offers to improve a buyer's credit history, record or rating in exchange for a fee.

Credit Repair Organization Act (CROA) **120**
A federal law protecting credit repair consumers from fraud perpetrated by credit repair organizations.

credit report **110**
A compilation of a buyer's collected credit history.

credit score **109**
A numerical representation of a borrower's creditworthiness, based on credit information obtained by a credit bureau.

credit score disclosure **339**
A disclosure of a consumer's credit score information as required by the Fair Credit Reporting Act (FCRA).

credit score exception notice **338**
A risk-based pricing notice disclosure provided to the consumer to fulfill the credit score disclosure and the Notice to Home Loan Applicant under the Fair Credit Reporting Act (FCRA).

creditworthiness **111, 158**
An individual's likelihood of repaying a mortgage, determined by their present income, wealth and previous debt payment history.

D

debt-to-income ratio (DTI) **92, 157**
The percentage of monthly gross income that goes towards paying debt.

declaration of default and demand for sale **404**
A document delivered to the trustee under a power of sale provision by the mortgage holder instructing the trustee to initiate foreclosure on the secured real estate by recording a notice of default (NOD).

deficiency **496**
Losses experienced by a mortgage holder at a foreclosure sale due to insufficient value of the mortgaged property to satisfy the mortgage debt.

desk review **144**
A second appraiser's review of an appraisal report to verify and evaluate the findings.

Desktop Underwriter (DU) **93**
Fannie Mae's automated underwriting (AU) system.

discount point 55
The amount of money the borrower or seller must pay the lender to get a mortgage at a stated interest rate.

Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) 3
A 2010 enactment of significant changes to U.S. financial regulation in response to the 2007 financial crisis.

draw period 264
The time period during which the homeowner may draw on the funds in a home equity line of credit (HELOC).

dwelling 5
A building or personal property occupied or designed to be occupied as a residence by one or more families.

due-on clause 384, 487, 527
A trust deed provision used by lenders to call the loan immediately due and payable, a right triggered by the owner's transfer of any interest in the real estate, with exceptions for intra-family transfers of their home.

E

eligible non-borrowing spouse 273
A non-borrowing spouse eligible to defer repayment of a home equity conversion mortgage (HECM) and remain on the property after the borrower's death.

end of draw (EOD) period 264
The time period following the draw period during which the home equity line of credit (HELOC) resets and the homeowner begins making monthly payments of principal and interest.

Energy-Efficient Mortgage (EEM) 235
A Federal Housing Administration (FHA) mortgage which finances energy-efficient improvements.

entitled person 506
The original borrower on a note and trust deed, their successor-in-interest or an authorized agent of either who may request, in writing, a beneficiary statement or payoff demand statement.

errors and omissions (E&O) insurance 64
An insurance policy protecting brokers and agents from negligent conduct when acting as a licensee.

Equal Credit Opportunity Act (ECOA) 344
A federal law which prohibits discriminatory and unfair lending practices.

exculpatory clause 526
A provision in a note secured by a trust deed which converts a recourse debt into nonrecourse debt to bar recovery by a money judgment against the borrower.

F

Fair Credit Reporting Act (FCRA) 337
A federal law controlling the collection and use of consumer credit reports, including the delivery of disclosures to credit consumers.

fair market value (FMV) 136
The price a reasonable, unpressured buyer would pay for property on the open market.

fair value hearing 423
The court proceeding at which a money judgment is awarded for any deficiency in the secured property's fair market value (FMV) at the time of the judicial foreclosure sale to fully satisfy all debt obligations owed the mortgage holder.

federally registered mortgage loan originator (MLO) 12
A mortgage loan originator (MLO) employed by a federally regulated bank, credit union or financial company.

federally related mortgage 322
A consumer mortgage made, insured, guaranteed, assisted or otherwise connected to the federal government, controlled by the Real Estate Settlement Procedures Act (RESPA).

field review 144
A second appraiser's independent visual inspection of the property to verify and evaluate the findings of the original appraisal report.

first-point-of-contact materials 163
Materials used to solicit or create a client relationship with prospective mortgage borrowers.

foreclosure consultant 372
An individual offering services which claim to aid homeowners with mortgage-related issues, for a fee.

foreclosure decree 418
Decree by a court ordering the sale of mortgaged property and the payment of the debt owing to the lender out of the proceeds.

fractionalizing 514
Selling a share of interest in one note to multiple investors.

freeze 265
A prohibition against additional extensions of credit under a home equity line of credit (HELOC).

front-end debt-to-income ratio (DTI) 92, 226
The percentage of monthly gross income that goes towards paying mortgage debt.

full credit bid 411
The maximum amount the foreclosing mortgage holder may bid at a trustee's sale without adding cash, equal to the debt secured by the property being sold, plus trustee's fees and foreclosure expenses.

fully indexed rate 206
The highest rate possible on the adjustable rate mortgage (ARM) during the first five years of its term.

future advances clause 433
A trust deed provision authorizing a mortgage holder to advance funds for payment of conditions impairing the mortgage holder's security interest in the mortgaged property, such as delinquent property taxes, assessments, improvement bonds, mortgage insurance premiums or elimination of waste.

G

Garn-St. Germain Federal Depository Institutions Act of 1982 386
A federal law which preempts state-level limitations on a mortgage holder's enforcement of the due-on clause contained in mortgages.

general qualified mortgage **103**
A consumer mortgage conforming to safe harbor status under the federal ability-to-repay (ATR) rules.

good faith deposit **534**
A money deposit made by a buyer to evidence their good faith intent to buy when making an offer to acquire property. Also known as earnest money. [See **RPI** Form 401 §1.1]

government-related mortgage **194**
A mortgage that is made, insured or guaranteed by the federal government.

government monitoring information (GMI)..**357, 348**
Demographic information collected from mortgage applications used to monitor lenders' compliance with anti-discrimination laws.

guaranty entitlement **243**
The portion of a veteran's mortgage guaranteed by the U.S. Department of Veterans Affairs (VA).

H

hard money mortgage..**441**
Real estate mortgages made by private lenders.

holder in due course **482**
One who has taken a note, check or bill of exchange in due course.

home equity conversion mortgage (HECM) program.....................................**272**
The Federal Housing Administration (FHA)'s reverse mortgage program.

home equity line of credit (HELOC) **263**
A mortgage giving a homeowner access to draw on their home's equity.

Home Mortgage Disclosure Act (HMDA) **354**
A federal law mandating data collection on mortgage originations and applications of lenders who meet Home Mortgage Disclosure Act (HMDA) threshold requirements.

hypothecation **468, 548**
The pledging of something as security without the necessity of giving up possession to it.

hybrid adjustable rate mortgage (ARM) **212**
A type of adjustable rate mortgage (ARM) which features a fixed rate for an introductory period and thereafter a periodically adjusted interest rate based on a predetermined formula.

I

impound account **179, 463**
A money reserve funded monthly by the property owner and maintained by the mortgage holder to pay annual recurring ownership obligations.

impound account provision **181**
A trust deed provision establishing a reserve of the owner's funds for the payment of annually recurring ownership expenses.

index **206**
A regularly issued composite market interest rate for an investment such as Treasury Securities or inter-bank loans used to set the basis for periodic interest rate adjustments.

individual mortgage loan originator (MLO) **52**
A natural person who meets the definition of a mortgage loan originator (MLO) .

initial interest rate cap..........208
A limit on the amount the interest rate may change on the first adjustment of an adjustable rate mortgage (ARM).

institutional lender..........195
A lender which pools deposits and invests them by making mortgages, e.g. a bank, credit union or insurance company.

inter vivos trust..........394
A title holding arrangement used as a vesting by a property owner for probate avoidance on death.

Interest Rate Reduction Refinance Loan (IRRRL)..........254
A U.S. Department of Veterans Affairs (VA)-guaranteed refinance that lowers the interest rate of an existing VA-guaranteed mortgage.

interest-only adjustable rate mortgage (ARM)..........212
A type of adjustable rate mortgage (ARM) which features an initial period of interest-only payments.

introductory interest rate..........206
The initial rate of interest on an adjustable rate mortgage (ARM), typically lower than the fully-indexed note rate and lasting for a set introductory period. Also known as a teaser rate.

J

jumbo mortgage..........196
A conventional mortgage with a principal amount exceeding the conforming or super-conforming mortgage limits set by Fannie Mae and Freddie Mac.

judicial foreclosure..........416
The court-ordered sale by public auction of the mortgaged property. Also known as a sheriff's sale.

K

kickback..........323
A fee improperly paid to a transaction agent (TA) who renders no service beyond the act of referring when the TA is already providing another service in the transaction for a fee.

L

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Lender-imposed standards on consumer mortgages to be met by applicants in addition to standards set by mortgage insurers and investors.

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Default mortgage insurance provided by private insurers in which the lender pays the mortgage insurance premium and recovers the cost through a higher interest rate.

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A lender-mandated portion of a home equity conversion mortgage (HECM) set aside for the payment of property charges.

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A limit on the amount the interest rate can increase over the life of an adjustable rate mortgage (ARM).

line of credit payment 280
A home equity conversion mortgage (HECM) payment option in which the homeowner may choose when and how much money to withdraw from their line of credit until they reach their principal limit.

lis pendens 412, 417
A notice recorded for the purpose of warning all persons that the title or right to possession of the described real property is in litigation.

litigation guarantee 417
A title insurance policy which lists all parties with a recorded interest in a property and their addresses of record, ensuring that all persons with a recorded interest in a property are named and served in litigation.

Loan/Application Register (LAR) 355
The electronic form used to collect Home Mortgage Disclosure Act (HMDA) data.

Loan Estimate 198, 306
An estimate of a buyer's settlement charges and mortgage terms handed to the buyer on a standard form within three business days following the lender's receipt of the mortgage application.

loan level price adjustment 194
Adjusted interest rates or fees based on the risk of default a mortgage poses.

Loan Prospector (LP) 93
Freddie Mac's automated underwriting (AU) system.

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A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property's fair market value (FMV).

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An interest rate fixed for the duration of the loan.

lump sum option 279
A home equity conversion mortgage (HECM) payment option in which the homeowner receives one payment after closing.

M

mandatory obligation 278
The costs associated with originating and closing a home equity conversion mortgage (HECM).

margin 207
The interest points added to an index by a lender as profit on the adjustment of an adjustable rate mortgage (ARM).

maximum claim amount 277
The ceiling amount for how much the homeowner is responsible for repaying once a home equity conversion mortgage (HECM) becomes due.

metropolitan statistical area (MSA) 354
A large region connected by common economic ties, considered as a unit for statistical purposes.

money judgment (on foreclosure) 416
An award for any unpaid balance remaining after a judicial foreclosure sale due to the secured property's insufficient fair market value (FMV) on the date of the sale to satisfy the debt owed, also called a deficiency.

Mortgage Acts and Practices — Advertising 162
A federal law governing consumer mortgage advertisements.

Mortgage Assistance Relief Services (MARS) rule 371
A federal regulation protecting homeowners by controlling the activities of mortgage assistance relief providers.

mortgage-backed loan (MBL) 468, 548
A loan secured by the assignment of an existing note and trust deed.

mortgage call report 81
A quarterly report on consumer mortgage data provided to the Nationwide Mortgage Licensing System (NMLS), used to enhance regulatory oversight.

Mortgage Loan Disclosure Statement (MLDS) 366
A California disclosure provided to a borrower by a mortgage broker who negotiates a mortgage on the borrower's behalf.

mortgage insurance premium (MIP) 220
Default insurance premiums required on a Federal Housing Administration (FHA)-insured mortgage, paid both up-front and annually.

mortgage loan activity notification 74
A report notifying the Department of Real Estate (DRE) when a licensee commences offering mortgage loan originator (MLO) services.

mortgage loan originator (MLO) 5, 47
An individual who receives fees to arrange a consumer mortgage.

mortgage loan originator (MLO) broker 52
A mortgage loan originator (MLO) who is other than a natural person, such as a corporate broker.

mortgage processing 88
The receipt of a mortgage application and the organization, preparation and confirmation of supporting documentation by the lender's mortgage processor for submission to the lender.

mortgage shopping worksheet 199
A worksheet designed for use by buyers when submitting applications for a consumer mortgage to compare mortgages offered by different lenders based on a list of all the variables commonly occurring as costs at the time of origination and over the life of the mortgage.

mortgage steering 54
A mortgage loan originator (MLO) practice of directing a homebuyer to a consumer mortgage with less favorable terms in order to obtain greater compensation.

N

Nationwide Mortgage Licensing System (NMLS) 3, 12, 47
The national registry of consumer mortgage loan originators (MLOs).

negative amortization 213
The addition of unpaid interest to the principal balance of a mortgage due to insufficient monthly interest payments.

Nationwide Mortgage Licensing System (NMLS) identification number (ID) 16
A unique number identifying a consumer mortgage loan originator (MLO) in the Nationwide Mortgage Licensing System (NMLS).

nonjudicial foreclosure 400, 416
When property is sold at a public auction by a trustee as authorized under the power-of-sale provision in a trust deed.

nonrecourse debt... 433, 462, 474, 509, 528
A debt recoverable on default solely through the value of the security interest in the secured property.

nontraditional credit 126
Accounts other than traditional mortgage, loan, credit card and bank accounts, used to analyze a consumer's ability to repay debt.

note rate 496
The interest rate agreed to between the homebuyer and the lender on the promissory note. Contrast with real interest rate.

notice of action taken 350
A notice disclosing to the applicant the specific reasons for a denial of credit, as required by the Equal Credit Opportunity Act (ECOA).

notice of default (NOD)..401
The notice filed to begin the nonjudicial foreclosure process. Generally, it is filed following three or more months of delinquent mortgage payments.

notice of incompleteness 349
A notice requesting additional information to complete a mortgage application, as required by the Equal Credit Opportunity Act (ECOA).

notice of right to rescind 316
A disclosure notifying a homeowner of their right to cancel a non-purchase money consumer mortgage secured by their principal residence, the circumstances allowing the homeowner to cancel and the effects of the rescission.

notice of trustee's sale (NOTS) 403
The notice recorded, posted and mailed to evidence an impending trustee's sale to the property owner and potential bidders.

Notice to Home Loan Applicant 339
A disclosure of the consumer's right to credit score disclosures and how consumer credit scores are used, as required by the Fair Credit Reporting Act (FCRA).

novation 510
An agreement entered into by a mortgage holder, buyer and seller to shift responsibility for a mortgage obligation to the buyer by an assumption and release the seller of liability.

novation agreement 253, 529
An agreement entered into by a mortgage holder, buyer and seller to shift responsibility for a mortgage obligation to the buyer by an assumption and release the seller of liability.

O

open-end mortgage 288
A mortgage which gives the borrower the ability to withdraw funds in a line of credit.

option adjustable rate mortgage (ARM)..213
An adjustable rate mortgage (ARM) giving the borrower the choice of a full monthly payment, an interest-only payment, and a minimum payment typically less than the interest due.

overage...543
A surplus amount in a trust account exceeding the amount of trust funds held in all the subaccounts for individuals.

P

payment cap 209
A limit on the amount of increase in the borrower's monthly principal and interest at the payment adjustment date on an adjustable rate mortgage (ARM).

payoff demand 504
A written demand, prepared by a mortgage lender, for the total dollar amount required on the date of preparation to pay off the mortgage as a requisite for recording a reconveyance of their trust deed lien on a property.

periodic interest rate cap 208
A limit on the amount the interest rate can increase with each future adjustment of an adjustable rate mortgage (ARM).

pledge 534
To offer an asset (such as an existing carryback note) as collateral or security for another, unrelated debt.

portfolio category income 459
Unearned income from interest on investments in bonds, savings, income property, stocks and trust deed notes.

portfolio lender 195
A lender who both funds and holds a mortgage to collect the interest income.

power-of-sale provision 400, 428
A trust deed provision authorizing the trustee to initiate a non-judicial foreclosure sale of the described property on instructions from the beneficiary.

pre-foreclosure workout 402
Negotiations between a mortgage holder and defaulting property owner with the purpose of exploring options to avoid foreclosure.

preliminary title report 487
A report constituting a revocable offer by a title insurer to issue a policy of title insurance, used by a buyer and escrow for an initial review of the vesting and encumbrances recorded and affecting title to a property.

prepayment penalty 107, 210, 526
A levy charged by a mortgage holder to a borrower who pays off the outstanding principal balance on a mortgage prior to its maturity.

principal, interest, taxes and insurance (PITI) 92
The four components of monthly mortgage debt.

principal limit 277
The maximum mortgage amount available to the homeowner on a home equity conversion mortgage (HECM).

private lender 441
An individual or non-government organization that lends money.

private mortgage insurance (PMI) 174, 459
Default mortgage insurance coverage provided by private insurers for conventional loans with loan-to-value ratios (LTVs) higher than 80%.

probate referee (on foreclosure) 423
An appraiser appointed by the court in a judicial foreclosure action to advise the court on a property's fair market value (FMV) on the date of the judicial foreclosure sale.

promissory note 481
A document given as evidence of a debt owed by one person to another.

property charges 273
On a home equity conversion mortgage (HECM), a collective term for property taxes, insurance, ground rents, fees and special assessments.

property profile 487
A report from a title company providing information about a property's ownership, encumbrances, use restrictions and comparable sales data.

purchase money paper 474
A nonrecourse note evidencing a debt for the purchase of a one-to-four unit residential property the buyer is going to occupy, or a seller carryback note and trust deed as an extension of credit to a buyer of any type of real estate which is secured solely by the property sold.

R

Real Estate Settlement Procedures Act (RESPA) 155, 322
A federal law governing the behavior of service providers on a federally related mortgage which prohibits them from giving or receiving unlawful kickbacks.

recast 488
A mortgage holder's demand to modify the note terms and receive payment of additional fees in exchange for waiving the due-on clause in their mortgage.

reconveyance 504
A document executed by a trustee named in a trust deed to release the trust deed lien from title to real estate, used when the secured debt is fully paid.

recourse debt 400, 416, 434, 474, 510, 525
A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

redemption 429
A property owner or junior lienholder's right to clear title to property of a mortgage lien prior to the completion of a trustee's sale or following a judicial foreclosure sale by paying all amounts due on the mortgage debt, including foreclosure charges.

redlining 365
Failure to provide financing in certain communities based on the demographics of that community.

regular financier 302
A lender subject to Truth in Lending Act restrictions by making more than a set threshold of consumer purpose loans or mortgage in a calendar year.

Regulation Z (Reg Z) 302
A federal regulation implementing the Truth in Lending Act (TILA).

reinstatement 428
A property owner or junior lienholder's right to reinstate a mortgage and cure any default prior to five business days before the trustee's sale by paying delinquent amounts due on the note and trust deed, plus foreclosure charges.

rescission 315
The homeowner's termination of a non-purchase money consumer mortgage, restoring the lender and homeowner to their original positions.

reserve requirement **92**
A requirement to hold cash in reserve as a buffer against default in case of a life-changing event.

residential mortgage credit report (RMCR) **129**
A detailed account of a buyer's credit, employment and residence history.

residential mortgage loan report **79, 357**
A report filed by Department of Real Estate (DRE)-licensed mortgage brokers who act as direct lenders.

residual income **245**
On a U.S. Department of Veterans Affairs (VA)-guaranteed mortgage, an analysis of a veteran's monthly debt obligations from their gross income to ensure the veteran is able to meet minimum living expenses.

reverse mortgage **272**
A mortgage which allows senior homeowners to use their home equity as a stream of income.

risk layering **91**
The increased risk of default posed by cumulative smaller risks.

S

Section 32 mortgage **287**
A consumer mortgage subject to additional disclosures and restrictions due to its high points and fees or an annual percentage rate (APR) or prepayment penalty duration which exceeds thresholds set by the federal Truth in Lending Act (TILA).

Section 35 mortgage **293**
A closed-end consumer mortgage secured by a principal residence and subject to mandatory impounds, appraisal requirements and restrictions due to an annual percentage rate (APR) which exceeds thresholds set by the federal Truth in Lending Act (TILA).

Section 609 credit dispute **122**
A credit repair tactic which disputes outdated and unverifiable derogatory information.

Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act) **3**
A federal consumer protection law which created a uniform national licensing and registration scheme for mortgage loan originators (MLOs).

servicer **372**
An individual responsible for receiving scheduled payments from a homeowner by arrangement with the mortgage holder.

service provider **321**
An individual or company which offers services connected with a prospective or actual consumer mortgage origination.

settlement service **323**
Any service provided in connection with a prospective or actual consumer mortgage origination.

short-term rate **496**
A variable interest rate which changes often, driven by Federal Reserve actions to keep inflation and deflation in check.

small lender **105**
In 2018, a lender with assets of $2112 billion or less which made 2,000 or fewer first-lien consumer mortgages in the preceding calendar year (two years, for applications received before April 1).

small lender qualified mortgage **105**
A type of qualified mortgage which allows small lenders to include features otherwise prohibited in consumer mortgages.

small mortgage **451**
A first trust deed debt not exceeding $30,000 or a junior trust deed debt not exceeding $20,000.

sole proprietor **63**
A broker who conducts business as an individual rather than through a licensed corporate entity.

Special Information Booklet **304**
A required Truth in Lending Act (TILA) disclosure containing information about the consumer mortgage process, mortgage features and costs.

stacking order **88**
The order of mortgage application documents requested by a lender.

state-licensed mortgage loan originator (MLO) **12, 47**
A mortgage loan originator (MLO) licensed and regulated by a state agency.

subaccount ledger **535**
An accounting document or file identifying the owner of trust funds and the amount held for the owner.

subordination **527**
An agreement entered into by a mortgage holder to permit their security interest in title to the mortgaged property to take a junior position to another encumbrance.

super-conforming mortgage **196**
A conforming mortgage with a maximum principal amount adjusted for a high-cost area.

surplus funds **412**
The price paid for property by the successful bidder at a trustee's sale in excess of the amount of debt and costs due under the foreclosed trust deed.

T

temporary qualified mortgage **103**
A transitional qualified mortgage for lenders originating mortgages insured or guaranteed by the federal government or sold to Fannie Mae or Freddie Mac.

tenure payment **280**
A home equity conversion mortgage (HECM) payment option in which the homeowner receives equal monthly payments until they die or sell the property.

term payment **279**
A home equity conversion mortgage (HECM) payment option in which the homeowner receives equal monthly payments for a fixed period of time.

three Cs of underwriting **91**
The three major components of a mortgage applicant reviewed by an underwriter: credit, capacity and collateral.

threshold broker **442**
A private lender in the business of making mortgages, or a mortgage broker who annually negotiates or services an aggregate dollar amount of mortgages above a statutory threshold.

tolerances **309**
Acceptable ranges of deviation for changes to fees and amounts disclosed on a Loan Estimate, set by type of charge.

transaction agent (TA) **150**
The term lenders use to identify the buyer's agent in a sales transaction.

transitional license **34**
A provisional mortgage loan originator (MLO) license which allows an MLO moving to another state to perform MLO services for a short period of time while they fulfill requirements to obtain an MLO license in the new state.

triggering terms **166**
Words and phrases in consumer mortgage advertisements which trigger the need for additional disclosures.

trust funds **533**
Items which have or evidence monetary value held by a broker for a client when acting in a real estate transaction.

trustee (on a mortgage) **401**
A party to a mortgage who, as a legal fiction, holds title to property as security for the performance of an obligation with the authority to sell the property or reconvey the trust deed on instructions from the mortgage holder.

trustee's sale guarantee **405**
A policy issued by a title insurance company to a trustee before or at the time the notice of default is recorded providing coverage for the trustee should they fail to serve notices on any party of record due to an omission in the guarantee.

trustor's offset statement **485**
Statement by owner of property or owner of lien against property setting forth the present status of liens against said property.

Truth in Lending Act (TILA) **157, 302**
A federal consumer mortgage law which controls the terms of a consumer mortgage and requires lenders to disclose mortgage rates and charges.

U

U.S. Department of Veterans Affairs (VA) automatic **245**
A lender authorized to certify a mortgage conforms to U.S. Department of Veterans Affairs (VA) regulations.

underwriting **89**
The analysis of the risk of default posed by the information in a complete mortgage application and documentation.

Uniform State Test (UST) **35**
A standardized test fulfilling both national and state components of the mortgage loan originator (MLO) exam.

Uniform Residential Loan Application (URLA) **150**
A standardized mortgage application completed by the buyer with the assistance of the transaction agent and the mortgage lender's representative.

unusable credit **128**
Freddie Mac's designation of credit other than usable credit, e.g., nontraditional debt.

upcharging **53**
The practice of marking up the price of a third-party service and keeping the difference.

usable credit. 128
Freddie Mac's designation that an applicant has enough accurate traditional credit history to generate a valid credit score.

usury 453
A limit on the lender's interest rate yield on nonexempt real estate mortgages.

W

waiver agreement 395
An agreement in which a mortgage holder consents to the owner's present or future transfer of an interest in the mortgaged property as a waiver of the mortgage holder's due-on rights. Also known as an assumption agreement.

warehouse lender 195
A lender who fund a mortgage under an agreement to immediately resell the mortgage in the secondary mortgage market.

Y

yield 495
The interest earned by an investor on an investment (or by a bank on the money it has loaned). Also, called return.

Mortgage Loan Brokering and Lending, First Edition Quizzes

Instructions: Quizzes are open book. All answers are Multiple Choice.
The answer key is located on Page 598.

Quiz 1 — Chapters 1-3, Pages 1-38

____ 1. The __________ compels the license and registration of all mortgage loan originators (MLOs).

a. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)
b. Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act)
c. Department of Motor Vehicles (DMV)
d. Wall Street Licensing Act

____ 2. The two categories of MLOs are:

a. federally registered MLOs and state-licensed MLOs.
b. federally registered MLOs and direct lenders.
c. state-licensed MLOs and Department of Real Estate (DRE) MLOs.
d. federally registered MLOs and federally exempt MLOs.

____ 3. A(n) __________ is used primarily for a consumer purpose and secured by a one-to-four unit residential property.

a. auto mortgage
b. business mortgage
c. consumer mortgage
d. trust fund

____ 4. The two California agencies which license and endorse MLOs are the:

a. DRE and the Internal Revenue Service (IRS).
b. DRE and the Legislative Analyst's Office (LAO).
c. DRE and the Department of Financial Protection and Innovation (DFPI).
d. DFPI and the IRS.

____ 5. The first step to being an MLO under the DRE scheme is to obtain a(n):

a. MLO endorsement.
b. law degree.
c. bachelor's degree.
d. DRE license.

____ 6. To qualify for an MLO endorsement, an individual broker or agent needs to complete __________ of pre-endorsement education.

a. 20 hours
b. ten hours
c. eight hours
d. 45 hours

____ 7. To renew an individual MLO endorsement, an individual broker or agent needs to complete __________ of continuing education.

a. 20 hours
b. ten hours
c. eight hours
d. 12 hours

____ 8. MLO licenses and endorsements are valid through __________ of each calendar year.

a. December 1
b. January 1
c. November 1
d. December 31

_____ 9. Individual DRE brokers and agents with MLO endorsements may perform consumer mortgage activities on behalf of a DFPI company if they hold a(n) __________ license.

a. passive
b. active
c. expired
d. federal

_____ 10. MLO applicants can take the __________ to fulfill the MLO testing requirements in any state which has adopted it.

a. Uniform State Test (UST)
b. State Bar exam
c. Standard Aptitude Test (SAT)
d. DRE broker exam

Quiz 2 — Chapters 4-7, Pages 39-72

_____ 1. Department of Real Estate (DRE) licensees who perform __________ activities need a mortgage loan originator (MLO) endorsement.

a. property management
b. real estate sales
c. consumer mortgage
d. business mortgage

_____ 2. The __________ website provides mortgage consumers with information about an MLO's licensing and employment records.

a. Federal Bureau of Investigation (FBI)
b. Federal Trade Commission (FTC)
c. Federal Reserve
d. Nationwide Mortgage Licensing System (NMLS) Consumer Access

_____ 3. An MLO may be compensated based on the __________ of a mortgage they originate.

a. interest rate
b. loan-to-value ratio (LTV)
c. principal amount
d. annual percentage rate (APR)

_____ 4. MLO compensation includes:

a. credit report fees.
b. appraisal fees.
c. title insurance fees.
d. bonuses.

_____ 5. A(n) __________ is a fee an MLO receives before MLO services are fully completed.

a. rent
b. advance fee
c. kickback
d. steering fee

_____ 6. In a consumer mortgage transaction, an __________ may collect a separate fee for performing other sales transaction services not included as part of mortgage origination services.

a. MLO broker
b. individual MLO
c. unlicensed finder
d. unlicensed assistant

_____ 7. To establish a corporation, a broker needs to file __________ with the California Secretary of State.

a. Articles of Incorporation
b. a rental agreement
c. an MU4 form
d. a notary exemption

_____ 8. A broker who conducts business as an individual and does not operate through a licensed corporate entity is a:

a. partnership.
b. tax-exempt charity.
c. sole proprietor.
d. salesperson.

_____ 9. __________ covers negligent conduct when acting as a licensee.

a. DRE insurance
b. Earthquake insurance
c. Errors and omissions (E&O) insurance
d. Workers' compensation insurance

_____ 10. Brokers are required to provide __________ to all employees, including their licensed agents.

a. health insurance
b. workers' compensation insurance
c. life insurance
d. mortgage insurance

Quiz 3 — Chapters 8-11, Pages 73-118

_____ 1. The mortgage loan activity notification must be filed by Department of Real Estate (DRE) licensees within __________ of commencing consumer mortgage activity.

a. 30 days
b. 90 days
c. three days
d. one year

_____ 2. The __________ provides to the DRE details about mortgage activity undertaken by an employing broker and their sales agents and broker-associates.

a. mortgage call report
b. Articles of Incorporation
c. license application
d. business activity report

_____ 3. The __________ is a report filed to the DRE by mortgage brokers who act as direct lenders.

a. residential mortgage loan report
b. appraisal
c. mortgage call report
d. credit report

_____ 4. The __________ is a report administered by the Nationwide Mortgage Licensing System (NMLS) and used to track origination activity and enhance regulatory oversight.

a. mortgage loan activity notification
b. mortgage call report
c. business activity report
d. title report

_____ 5. A DRE broker who __________ is required to file an expanded mortgage call report.

a. sells mortgages to Fannie Mae or Freddie Mac
b. arranges consumer mortgages
c. only provides real estate services
d. makes Federal Housing Administration (FHA)-insured mortgages

_____ 6. One of the three Cs of underwriting is:

a. commingling.
b. cash.
c. credit.
d. consumer protection.

_____ 7. A mortgage holder who originates a __________ is deemed to have met the Regulation Z (Reg Z) ability-to-repay requirements.

a. negative amortization mortgage
b. business mortgage
c. qualified mortgage
d. disqualified mortgage

_____ 8. Only __________ may originate balloon-payment qualified mortgages.

a. small lenders
b. banks
c. large lenders
d. government agencies

_____ 9. Foreclosures stay on a buyer's credit file for:

a. ten years.
c. seven years.

b. three years. d. 90 days.

____ 10. Hard inquiries stay on a credit report for:

a. ten years. c. seven years.

b. two years. d. one year.

Quiz 4 — Chapters 12-14, Pages 119-148

____ 1. A(n) __________ is any individual or company who offers or provides services to improve a buyer's credit history in exchange for a fee.

a. appraiser c. housing counselor

b. credit repair organization d. lender

____ 2. A buyer can cancel a credit repair agreement within __________ after signing it.

a. 30 days c. 20 days

b. ten days d. three business days

____ 3. A credit repair tactic involving disputing outdated and unverifiable derogatory information is known as:

a. a reverse mortgage. c. Section 8 housing.

b. a Section 609 credit dispute. d. acceleration.

____ 4. Nontraditional credit may be used:

a. for minorities only. c. for thin credit files.

b. in lieu of bad credit files. d. only by senior citizens.

____ 5. __________ are companies which compile credit information from the credit bureaus and sell credit reports to consumers or lenders.

a. Direct lenders c. Government-sponsored enterprises

b. Consumer reporting agencies d. Credit repair organizations

____ 6. Fannie Mae's Tier I nontraditional credit sources include:

a. medical insurance payments. c. electricity bills.

b. child care payments. d. car insurance payments.

____ 7. The fair market value of a property arrived at by the appraiser is known as:

a. the standard deviation. c. the full credit bid.

b. the property's appraised value. d. anti-deficiency.

____ 8. An appraiser may take the __________ into account when determining a property's value.

a. property's utility c. equity in the property

b. listing price d. present owner's acquisition cost

____ 9. The __________ is the most commonly used method to establish a property's fair market value.

a. capitalization approach c. cost approach

b. mortgage approach d. comparative market approach

_____ 10. Asking an appraiser to __________ is a violation of appraiser independence.

a. consider additional relevant property information
b. correct errors in the appraisal report
c. inflate a property's value to facilitate a mortgage approval
d. provide further explanation of their valuation

Quiz 5 — Chapters 15-17, Pages 149-178

_____ 1. URLA stands for:

a. Uniform Real Loan Application.
b. Uniform Residential Loan Application.
c. Universal Real Estate Application.
d. Uniform Rental Lease Application.

_____ 2. The buyer's __________ disclose(s) their net worth.

a. assets and liabilities
b. tax return release
c. credit score
d. debt-to-income ratio (DTI)

_____ 3. In disclosing assets and liabilities on the URLA, a balance is struck between financial privacy and:

a. tenant improvements.
b. getting creditworthiness clearance.
c. discrimination.
d. employment opportunities.

_____ 4. Department of Real Estate (DRE) licensees need to disclose their __________ on all marketing materials advertising mortgages.

a. DRE license number
b. trade union status
c. picture
d. political affiliation

_____ 5. Materials used to solicit or create a client relationship are known as:

a. disclosures.
b. first-point-of-contact materials.
c. third-party materials.
d. guarantees.

_____ 6. The use of __________ in a consumer mortgage advertisement is a triggering term.

a. the lender's name
b. the lender's license number
c. the percentage of a down payment
d. whether the rate is fixed or adjustable

_____ 7. __________ indemnifies the mortgage lender in case of a loss due to the buyer's default.

a. Mortgage life insurance
b. Private mortgage insurance (PMI)
c. Health insurance
d. Unemployment insurance

_____ 8. With __________, the lender pays the mortgage insurance premium and charges the buyer a higher interest rate.

a. buyer-paid PMI
b. lender-paid PMI
c. subsidized PMI
d. government-insured PMI

_____ 9. A __________ may qualify for PMI.

a. corporation
b. partnership
c. natural person
d. limited liability company (LLC)

_____ 10. PMI providers are required by law to cancel PMI payments at __________ loan-to-value ratio (LTV), upon the buyer's request.

a. 20%
b. 10%
c. 70%
d. 80%

Quiz 6 — Chapters 18-20, Pages 179-218

_____ 1. The impound provision calls for monthly payments to be applied towards:

a. principal and interest only.
b. taxes and insurance.
c. interest only.
d. maintenance costs.

_____ 2. A consumer mortgage lender is required to deliver an initial impound statement within __________ after the close of escrow.

a. 45 days
b. 30 days
c. ten days
d. 90 days

_____ 3. A Federal Housing Administration (FHA)-insured mortgage is a:

a. conventional mortgage.
b. government-related mortgage.
c. business mortgage.
d. lender overlay.

_____ 4. Additional minimum requirements imposed by a lender in addition to mortgage insurer and investor guidelines are called:

a. lender overlays.
b. private mortgage insurance (PMI).
c. government sponsorships.
d. shopping worksheets.

_____ 5. Mortgages with principal amounts at or below the ceilings set by Fannie Mae and Freddie Mac are known as:

a. government-related mortgages.
b. fixed-rate mortgages.
c. jumbo mortgages.
d. conforming mortgages.

_____ 6. The __________ is the initial rate on an adjustable rate mortgage (ARM).

a. introductory interest rate
b. margin
c. index
d. ceiling

_____ 7. The 12-month Treasury Average and the COFI are examples of:

a. lender overlays.
b. margins.
c. lifetime caps.
d. ARM indexes.

_____ 8. On an ARM, the fully-indexed rate is determined by adding:

a. the introductory interest rate and the periodic adjustment cap.
b. the index and the ceiling.
c. the index and the introductory interest rate.
d. the index and the margin.

_____ 9. All consumer-purpose ARMs secured by liens on one-to-four unit residential dwellings must have:

a. prepayment penalties.
b. payment caps.
c. lifetime interest rate caps.
d. lifetime margin calls.

_____ 10. The __________ has a fixed rate for the initial fixed period, with an adjustable rate for the remainder of the term.

a. option ARM
b. fixed-rate mortgage
c. hybrid ARM
d. interest-only ARM

Quiz 7 — Chapters 21-23, Pages 219-262

____ 1. The most common Federal Housing Administration (FHA) program is the owner-occupied, one-to-four unit _________ program.

a. 401(k)
b. 225
c. 203(b)
d. Title I

____ 2. The _________ on an FHA-insured mortgage is paid on closing.

a. up-front mortgage insurance premium (MIP)
b. private mortgage insurance (PMI)
c. annual MIP
d. lender-paid PMI

____ 3. The minimum down payment on an FHA-insured mortgage is:

a. 3%.
b. 3.5%.
c. 96.5%.
d. 80%.

____ 4. In general, for a borrower to be deemed creditworthy by the FHA, the buyer's mortgage payment ratio must not exceed _________ of the buyer's gross effective income.

a. 25%
b. 27%
c. 31%
d. 45%

____ 5. An FHA Energy-Efficient Mortgage (EEM) may be used in connection with:

a. only purchase mortgages.
b. only refinances.
c. Both a. and b.
d. Neither a. nor b.

____ 6. The set of EEM improvements agreed to by the homebuyer based on the energy rater's report is called the:

a. energy package.
b. audit.
c. stacking order.
d. rehabilitation order.

____ 7. On an EEM secured by an existing property, the energy package is to be installed within _________ of closing on the mortgage.

a. 45 days
b. 25 days
c. 90 days
d. ten days

____ 8. The amount of a U.S. Department of Veterans Affairs (VA) mortgage guaranteed by the VA is called the:

a. closing cost fee.
b. financing fee.
c. guaranty entitlement.
d. PMI premium.

____ 9. A veteran buying their first home with a VA-guaranteed mortgage and a 0% downpayment pays a _________ funding fee.

a. 1.25%
b. 2.25%
c. 3.00%
d 2.15%

____ 10. The _________ is the VA's version of a rate and term refinance.

a. Interest Rate Reduction Refinance Loan (IRRRL)
b. EEM
c. home equity line of credit (HELOC)
d. Section 203(b) refinance

Quiz 8 — Chapters 24-26, Pages 263-300

_____ 1. A homeowner can draw on a home equity line of credit (HELOC) during the:

a. end-of-draw period.
b. draw period.
c. amortization period.
d. freeze.

_____ 2. During the __________ of a HELOC, the homeowner must make monthly payments of principal and interest.

a. end-of-draw period
b. draw period
c. hold phase
d. application process

_____ 3. Under what circumstances may a lender change the terms of a HELOC?

a. The lender's security interest in the property is less than 120% of the credit line.
b. The homeowner draws the full amount of the HELOC.
c. The homeowner installs drought-tolerant landscaping.
d. The homeowner obtains a new auto loan.

_____ 4. A lender is required to issue written notice of a change in the terms of a HELOC __________ or more before the change goes into effect.

a. three days
b. three years
c. ten days
d. 15 days

_____ 5. To be eligible for a home equity conversion mortgage (HECM), the borrower must be at least:

a. 65 years old.
b. 73 years old.
c. 62 years old.
d. 21 years old.

_____ 6. On a HECM, the __________ is the lesser of the appraised value and the maximum loan amount allowed for the area, as set by the Federal Housing Administration (FHA).

a. maximum claim amount
b. principal limit
c. mortgage balance
d. equity

_____ 7. On a HECM, the __________ is the maximum mortgage amount available to the homeowner.

a. maximum claim amount
b. principal limit
c. mortgage balance
d. equity

_____ 8. Which scenario triggers repayment of a HECM?

a. The homeowner dies without a surviving spouse.
b. The homeowner's non-borrowing spouse dies.
c. The homeowner purchases a rental property.
d. The homeowner divorces their non-borrowing spouse.

_____ 9. Which of these is NOT a requirement on a Section 32 mortgage?

a. Pre-mortgage counseling.
b. Advance fees paid to the lender for the additional risk.
c. Section 32 disclosures.
d. Limited transaction terms, fees and practices.

_____ 10. Which of these is a requirement on a Section 35 mortgage?

a. Impound accounts.
b. Negative amortization.
c. A prepayment penalty lasting the term of the mortgage.
d. Triple appraisals on a flip.

Quiz 9 — Chapters 27-30, Pages 301-336

_____ 1. Regulation Z (Reg Z) disclosures are triggered when a lender makes more than __________ Section 32 high-cost loan(s) in a calendar year.

a. one
b. five
c. 25
d. ten

_____ 2. A lender may charge a(n) __________ to the homebuyer before the Loan Estimate is delivered.

a. appraisal fee
b. title report fee
c. origination fee
d. credit report fee

_____ 3. The Loan Estimate form is delivered to the borrower within __________ after a homebuyer submits a consumer mortgage application.

a. three calendar days
b. seven calendar days
c. three business days
d. 90 days

_____ 4. The amount for __________ disclosed on a Loan Estimate may change without restriction.

a. recording fees
b. an origination fee charged by a mortgage loan originator (MLO)
c. prepaid interest
d. transfer taxes

_____ 5. At least __________ must pass between delivering the Loan Estimate and mortgage closing.

a. three business days
b. ten business days
c. seven business days
d. one business day

_____ 6. At least __________ must pass between delivering the Closing Disclosure and mortgage closing.

a. three business days
b. ten business days
c. seven business days
d. one business day

_____ 7. The right of rescission applies to a:

a. mortgage used to purchase a principal residence.
b. refinance of a mortgage secured by an investment property.
c. refinance of a mortgage secured by a principal residence.
d. mortgage used to purchase a rental property.

_____ 8. The borrower's right to rescind is extended up to __________ from the date the loan documents are signed if the lender fails to provide a timely notice of the right to rescind.

a. two years
b. three years
c. six years
d. one year

_____ 9. Which of the following is an unlawful kickback under the Real Estate Settlement Procedures Act (RESPA)?

a. A lender pays an MLO for their MLO services.

b. A title company pays for a broker's vacation in exchange for business referrals.

c. A broker pays an unlicensed assistant for clerical work relating to a mortgage origination.

d. All of the above.

_____ 10. A broker may receive a __________ for referring a client to a service provider they own under an affiliated business arrangement.

a. referral fee

b. share of an annual increase in the provider's earnings due to the referral

c. nonmonetary bonus

d. car

Quiz 10 — Chapters 31-34, Pages 337-370

_____ 1. The credit score exception notice required by the Fair Credit Reporting Act (FCRA) contains the:

a. credit score disclosure.

b. good faith estimate.

c. Closing Disclosure.

d. HUD-1 settlement statement.

_____ 2. The credit score disclosure required by the FCRA contains up to __________ key factors which adversely affect an applicant's credit score.

a. one

b. two

c. four

d. eight

_____ 3. The Equal Credit Opportunity Act (ECOA) anti-discrimination rules apply to:

a. mortgage loan originators (MLOs).

b. lenders.

c. mortgage loan brokers (MLBs).

d. All the above.

_____ 4. Both the __________ and the __________ require the collection of government monitoring information (GMI).

a. ECOA ; Home Mortgage Disclosure Act (HMDA)

b. ECOA ; Real Estate Settlement Procedures Act (RESPA)

c. HMDA ; FCRA

d. ECOA ; FCRA

_____ 5. The ECOA requires the lender to notify a loan applicant of its decision to approve, deny or counter a loan application within __________ of receiving a complete application.

a. 30 days

b. 45 days

c. 15 days

d. three days

_____ 6. Home Mortgage Disclosure Act (HMDA) data is collected electronically on the:

a. good faith estimate.

b. Loan Estimate.

c. Loan/Application Register (LAR).

d. credit report.

_____ 7. HMDA data is collected on:

a. purchase-assist mortgages.
b. construction mortgages.
c. home improvement mortgages.
d. All of the above.

_____ 8. If an applicant chooses not to provide GMI, the mortgage loan originator (MLO) must:

a. notify the applicant they are subject to fines for violation of HMDA.
b. force the applicant to provide the data.
c. note the data on the basis of visual observation and surname.
d. report their noncompliance to the police.

_____ 9. Annually reported HMDA data is compiled by the FFIEC into the:

a. disclosure statement.
b. affiliated business disclosure.
c. Section 32 disclosure.
d. adverse action notice.

_____ 10. Failure to provide financing in a community based on the demographics of that community is called:

a. redshifting.
b. redlining.
c. moonlighting.
d. hypothecation.

Quiz 11 — Chapters 35-37, Pages 371-414

_____ 1. A(n) __________ is any individual offering services which claim to aid homeowners with mortgage-related issues, for a fee.

a. dwelling
b. lender
c. foreclosure consultant
d. arbitrator

_____ 2. A(n) __________ is anything written or spoken used to attract homeowners to a service.

a. commercial communication
b. open house
c. agency disclosure
d. notice of default

_____ 3. A commercial communication not geared towards a specific consumer is called a:

a. general commercial communication.
b. mass-media commercial communication.
c. trans-commercial communication.
d. lis pendens.

_____ 4. A demand for full payment remaining due on a mortgage is called:

a. hastening.
b. acceleration.
c. assumption.
d. creditworthiness.

_____ 5. A due-on clause can be triggered by a:

a. sale.
b. land sales contract.
c. lease with a four-year term.
d. All of the above.

_____ 6. The inter-family transfer exception applies to transfers:

a. from child to parent.
b. from parent to a child.
c. from roommate to roommate.
d. from tenant to child.

_____ 7. A trustee begins the nonjudicial foreclosure process by recording a(n):

a. writ of execution.
b. easement action.
c. beneficiary statement.
d. notice of default (NOD).

_____ 8. At least __________ before initiating the foreclosure process, a mortgage holder needs to conduct a preforeclosure workout with the homeowner.

a. one year
b. two years
c. 45 days
d. 30 days

_____ 9. Within __________ after recording an NOD, two copies of the NOD are mailed to the property owner.

a. 45 calendar days
b. 30 business days
c. ten business days
d. 15 calendar days

_____ 10. At least __________ days before the trustee's sale, the trustee sends two copies of the notice of trustee's sale to each party who received the NOD.

a. 45 calendar days
b. 20 calendar days
c. ten business days
d. 15 business days

Quiz 12 — Chapters 38-40, Pages 415-446

_____ 1. A(n) __________ is the court-ordered sale by public auction of the secured property.

a. judicial foreclosure
b. easement sale
c. trustee's sale
d. fair value hearing

_____ 2. The first step in a judicial foreclosure process is to:

a. evict the property owner.
b. file a complaint in the Superior Court of the county where the property is located.
c. file a notice of default (NOD).
d. file a notice of trustee's sale (NOTS).

_____ 3. A __________ is issued to the successful bidder on the completion of a judicial foreclosure sale.

a. below market bid
b. certificate of sale
c. certificate of test administrator
d. writ of sale

_____ 4. An owner is able to terminate the foreclosure proceedings through __________ by paying the foreclosure charges and delinquent amounts due on the mortgage debt.

a. redemption
b. anti-deficiency
c. reinstatement
d. waste

_____ 5. An owner is able to terminate the foreclosure proceedings through __________ by paying the foreclosure charges and the entire amount due on the mortgage debt.

a. redemption
b. anti-deficiency
c. reinstatement
d. waste

_____ 6. An owner who fails to meet their obligations to maintain the secured real estate is in default under the:

a. due-on clause.
b. safety clause.
c. waste provision.
d. recourse provision.

_____ 7. A mortgage holder of a __________ may pursue the homeowner personally to collect for a deficiency in the property value to pay off the debt after a default.

a. nonrecourse debt
b. carryback note
c. recourse debt
d. All of the above.

____ 8. A __________ is made for other than personal, household or family use and secured by any type of real estate.

a. consumer mortgage
b. qualified mortgage
c. small lender qualified mortgage
d. business mortgage

____ 9. Individuals who make __________ or more mortgages secured by one-to-four unit residential real estate during a calendar year from their own funds are required to have a Department of Real Estate (DRE) broker license.

a. one
b. three
c. five
d. eight

____ 10. A __________ is a business mortgage secured by real estate, with a term of one year or less.

a. consumer mortgage
b. hard money mortgage
c. reverse mortgage
d. home equity line of credit (HELOC)

Quiz 13 — Chapters 41-43, Pages 447-480

____ 1. A __________ is in the business of buying and selling trust deed notes, mortgage-backed loans and land sales contracts for their own account.

a. credit repair organization
b. mortgage loan originator (MLO)
c. trust deed dealer
d. trust deed broker

____ 2. A small mortgage is a first trust deed with a principal balance of __________ or less.

a. $100,000
b. $30,000
c. $35,000
d. $50,000

____ 3. Today, the goal of __________ is the prevention of loan-sharking by non-exempt lenders.

a. fair lending laws
b. credit repair laws
c. real estate licensing laws
d. usury laws

____ 4. __________ are all mortgages made by lenders that are neither made nor arranged by a broker.

a. Business mortgages
b. Restricted mortgages
c. Unrestricted mortgages
d. Consumer mortgages

____ 5. __________ occurs when a seller carries back a note and trust deed executed by the buyer to evidence a debt owed for purchase of the seller's property.

a. Carryback financing
b. Foreclosure
c. Hypothecation
d. Rescission

____ 6. With a(n) __________, the amount owed to the seller on the carryback note is always secured by a junior trust deed lien on the property.

a. consumer mortgage
b. all-inclusive trust deed (AITD) carryback
c. adjustable rate mortgage (ARM)
d. option ARM

____ 7. Surplus funds accumulated in an impound account by a carryback seller are to be refunded within __________ of the surplus being incurred.

a. 45 days
b. 60 days
c. 90 days
d. 30 days

_____ 8. A seller carrying back a mortgage on a one-to-four unit residential property with an impound provision has to provide the buyer with an annual impound accounting within __________ after the end of the calendar year.

a. 45 days
b. ten days
c. 60 days
d. 120 days

_____ 9. The repayment of a mortgage-backed loan (MBL) is secured by:

a. a trust deed note.
b. real estate.
c. a car.
d. Nothing; it is unsecured.

_____ 10. On the close of escrow, a trust deed note may be transferred from the noteholder to the investor by:

a. assignment.
b. endorsement.
c. guarantee.
d. Any of the above.

Quiz 14 — Chapters 44-47, Pages 481-522

_____ 1. For a trust deed investor to enforce collection of principal and interest payments called for in a trust deed note, they need to qualify as a:

a. limited liability company (LLC).
b. mortgage loan originator (MLO).
c. holder in due course.
d. real estate broker.

_____ 2. A __________ uncovers defects in the note the owner of the real estate obligated to pay the debt might assert against the investor's enforcement of the note.

a. trustor's offset statement
b. Closing Disclosure
c. rescission notice
d. notice of trustee's sale

_____ 3. A written disclosure made by a mortgage holder regarding the condition of a debt owed to them is called a(n):

a. authorized agent.
b. beneficiary statement.
c. yield.
d. mortgage call report.

_____ 4. A __________ is the initial disclosure of the mortgages of record recorded prior to and after the trust deed securing the note being sold was recorded.

a. novation agreement
b. adverse action notice
c. due-on clause
d. property profile

_____ 5. An installment sale produces the financial benefit of a deferred tax liability until:

a. the principal balance is paid.
b. the possession of the property passes to the buyer.
c. the buyer signs the purchase agreement.
d. All of the above.

_____ 6. A __________ is a person entitled to receive a beneficiary statement.

a. property owner
b. successor-in-interest
c. junior mortgage holder
d. All of the above.

_____ 7. A release of liability from the mortgage holder for any future errors in the beneficiary statements is called a(n):

a. allonge.
b. lis pendens.
c. novation.
d. recourse.

_____ 8. Accepting money from an investor before locating the real estate securing the trust deed is called a:

a. desk review.
b. full credit bid.
c. margin.
d. blind pool investment.

_____ 9. A mortgage loan broker (MLB) who solicits investors for fractionalized trust deed investments can solicit the public to invest and avoid registration as a securities dealer under the:

a. 35-or-less interrelationship rule.
b. ten-or-less trust deed investment plan.
c. impound account provision.
d. notice of right to rescind.

_____ 10. An MLB needs to have a meaningful pre-existing relationship with the investors they solicit for a fractionalized trust deed investment under the __________ to avoid registration as a securities dealer.

a. notice of right to rescind
b. 35-or-less interrelationship rule
c. impound account provision
d. ten-or-less trust deed investment plan

Quiz 15 — Chapters 48-50, Pages 523-558

_____ 1. The __________ releases an owner for liability in the event circumstances beyond their control impair the security.

a. exculpatory clause
b. due-on clause
c. inter vivos trust
d. property profile

_____ 2. A __________ occurs when a mortgage holder agrees to take a junior position to another encumbrance.

a. foreclosure
b. reinstatement
c. conversion
d. subordination

_____ 3. Funds belonging to others which a broker handles when acting as an agent in a transaction are called:

a. trust funds.
b. commissions.
c. residual income.
d. the principal limit.

_____ 4. __________ is an example of a trust fund.

a. A deposit on an offer to purchase
b. An advance fee
c. A tenant's security deposit
d. All of the above.

_____ 5. A broker needs to deposit negotiable trust funds prior to the end of the __________ after receiving them.

a. seventh business day
b. first business day
c. tenth business day
d. third business day

_____ 6. __________ occurs when a broker places personal funds in excess of set limits in a trust fund account.

a. Improper commingling
b. Negative amortization
c. Extortion
d. Redlining

_____ 7. All records of trust funds are retained by the broker for __________ after closing.

a. three years
b. ten years
c. 90 days
d. 120 days

_____ 8. A(n) __________ occurs when the amount of all funds held in the trust account exceeds the amount of trust funds held in all the subaccounts for individuals.

a. tolerance
b. recast
c. overage
d. balloon payment

_____ 9. A __________ is written authorization for a broker to service a note on behalf of the noteholder.

a. stacking order
b. loan servicing agreement
c. litigation guarantee
d. waiver agreement

_____ 10. Threshold mortgage loan brokers (MLBs) file a quarterly report on the status of their trust funds within __________ after the end of the first three fiscal quarters.

a. 30 days
b. 45 days
c. 60 days
d. 90 days

Answer References

The following are the answers to the quizzes for *Mortgage Loan Brokering and Lending, First Edition* and the page numbers in the printed material where they are located.

Quiz 1

1.	b	3
2.	a	4
3.	c	5
4.	c	12
5.	d	17
6.	a	20
7.	c	22
8.	d	25
9.	b	32
10.	a	35

Quiz 2

1.	c	40
2.	d	48
3.	c	53
4.	d	53
5.	b	56
6.	a	57
7.	a	62
8.	c	63
9.	c	64
10.	b	68

Quiz 3

1.	a	74
2.	d	76
3.	a	78
4.	b	81
5.	a	82
6.	c	91
7.	c	102
8.	a	106
9.	c	113
10.	b	114

Quiz 4

1.	b	120
2.	d	121
3.	b	122
4.	c	126
5.	b	127
6.	c	128
7.	b	136
8.	a	137
9.	d	140
10.	c	147

Quiz 5

1.	b	150
2.	a	153
3.	b	153
4.	a	162
5.	b	163
6.	c	166
7.	b	173
8.	b	174
9.	c	176
10.	d	177

Quiz 6

1.	b	180
2.	a	184
3.	b	194
4.	a	194
5.	d	196
6.	a	206
7.	d	206
8.	d	207
9.	c	208
10.	c	212

Quiz 7

1.	c	220
2.	a	220
3.	b	222
4.	c	226
5.	c	236
6.	a	236
7.	c	239
8.	c	243
9.	d	249
10.	a	254

Quiz 8

1.	b	264
2.	a	264
3.	a	267
4.	d	267
5.	c	272
6.	a	277
7.	b	277
8.	a	284
9.	b	290
10.	a	293

Quiz 9

1.	a	302
2.	d	307
3.	c	307
4.	c	309
5.	c	310
6.	a	311
7.	c	316
8.	b	318
9.	b	323
10.	b	330

Quiz 10

1.	a	338
2.	c	339
3.	d	344
4.	a	348
5.	a	349
6.	c	354
7.	d	355
8.	c	357
9.	a	357
10.	b	365

Quiz 11

1.	c	372
2.	a	374
3.	a	374
4.	b	386
5.	d	388
6.	b	394
7.	d	401
8.	d	402
9.	c	406
10.	b	409

Quiz 12

1.	a	416
2.	b	417
3.	b	422
4.	c	429
5.	a	429
6.	c	433
7.	c	434
8.	d	439
9.	d	440
10.	b	441

Quiz 13

1.	c	448
2.	b	451
3.	d	453
4.	b	453
5.	a	458
6.	b	461
7.	d	464
8.	c	464
9.	a	468
10.	d	473

Quiz 14

1.	c	481
2.	a	485
3.	b	486
4.	d	487
5.	a	498
6.	d	506
7.	c	510
8.	d	514
9.	b	514
10.	b	514

Quiz 15

1.	a	526
2.	d	527
3.	a	533
4.	d	534
5.	d	535
6.	a	539
7.	a	542
8.	c	543
9.	b	548
10.	a	553