Chapter 4

Learn Mortgage

Conventional Loans/Financing

Chapter Objectives

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

Conventional Loans and Financing

- **Conventional Loans**
  - Made by a bank or institutional lender; not insured/guaranteed by government
  - Most conform to GSE guidelines to sell in secondary market; called a conforming loan

12 CFR 1026, § 1026.43(e)

Conventional Loans and Financing

- **Conventional Loans**
  - Made by a bank or institutional lender; not insured/guaranteed by government
  - May be conforming loans or nonconforming loans
- **Conforming Loans**
  - Meets the criteria necessary to be sold in the secondary market

Conventional Loans and Financing

- **Traditional Mortgages**
  - Features that must always be present:
    - 30-year repayment term
    - Fixed interest rate
    - Full amortization schedule
- **Nontraditional Mortgages**
  - Any mortgage loan that is not a 30-year, fixed-rate, fully-amortizing mortgage loan

Conventional Loans and Financing

- **Traditional Loan Features**
  - **Repayment Terms**
    - Longer terms: lower monthly payments, higher total interest paid
    - Shorter terms: higher monthly payments, less interest paid
    - Shorter-term loans typically have a lower rate
  - **30-year Repayment Term**
    - Traditional mortgage loan must have a 30-year loan repayment term

Conventional Loans and Financing

- **Traditional Loan Features**
  - **Amortization**
    - Reduction of the balance of the loan by paying back some of the principal owed on a regular basis
  - **Full Amortization**
    - Feature of traditional mortgage loan
    - Total payments over the life of a loan pay off the entire balance of principal and interest due at the end of the term
    - Also known as self-liquidating loans

Conventional Loans and Financing

30-Year Fixed-Rate Fully Amortizing Loan
Beginning Balance: $100,000
Interest Rate: 5% Fixed
Monthly Payment: $537

Year	Total Payment	Interest Paid	Principal Paid	Ending Balance
1	$6,442	**$4,966**	**$1,475**	$98,525
5	$6,442	$4,641	$1,801	$91,828
10	$6,442	$4,130	$2,312	$81,431
15	$6,442	$3,475	$2,697	$67,882
20	$6,442	**$2,635**	**$3,808**	$50,609
25	$6,442	$1,555	$4,887	$28,441
30	$6,435	$171	$5,264	$0
Total	**$193,252**	**$93,252**	**$100,000**	

15-Year Fixed-Rate Fully Amortizing Loan
Beginning Balance: $100,000
Interest Rate: 5% Fixed
Monthly Payment: $791

Year	Total Payment	Interest Paid	Principal Paid	Ending Balance
1	$9,490	**$4,896**	**$4,594**	$95,406
5	$9,490	$3,881	$5,609	$74,557
10	$9,490	$2,292	$7,198	$41,904
15	$9,488	$252	$9,236	$0
Total	**$141,342**	**$42,342**	**$100,000**	

Numbers shown are not exact to simplify sample amortization schedules.

Conventional Loans and Financing

- **Nontraditional Loan Features**
  - Partial, no, negative amortization
  - No amortization; interest-only loan; pay only interest
  - Negative amortization schedule; make payments that do not pay any principal and only partially pay interest that is accruing; reverse mortgage

Conventional Loans and Financing

- **Traditional Loan Features**
  - **Interest Rate**
    - Rate types are primarily classified as fixed or adjustable (variable)
    - Within those classifications, there are sub-classifications, such as hybrid loans, which incorporate aspects of both
  - **Fixed Interest Rate**
    - Feature of traditional mortgage loan
    - Interest rate remains constant for the duration of the loan

4.1 Knowledge Check

1. A _____ loan is BEST defined as a loan that meets the criteria necessary to be sold in the secondary market.

A. conforming

B. conventional

C. fixed-rate

D. nonconforming

4.1 Knowledge Check

2. A self-liquidating loan

A. requires a balloon payment to be made at the end of the loan term.

B. is one where the borrower’s monthly payments reduce the principal balance of the loan over the term of the loan.

Conforming vs. Nonconforming Loans

- **Conforming Loans**
  - Meet Fannie Mae / Freddie Mac standards; can be sold on the secondary market
  - Qualifying Guidelines
    - 28% total housing expense ratio
    - 36% total debt-to-income ratio
    - Borrowers must qualify under both ratios
    - Borrowers should have 2 months of reserves
- **Nonconforming Loans**
  - Do **not** meet standards and **cannot** be sold to Fannie Mae / Freddie Mac
  - Can be sold to other secondary markets

Conforming vs. Nonconforming Loans

- **Nonconforming Classification Reasons**
  - **Size of the loan:** Jumbo loans exceed the maximum loan amount established by the FHFA for Fannie Mae and Freddie Mac conforming mortgage loan limits
  - **Credit quality of borrower:** Borrower does not meet the minimum standards established by Fannie Mae/Freddie Mac; classified as a B or C borrower
- **A-Minus Conventional Loans**
  - Limit the loss of market share to the subprime nonconforming lenders; interest rate and fees based on risks; rarely offered

Conventional Loan Products

- **Fannie Mae Standardized Products**
  – HomeReady
  – HomeStyle Renovation
  – 97% LTV Options
- **Freddie Mac Standardized Products**
  – Home Possible
  – HomeOne
  – CHOICERrenovation

Refer to Fannie Mae and Freddie Mac selling guides for current list of products, including purpose and general borrower qualifications

Conventional Loan Programs

- **Loan-to-Value Ratio**
  - Amount of money borrowed compared to value of the property
  - Lender uses the lower of appraised value or sales price to protect own interest
  - The lower the LTV, the higher the borrower's down payment
- **80% LTV Conventional Loan**
  - Standard for years
  - Example: $200,000 x 0.8 = $160,000 loan amount. $200,00 - $160,000 = $40,000 down payment

Conventional Loan Programs

- **Loans Higher than 80% LTV**
  - Possible because of PMI and secondary financing
  - Qualifying standards more stringent; property must be owner-occupied
  - May have higher interest rate
  - Call for higher loan origination fees
- **Options**
  - 80% to 95% Conventional Loan
  - 97% Conventional Loan

4.2 Apply Your Knowledge

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

1. **How much can Bill borrow?**

   $128,000

2. **What would be the required down payment?**

   $32,000

4.2 Apply Your Knowledge

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

$120,000

4. Assuming Bill already signed the contract of sale at $160,000 and paid the $32,000 down payment before the appraisal was performed, Bill could renegotiate the sales price with the seller to support the appraised value of $150,000 or he will need to come up with what additional amount as part of his down payment?

$8,000

Private Mortgage Insurance (PMI)

- **Lender Insurance**
  - Insures against losses suffered due to borrower default on a non-government insured/guaranteed loan
  - Fannie Mae and Freddie Mac require on home loans with less than 20% down
  - Lender-paid mortgage insurance: lender accepts higher risk in exchange for charging a higher interest rate
  - Borrower-paid mortgage insurance: policy purchased from a mortgage loan insurance company (chosen by the lender) and paid as part of the monthly loan payment by the borrower

Private Mortgage Insurance (PMI)

- **How it Works**
  - Mortgage insurer shares part of lender’s risk
  - Insures upper portion that exceeds standard 80% LTV
  - Coverage amount varies; typically 20-25% of loan amount
  - Example: 20% coverage on a 90% loan = $18,000 PMI
  - If lender is not fully compensated by the insurance, may be able to pursue a deficiency judgment; referred to as recourse

PMI Payment Options

- **Options for Paying Mortgage Insurance**
  - Monthly premiums, annual premiums, split premiums and a single premium
- **Monthly Premium**
  - Traditional payment method
  - Borrower-paid monthly insurance premiums (BPMI) or PMI
  - Each month the payment is renewed and is added to your PITI payment (renewal premium)
  - Each insurer provides PMI rate cards that are used to determine the monthly premium; see example

4.3 Apply Your Knowledge

If the sales price of a home is $100,000 on a 90% LTV 30-year fixed mortgage, calculate the PMI using the sample rate card. Use the Fannie Mae/Freddie Mac-required 25% coverage at a rate of 0.62%.

1. **What is the loan amount?** **$90,000**
2. **What is the premium amount in first year?** **$558**
3. **How much will be added to the borrower's monthly mortgage payment?** **$46.50**

PMI Payment Options

- **Annual Premiums**: Renewed and remitted annually; rate is generally higher in the initial year and reduced for the renewal years; less than monthly payments made over a 12-month period
- **Split Premiums**: Pay a one-time, non-refundable fee at closing covering the initial 12 months and a renewal premium, added to the borrower’s monthly mortgage payment; may be a beneficial when DTI ratio is high
- **Single Premium**: Combine initial premium and renewal premiums into one payment; allows the borrower to finance the PMI premium; monthly payments may still be lower than if the renewal premiums are added to the regular monthly PITI payment

PMI Cancellation and Underwriting

- **Cancel PMI**
  - Automatically cancel PMI when home has been paid down to 78% of its original/present value or has attained 22% equity based on original/present value; borrower cannot be delinquent
  - At Borrower's Request: Appraisal shows that the loan has been paid down to 80% or less of the home's current value; history of timely repayment over the past 12 months; certification that equity is unencumbered by subordinate lien
- **Underwriting PMI**
  - Guidelines for considering risks of insuring loans in markets where property values are declining

Secondary Financing

- **Secondary Financing**
  - When buyer borrows money from another source to pay part of purchase price or closing
  - Allows conventional loan without a 20% down payment
  - Can be fully amortized, partially amortized, or interest-only
  - Lender will include the payment as part of the borrower's monthly housing expense and consider the total amount borrowed when determining the combined LTV
- **Combined LTV**
  - Percentage of the property value borrowed through a combination of more than one loan
  - Add all loan amounts and divide by the home's appraised value or purchase price, whichever is lower

CLTV Example

A buyer purchases a property valued at $100,000 with two loans: A first mortgage for $80,000 and a second for $10,000:

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

Secondary Financing - Conditions

- **LTV and CLTV**
  – First mortgage cannot exceed 80% LTV and CLTV cannot exceed 95%
- **Loan Terms**
  – Term of second loan cannot exceed 30 years or be less than 5 years
- **Interest Rate**
  – Interest rate on second mortgage could be fixed or adjustable
- **No Prepayment Penalty**
  – Second mortgage payable in full or in part without penalizing borrower for paying debt early

Secondary Financing - Conditions

- **Regularly Scheduled Payments**
  - Secondary finance payments can be any regular schedule
  - Payments fully or partially amortize the debt, or pay interest only
- **No Negative Amortization**
  - Payments on second mortgage must equal interest on loan
  - Loan balances cannot grow because of deferred interest
- **Ability to Qualify**
  - Borrower must afford payments on first and second mortgages
  - Primary lender on first mortgage counts on both mortgages
- **Subordination Clause**
  - Primary lenders require secondary financing to have subordination clause; ensures primary lender's lien takes priority, even if second mortgage recorded first

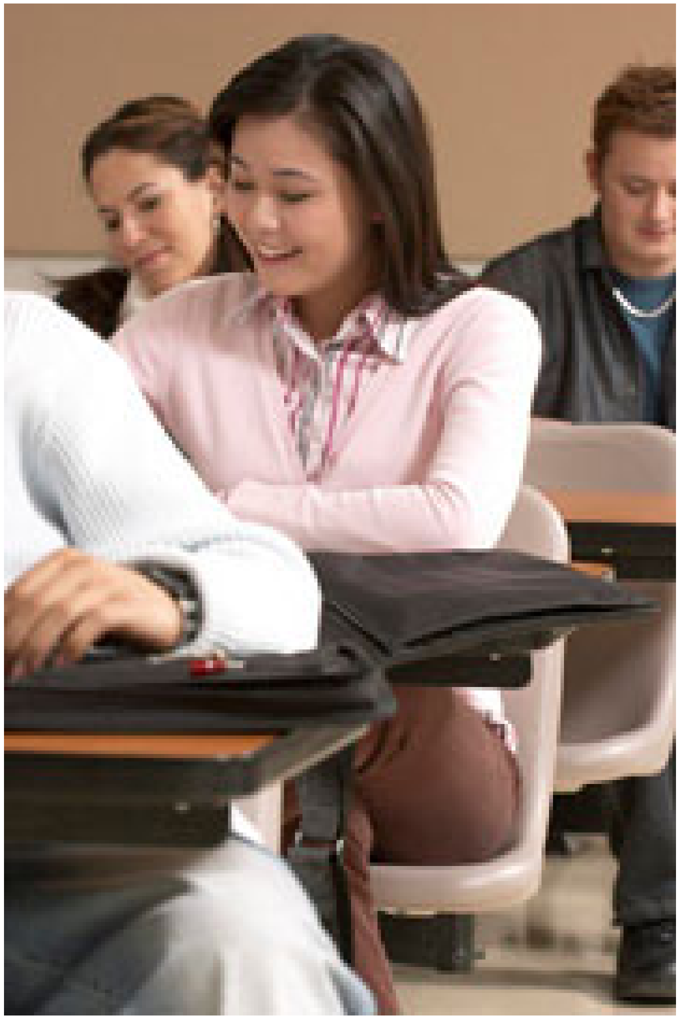
4.4 Apply Your Knowledge

Review the example below of secondary financing for a $120,000 home:

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

1. **What is the loan-to-value (LTV)?** **75%**
2. **What is the combined loan-to-value (CLTV)?** **90%**

Chapter 4



Chapter Quiz

Chapter 4 Quiz

1. A loan that is repaid with periodic payments of both principal and interest so that the entire loan amount is paid in full at the end of the loan term is a(n)

A. annualized loan.

B. conventional loan.

C. fully amortizing loan.

D. partially amortizing loan.

Chapter 4 Quiz

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

Chapter 4 Quiz

3. You are pre-qualifying buyers for a conventional loan on a house with a purchase price of $160,000. The buyers state they don't want to pay PMI on the loan. In that case, what is the maximum loan amount they can receive (assuming no lender-paid PMI)?

A. $32,000

B. $128,000

C. $136,000

D. $144,000

Chapter 4 Quiz

4. Which type of mortgage is NOT insured or guaranteed by the government?

A. conventional mortgage

B. FHA mortgage

C. rural home mortgage

D. VA mortgage

Chapter 4 Quiz

5. PMI must be cancelled

A. any time the borrower requests it.

B. only if the lender is satisfied that the borrower is no longer a credit risk.

C. when a home has been paid down to 78% of its original value and the borrower is current.

D. whenever a new appraisal is ordered, regardless of the value.

Chapter 4 Quiz

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

Chapter 4 Quiz

7. A buyer is paying $200,000 for a house. He makes a $30,000 down payment, gets a first mortgage for $160,000, and a second mortgage to cover the balance. What is his CLTV?

A. 70%

B. 75%

C. 80%

D. 85%