Buying And Selling/Mortgages

Background

Most people borrow money in order to purchase their home. A loan for this purpose is commonly called a home loan or MORTGAGE. The term mortgage originates from two Latin words. The first, "mort" is from the Latin word for death. The second, "gage" means pledge or promise. The word "mortgage" literally means "dead promise." While this may seem nonsensical at first, it actually makes sense: the property was considered forfeited or "dead" to the borrower if the loan were not repaid. Similarly, once the loan was satisfied, the promise itself was dead or unenforceable.

Typically, a mortgage is secured by a LIEN on the property. The mortgagor is the party transferring the interest in land. The mortgagee is the provider of the loan. A mortgage is paid in installments that include both interest and a payment on the principle amount borrowed. With respect to which entity has title to the property, a number of possibilities exist. Under the title theory, title to the security interest rests with the mortgagee. Most states follow the lien theory under which the legal title remains with the mortgagor unless there is FORECLOSURE. The intermediate theory applies the lien theory until there is a DEFAULT on the mortgage whereupon the title theory applies.

Types of Mortgages

A mortgage involves the transfer of an interest in land as security for a loan. The mortgagor and the mortgagee generally have the right to transfer or assign their respective interest in the mortgage. Standard contract and property law provisions govern the transfer or assignment of any interest. There are several different types of mortgages available.

Fixed Rate Mortgage

A fixed rate mortgage carries an interest rate that will be set at the inception of the loan and remain constant for the length of the mortgage. A 30-year mortgage will have a rate that is fixed for all 30 years. At the end of the 30th year, if payments have been made on time, the loan is fully paid off. To a borrower the advantage is that the rate will remain constant and the monthly payment will remain the same throughout the life of the loan. The lender is taking the risk that interest rates will rise and it will carry a loan at below market interest rates for some or part of the 30 years. Because of this there is usually a higher interest rate on a fixed rate loan than the initial rate and payments on adjustable rate or balloon mortgages. If the rates fall, homeowners can pay off the loan by refinancing the house at the then lower interest rate.

Adjustable Rate Mortgage

An adjustable rate mortgage (ARM) provides a fixed initial interest rate and a fixed initial monthly payment for a short period of time. With an ARM, after the initial fixed period, which can be anywhere from six months to six years, both the interest rate and the monthly payments adjust on a regular basis to reflect the then current market interest. Some ARMs may be subject to adjustment every three months while others may be adjusted once a year. Also, some ARMs limit the amount that the rates can change. While an ARM usually carries a lower initial interest rate and lower initial monthly payment, the purchaser is taking the risk that rates may rise in the future.

Owner Carryback and Financing

An alternative form of financing, usually a last resort for those who cannot qualify for other mortgages, is owner financing or owner carryback. The owner finances or "carries" all or part of the mortgage. Owner financing often involves balloon mortgage payments, since the monthly payments are frequently interest only. A balloon mortgage has a fixed interest rate and fixed monthly payment, but after a fixed period of time, such as five or ten years, the whole balance of the loan becomes due at once. This means that the buyer must either pay the balloon loan off in cash or refinance the loan at current market rates.

Home Equity Loan

A home equity loan is usually used by homeowners to borrow some of the equity in the home. Doing so may raise the monthly housing payment considerably. More and more lenders are offering home equity lines of credit. The interest may be tax DEDUCTIBLE because the debt is secured by a home. A home equity LINE OF CREDIT is a form of revolving credit secured by a home. Many lenders set the credit limit on a home equity line by taking a percentage of the home's appraised value and subtracting from that the balance owed on the existing mortgage. In determining the credit limit, the lender will also consider other factors to determine the homeowner's ability to repay the loan. Many home equity plans set a fixed period during which money can be borrowed. Some lenders require payment in full of any outstanding balance at the end of the period.

Home equity lines of credit usually have variable rather than fixed interest rates. The variable rate must be based on a publicly available index such as the prime rate published in major daily newspapers or a U. S. Treasury bill rate. The interest rate for borrowing under the home equity line will change in accordance with the index. Most lenders set the interest rate at the value of the index at a particular time plus a margin, such as 3 percentage points. The cost of borrowing is tied directly to the value of the index. Lenders sometimes offer a temporarily discounted interest rate for home equity lines. This is a rate that is unusually low and may last for a short introductory period of merely a few months.

The cost of setting up a home equity line of credit typically includes a fee for a property APPRAISAL, an application fee, fees for attorneys, TITLE SEARCH, mortgage preparation and filing fees, property and TITLE INSURANCE fees, and taxes. There may also be recurring maintenance fees for the account or a transaction fee every time there is a draw on the credit line. It might cost a significant amount of money to establish the home equity line of credit, although interest savings can justify the cost of establishing and maintaining the line.

The federal Truth in Lending Act requires lenders to disclose the important terms and costs of their home equity plans, including the APR, miscellaneous charges, the payment terms, and information about any variable-rate feature. If the home involved is a principal dwelling, the Truth in Lending Act allows 3 days from the day the account was opened to cancel the credit line. This right allows the borrower to cancel for any reason by informing the lender in writing within the 3-day period. The lender must then cancel its security interest in the property and return all fees.

Second Mortgage

A second mortgage provides a fixed amount of money repayable over a fixed period. In most cases the payment schedule calls for equal payments that will pay off the entire loan within the loan period. A second mortgage differs from a home equity loan in that it is not a line of credit, but rather a more traditional type of loan. The traditional second mortgage loan takes into account the interest rate charged plus points and other finance charges. The ANNUAL PERCENTAGE RATE for a home equity line of credit is based on the periodic interest rate alone. It does not include points or other charges.

Reverse Mortgage

A reverse mortgage works much like traditional mortgages, only in reverse. It allows homeowners to convert the equity in a home into cash. A reverse mortgage permits retired homeowners who own their home and have paid all of their mortgage to borrow against the value of their home. The lender pays the equity to the homeowner in either payments or a lump sum. Unlike a standard home equity loan, no repayment is due until the home is no longer used as a principal residence, a sale of the home, or death of the homeowner.

Deed of Trust

A **D**EED OF **T**RUST is similar to a mortgage, with one important exception. If the borrower breaches the agreement to pay off the loan, the foreclosure process is typically much quicker and less complicated than the formal mortgage foreclosure process. While a mortgage involves a relationship between the borrower/homeowner and the bank/lender, a **D**EED of Trust involves the homeowner, the lender, and a title insurance company. The title insurance company holds legal title to the real estate until the loan is paid in full, at which time the title company transfers the property title to the homeowner.

Escrow

An ESCROW company or agent is an independent third party who handles aspects of the purchase and related loan transaction. The escrow company will often hold the DOWN PAYMENT until the closing, receive the amount of the loan from the lender, transfer the down payment and mortgage money to the seller, transfer and record the deed of title to the buyer or title company, and make sure the lender is protected by filing and recording the mortgage with the local county recorder of deeds. In some states the escrow functions are handled by a licensed title insurance company or an escrow company, while in other states an attorney handles the transaction. The purchase is said to be held in escrow pending certain investigations, inspections, and contingencies.

Abstract of Title

An abstract is a document that a title insurance company or, in some states, an attorney, will prepare giving the history of the home. The document usually lists who owned the property all the way back to its first original owner. The document will also disclose any liens or encumbrances on the title which may affect whether lenders will provide a loan or whether the new homeowner will want to take title to the property.

Prepayment Penalty Clause

A prepayment PENALTY is a charge the borrower pays when a mortgage is repaid before a certain period of time elapses. Not all lenders impose a prepayment penalty. From a mortgage lender's perspective a prepayment penalty helps the lender at least recoup some or all of the significant expense it incurs in putting a new loan on the books. If the loan is to be repaid quickly due to a refinance, the lender may have a significant loss. A prepayment penalty provision must be set out in the mortgage contract in order for the lender to collect one.

Mortgage Contingency Clause

A mortgage contingency clause is a provision in the home purchase contract that says that if the prospective buyer cannot get a mortgage within a fixed period of time, the buyer may cancel the entire transaction.

Types of Lenders

Mortgage Bankers and Brokers

A mortgage broker can submit a loan to many different lenders and typically has access to several types of loan programs. A mortgage broker can shop for the best and most competitive mortgage rates and terms available tailored to meet a borrower's needs. Some charge processing or origination fees. Mortgage bankers are lenders that are large enough to originate loans and create pools of loans. Some companies do not sell directly to those major investors but sell their loans to the mortgage bankers. They often refer to themselves as mortgage bankers as well.

Direct Lenders

A direct lender loans the money directly to the borrower. Banks and credit unions are often direct lenders.

Secondary Market Lenders

Federal National Mortgage Association (FNMA or Fannie Mae), Government National Mortgage Association (GNMA or Ginnie Mae) and Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) are all secondary market lenders. Many retail lenders actually receive their funds from a secondary market lender. These secondary lenders have assisted the national mortgage market by allowing money to move easily from state-to-state. The movement of loan funds helps to avoid a situation where mortgages are only available in certain areas or states. Also, the secondary lenders have established regulations and guidelines that help the general public.

Defaults and Foreclosures

If a homeowner fails to make payments upon the mortgage, the lender may foreclose on the property. Foreclosure allows the mortgagee to declare that the entire mortgage debt is due and must be paid immediately. This action is accomplished through an acceleration clause in the mortgage. Many states regulate acceleration clauses and allow late payments to avoid foreclosure. Depending upon the terms and agreements made in the mortgage contract, the lender may do a STATUTORY foreclosure or a judicial foreclosure. A statutory foreclosure can be performed without bringing a court action. The lender does have to follow strict state regulations as to the proper notices and opportunities to provide payment by the homeowner before a sale of the property occurs. This procedure is relatively quick. If a judicial foreclosure action is required, the lender must file a complaint with the court system and go through the LITIGATION process to obtain the right to foreclose on the property. In several state jurisdictions, the homeowner is allowed the right to stay in possession of the home until the foreclosure process is finalized or a sale of the home occurs.

Since lenders want to avoid the cost of foreclosure, the lender will sometimes work out an agreement with the homeowner whose payments have fallen behind. The lender may accept interest only payments or partial payments for a while in order to assist the homeowner. There are detailed regulations regarding foreclosure procedures. Filing a Chapter 7 BANKRUPTCY temporarily stalls a lender's right to foreclosure, until it gets court permission to go forward with the foreclosure proceedings. Under a Chapter 13 plan, it is possible for a homeowner to make up the missed payments. Liens do not automatically go away in any bankruptcy. A bankruptcy discharge does not extinguish a lien on property.

Anti-Deficiency Laws

Some states have anti-deficiency laws which protect purchasers of residential real property used as primary residence. If the purchaser fails to make the mortgage payment the property is foreclosed and title is obtained by the lender through a legal procedure. The property is then typically sold to pay the mortgage and a deficiency between the sale price and the outstanding balance of the mortgage usually exists. Under anti-deficiency laws, if the mortgage is a purchase money mortgage for the purchase of a dwelling occupied by the purchaser, the purchaser will not be held responsible for any deficiency. The lender can only recover the property and the proceeds of a subsequent sale. The purchaser does not pay any deficit between the sale proceeds and the outstanding loan balance. This allows the purchaser to walk away from a property without owing a deficiency judgment amount. Anti-deficiency laws typically provide no protection for second mortgages or home equity lines. Also, there is no protection when the property is not used as the primary residence of the purchaser.

Mortgage Insurance

Private mortgage insurance and government mortgage insurance protect the lender against default and enable the lender to make a loan which the lender considers a higher risk. Lenders often require mortgage insurance for loans where the down payment is less than 20% of the sales price. Mortgage insurance should not be confused with mortgage life, credit life, or DISABILITY insurance, which are designed to pay off a mortgage in the event of the borrower's death or disability.

With lender paid mortgage insurance (LPMI), the lender purchases the mortgage insurance and pays the premiums to the insurer. The borrower cannot cancel LPMI or government mortgage insurance during the life of the loan. However, it may be possible to cancel private mortgage insurance at some point, such as when the loan balance is reduced to a certain amount.

Tax Credit

A mortgage interest credit is available for first-time home buyers whose income is generally below the median income for the area in which they live. The credit is intended to help lower-income individuals afford home ownership. A tax credit is allowed each year for part of the home mortgage interest paid. Any mortgage interest DEDUCTION is reduced by the amount of the credit taken. The interest on home mortgages is typically tax deductible.

State Laws

ALASKA: Alaska has a broad form of anti-deficiency STATUTE that precludes a deficiency judgment following the completion of a nonjudicial foreclosure.

ARIZONA: Arizona's anti-deficiency statutes prevent a lender from suing a person for any losses on a home after foreclosure. A person may not be sued by the lender for property located on 2.5 acres or less that is a single family residence or duplex. This provision is only applicable if the decrease in value is not due to the home owner's neglect. If a lender seeks a deficiency judgment, it has 90 days after the sale of the property to begin judicial proceedings to recover any losses. Failure to do so may result in the lender's loss of its right to recover the deficiency. In the event the property is something other than the foregoing, a deficiency judgment may still be avoided by deeding the property back to the lender prior to foreclosure. This is known as a deed-in-lieu of foreclosure. By accepting the deed, the lender is agreeing to accept the property for the amount that the borrower owes, thus eliminating any potential deficiency. However, when a person deeds the property back to the lender, he or she may be taxed on the amount of the deficiency that was forgiven by the lender. The only exception to Arizona's anti-deficiency statutes are VA loans. VA is allowed to obtain a deficiency judgment despite current state laws that prohibit such actions.

CALIFORNIA: California's anti-deficiency law applies only to funds used to purchase a residence. The anti-deficiency law does not apply to additional financing such as second mortgages or home-equity loans. California requires foreclosure on real property trust deeds and mortgages instead of a suit on the note. No deficiency judgment is possible where the seller takes back a purchase money note and deed of trust as part of the sale financing. If a third-party lender finances the purchase, the third party cannot recover a deficiency judgment if that loan is given and used for paying all or part of the purchase price, is secured by the property purchased, is a property for use by no more than four people, and is owner occupied. A deficiency judgment is not available if the lender forecloses by private sale by TRUSTEE instead of a judicial foreclosure law suit. Federally made or guaranteed loans are generally not subject to the anti-deficiency laws of the state. V. A., FHA and Small Business Administration loans may subject the borrower to a deficiency judgment. A third-party refinance of a purchase money loan is not a purchase money loan and the buyer could be personally liable for payment of the seller's note after a judicial foreclosure.

FLORIDA: In Florida, mortgages must be foreclosed by filing a lawsuit in court. Florida is unusual in that the state has passed few statues regulating foreclosures. A sale can be set aside if there is an error in the procedure to foreclose; however, it cannot be set aside because of a too low sale price. After the sale takes place, the sale terms must be confirmed by the court. If the terms of the sale order are met, title in the buyer's name can become complete by filing a certificate of title. At the discretion of the court, junior lien holders can redeem the property, up to the time of the confirmation of the sale. The EQUITY OF REDEMPTION is cut off when the sale is confirmed, but it exists prior to that time. The borrower can redeem the property from foreclosure by curing the default prior to confirmation. Any action for a deficiency must be filed within four years from the foreclosure.

MASSACHUSETTS: Under the Massachusetts Uniform **F**RAUDULENT Conveyance Act if the foreclosure sale took place for less than MARKET VALUE, it may be ruled to be a fraudulent conveyance. Therefore the lender should have the property appraised at the time of foreclosure. In Massachusetts, there are two methods by which a mortgage may be foreclosed. The lender may enter and take possession of the premises and then wait three years for title to become final in the name of the lender. The other method is that the lender may complete a non-judicial sale under a power of sale clause. Unless the borrower can come up with enough money to pay off the mortgage within three years, however, the lender's ownership becomes final and the borrower's right to redeem the property is cut off. Despite this provision, the usual method of foreclosure is through sale under a power of sale clause in the mortgage. The sale must be conducted in accordance with the requirements specified in the power of sale clause. Notice of the foreclosure must be given. There is no requirement for the borrower to actually receive the notice, merely for the lender to make a diligent effort to locate the borrower. If there is any money left from the foreclosure sale after paying off the lender, the surplus goes to the borrower. A proper sale prevents the borrower from exercising any right to reclaim the property through redemption. If the foreclosure sale proceeds are not enough to pay off the lender, then the borrower is liable for the deficiency.

NORTH DAKOTA: In North Dakota, a lawsuit may be brought in district court for foreclosure or for satisfaction of a mortgage on real estate. Prior to bringing any lawsuit, the lender must give the borrower advance notice. This notice must be sent no later than 90 days before the suit is filed. The notice must state a description of the real estate, the date and amount of the mortgage, the amount due for principal, interest, and taxes. The notice must also state the time period for redemption, which is either one year, or, for small tracts with substantial balances and the properly worded mortgages, six months. The notice must be served by registered or certified mail addressed to the owner of record. If the borrower brings in the missing payments any time within 30 days after receipt of the notice, the loan must be reinstated. North Dakota law requires the lawsuit paperwork to include several allegations that are unusual. First, North Dakota law requires the attorney bringing the suit to hold a POWER OF ATTORNEY to act on behalf of the lender. Second, the lender must also declare in the original lawsuit whether the lender will pursue a deficiency judgment against the borrower if the foreclosure sale does not bring in enough money to pay off the outstanding loan balance. The lender may not ask for a deficiency in the foreclosure suit if it has already brought another suit just to collect on the loan. If the borrower can bring in the missed payments plus foreclosure costs before the DECREE of sale is issued by the court, then the lender's lawsuit to foreclose must be dismissed. Whenever the real estate is sold at foreclosure, the sheriff or deputy must give the buyer a certificate of sale, and at the expiration of the redemption time period, a deed must be given to the buyer. Any cash surplus from the sale, beyond that needed to pay off the mortgage and the foreclosure costs, must be paid to the borrower.

OREGON: Foreclosure in Oregon may be either by court action or by advertisement and sale. The borrower, or any junior lien holder, can cure the default prior to foreclosure. A deficiency judgment cannot be obtained through a non-judicial deed of trust foreclosure by advertisement. A person who was entitled to receive notice of the foreclosure but did not receive it may sue to invalidate the foreclosure at any time within five years of the sale. On a judicial foreclosure, the borrower or a successor in interest may redeem property within 180 days after sale.

SOUTH CAROLINA: South Carolina uses judicial foreclosure. The lender must file a lawsuit and seek either an order of sale or a judgment for the loan balance against the borrower or both. Deficiency judgements are permitted. Within 30 days after the sale, a borrower who was sued for a deficiency can apply to the court for an order of appraisal. The DEFENDANT appoints one APPRAISER, the judgment CREDITOR appoints another, and the judge appoints another. If the appraised value is greater than what remains owed on the loan, after subtracting the foreclosure sale proceeds, then there is no deficiency. However if it is less, then the borrower still gets credit against the judgment for the higher appraised value of the property.

TEXAS: Texas has laws which make foreclosure easy. Deficiency judgments can only be for the difference between FAIR MARKET VALUE and the balance owed on the loan. There is no right of redemption.

Additional Resources

All about Escrow and Real Estate Closings. Gadow. Sandy, Escrow Publishing Company, 1999.

How to Find a Home and Get a Mortgage on the Internet. Johnson, Randy, Wiley, John & Sons, Incorporated, 2000.

Owner Will Carry: How to Take Back a Note or Mortgage without Being Taken. Broadbent, Bill, Dry Bones Press, 2000.

Organizations

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