

## The Basics of Real Estate Lending and Mortgage Loans

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### 1. INTRODUCTION

Most first-time buyers find mortgages hopelessly complicated and arbitrary, and they are absolutely right. But a basic understanding of the players and the plays can make the loan qualification process considerably less frustrating. Begin by thinking of home loans as products like cars with specific features, drawbacks and prices. Think of lenders as loan dealerships which offer a variety of loan products and make money from selling you a loan. Now you are ready to enter the twilight zone of mortgage lending.

### 2. LOAN BROKERS AND AGENTS

There are many different types of loan dealers, but they all fall into two categories: loan originators and loan distributors. Loan originators including banks, savings and loan associations and credit unions, actually lend their own money. Loan distributors, called mortgage brokers, act as middlemen between loan originators and borrowers. When you go directly to a loan originator for a loan, they will only feature their own loan products, but the information you get about your ability to qualify for those loan products is almost always right. When you go to a loan distributor, he can help you shop among a variety of loan products from different originators, but what you see may not be what you get. Every borrower's worst nightmare, and an all too common real life occurrence, is to be told at the last minute that the lender rejected your loan application, or that the loan terms have suddenly changed. To guard against this risk, always submit at least one loan application to a loan originator.

All loan dealers charge fees for their services. When loan dealers advertise "no fee" or "no points" loans, they mean the fees are hidden as extra interest charges. Up-front fees are often called **loan points** and based on a percentage of the loan amount. A fee of one point is one percent of the loan amount. Loan dealer fees can also be called **appraisal fees** and **application fees** in which case they are usually flat fees rather than percentages. When a loan distributor is involved, fees are split between loan distributor and loan originator. If possible, avoid paying any fees before your loan is approved in writing; if you must pay an advance fee, get a written promise from the dealer that the fee will be returned if he does not deliver the promised loan.

### 3. THE RISK SEESAW

Loan shopping is complicated because there are so many different features to compare. To be a smart shopper, you need to understand how the features fit together from the lender's perspective. You then have the foundation to evaluate which loan is the best deal for you. Each loan has its own set of **terms** and **underwriting guidelines**. Terms and underwriting guidelines are like two ends of a seesaw: the more risky the terms for the lender, the tougher the underwriting guidelines. The risk seesaw is important to you because tough underwriting guidelines will often lower your maximum mortgage amount. Your best loan will

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combine most of the terms you want with underwriting guidelines that allow you to qualify for the mortgage amount you need.

Here is a list of types of loan terms you should compare along with a description of how they affect lender risk.

### List 3.A.--Types of Loan Terms

- **Interest:** The mortgage **interest rate** is the amount you pay the lender for the use of its money. An interest rate can be **fixed**, meaning it stays the same until the loan is repaid, or **adjustable**, meaning it floats up and down with the market. A loan with an adjustable rate is typically called an "**ARM**", although this same term is sometimes also used to describe a loan which begins as a fixed-rate loan and later changes to an ARM. We compare fixed loans and ARMs from your perspective in Section 4; for now, we focus on lender risk. Lenders pay for the money they lend and lose money if the interest they receive is less than the interest they pay. The interest a lender pays is not fixed, so when it makes a fixed-rate loan it takes the risk that the interest it pays will rise above the interest it receives. This risk is lower with ARMs. The more freely and often a lender can adjust an interest rate, the lower the risk that the interest it pays will ever exceed the interest it receives. The most freely adjustable loans will have the best other terms.
- **Loan-To-Value Ratio:** The **loan-to-value ratio** or **LTV** is the relationship of the loan amount to the property value expressed as a percentage.

$$\text{LTV \%} = \frac{\text{Loan Amount}}{\text{Property Value}}$$

Each loan has a maximum LTV. The higher the maximum LTV, the lower the minimum down payment. If you have a relatively small down payment, you will need a loan with a high maximum LTV. But higher maximum LTV means higher lender risk. The risk is that the property value will fall close to or below the loan amount. When that happens, a foreclosure sale may not yield enough to repay the loan balance and foreclosure costs. Loans with the lowest maximum LTV will have the best other terms.

- **Fees:** Loan fees are explained in Section 2. You want to pay the lowest possible fees, especially if you have limited down payment funds. Every dollar of loan fees means a dollar less for down payment. But higher fees mean the lender makes money sooner and can afford to take greater risks on other loan terms. Loans with the highest fees will have the best other terms.
- **Term:** The loan **term** is the number of years before the loan must be fully repaid. You want the longest possible term so that you will never be forced to repay the loan before you are financially ready. Remember that you can always repay a 30-year mortgage on a 15-year schedule, but you can never do the opposite. A longer term means more lender risk because there is more time for bad things to happen like falling property values, rising interest rates, or borrower insolvency. Loans due sooner will have the best other terms.
- **Loan Amount: Maximum loan amount** is the largest sum the bank will lend on a particular loan product. Lenders risk less when they loan less, so the smallest loans will have the best other terms.
- **Prepayment: Prepayment** is repaying the loan before it is due. Some loans have a **prepayment penalty**, an extra charge imposed on a borrower if he makes a prepayment. You probably won't expect a prepayment penalty to matter because you won't expect to prepay. But some change in your life may cause you to need to sell your home, or falling interest rates may make refinancing attractive. Having a prepayment penalty may then become a very

expensive mistake. Lenders charge prepayment penalties when they need to collect a certain amount of interest before they break even on loan processing costs and start making a profit. This is often true with "no fee" loans, where the lender has buried most or all of its processing costs and profits in the interest. The more free the borrower is to repay the loan, the higher the chance that the borrower will repay (by selling the property or refinancing) before the lender recovers its costs and starts making a profit. The greater the restrictions or fees on prepayment, the lower the risk. Loans with prepayment penalties will have the best other terms.

- **Assumability:** In a loan **assumption**, a new borrower substitutes himself for the original borrower. Some loans allow assumption provided the new borrower is qualified and pays an assumption fee. Assumability is a valuable feature because it can get you a higher price when you sell your property. This will occur in two situations: when interest rates have risen and your loan has a lower rate than any new loan your buyer can get, and when property values have fallen and your loan has a higher LTV than any new loan your buyer can get. These same situations create risk for the lender who may be stuck continuing a loan with a below-market interest rate or a high LTV for longer than it would have if the loan were not assumable. Non-assumable loans will have the best other terms.
- **Private Mortgage Insurance: Private mortgage insurance or PMI** is an insurance policy for the lender against your default. If you don't make your payments, the lender collects on the PMI. You pay the premiums for PMI which can be as high as 1%-2% of the loan amount per year and are not tax deductible. Loans with the best terms are the most likely to require PMI.

Use this list as a guide to question lenders about the loans they offer. Make sure you get all the information about each loan so that you can truly compare. You will find that lenders create loan products by combining some risky terms with other less risky terms. For example, loans with higher risk LTV ratios may only be available in less risky smaller amounts or require risk-reducing PMI; high risk "no point" loans may only be available with low risk adjustable interest rates and prepayment penalties; fixed-rate loans may not be assumable. It is likely that you will sacrifice some terms you would like to have but can live without for others that are more important to you. The important thing is to understand what you are getting and what you are giving up.

Now that you understand loan terms, let's examine the other end of the seesaw: underwriting guidelines. Where loan terms determine the risk of the loan, underwriting guidelines determine the risk of the borrower. A lender taking more risk with loan terms will accept less risk with the borrower. For each set of terms, a lender has underwriting guideline that establish standards for borrower risk.

There are two types of **underwriting guidelines: creditworthiness** and **debt-to-income ratio or DTI**. Creditworthiness is an assessment of your stability and responsibility. Typical creditworthiness standards dictate a maximum number of blemishes on a credit report, demand an indisputable verification of earnings, or require a long job history with big employer. If you are strong on creditworthiness, you need not worry about these standards; but if you have a bad credit report, are self-employed and show little income on your tax return, or recently changed jobs, you will be limited to loans with less stringent creditworthiness guidelines.

Debt-to-income ratio is an assessment of the borrower's income strength. It is the percentage that expresses the relationship between minimum monthly housing expense (often referred to as "PITI" which stands for principal, interest, taxes and insurance) and gross monthly income.

$$\text{DTI \%} = \frac{\text{PITI}}{\text{Gross Monthly Income}}$$

In other words, DTI is the percentage of your monthly income that you spend on house payments. The underwriting guidelines for a particular loan establish a

maximum DTI for that loan. If you are trying to qualify for the largest possible loan, look for the one with the lowest interest rate and the highest maximum DTI. A borrower who earns \$25,000 will qualify for \$69,000 on a 7.25% fixed-rate mortgage with a 28% maximum DTI; the same borrower will qualify for \$105,000 on a 6% ARM with a 35% maximum DTI.

Now that you understand the risk seesaw, you are ready to tackle the most fundamental decision in loan shopping: adjustable or fixed.

#### 4. HOW ADJUSTABLE RATE LOANS (ARMS) WORK

To understand and evaluate adjustable-rate mortgages, you need to learn more terminology. The **interest rate** is the amount of interest you are paying on the mortgage on any given day. The interest rate moves up or down according to an **index**. The index is always some published benchmark that is beyond the control of the lender. Think of an index as if it was air temperature in a particular city. In Boston, the air temperature changes often, moves quickly when it changes, and has a wide differential between its highs and its lows. But in San Diego, the temperature never changes very much or very fast. Some indices are more **volatile** like Boston temperatures, and some are less volatile like San Diego temperatures. Your interest rate is like a thermometer: it rises with the index. So when you evaluate an ARM, you need to determine how volatile is its index. The lender can provide historical charts to help you.

The **margin** is the amount the lender adds to the index to determine the interest rate. The margin is only important when comparing two adjustable loans with the same index. As between two loans with the same index, you will pay less interest on the one with the lower margin. The **change date** is the day when the interest rate is adjusted. An adjustable mortgage may have change dates once a month, once a year, or according to some other schedule. The fewer the change dates, the better the loan. **Caps** are limits on the amount the interest rate can change. Most adjustable loans have at least two types of caps: a cap on the amount the interest rate can change on each change date, and a cap on the amount it can change during the entire life of the loan. Like mercury reaching the top of a thermometer, the interest rate stops following the index whenever it bumps into a cap.

Here's how an ARM works. It usually begins with an artificially low interest rate often called a **start rate** or a **teaser rate**. We say the rate is artificially low because it is less than the index plus the margin. For example, a loan with a margin of 2% and an index that happens to be 4.5% on June 15, 2004 should have an interest rate of 6.5% on that date; but people who borrow their mortgage on that day might start with a teaser rate of 4.5%. The teaser rate lasts until the first change date when the mortgage moves up to the index plus the margin unless it bumps into a cap. Regardless of the cap, the interest rate catches up to the index-plus-margin by the second or third change date. Then, on each change date, it moves up or down with the index unless it bumps into a cap.

#### 5. ADJUSTABLE VERSUS FIXED

Adjustable-rate loans offer two major advantages over fixed-rate loans: lower short-term costs and larger loan amounts. In the first few years, you pay less interest on an ARM even if the interest rate moves up as fast as it can. Your interest savings comes from lower fees, a teaser rate and, after the teaser rate ends, an index-plus-margin interest rate that is still lower than the rate on fixed loans. To see this cost savings in action, compare total payments over three years for a fixed and an adjustable loan assuming the adjustable goes up as fast as it can.

Example 5.A.--Cost Savings of Adjustable Mortgage

<b>Loan # 1:</b> \$200,000 loan at 7.5% fixed with fees of \$4,250.	
Loan Fees	\$4,250
36 Interest Payments at 7.5%	<u>45,000</u>

Total Payments	\$49,250
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**Loan # 2:** \$200,000 loan starting at 4.5% that an adjustment cap of 1/2% every 6 months, and fees of \$2,250. (The index-plus-margin rate is 5.75% at the start of the loan).

Loan Fees	\$2,250
6 months Interest Payments at 4.5%	4,500
6 months Interest Payments at 5.0%	5,000
6 months Interest Payments at 5.5%	5,500
6 months Interest Payments at 6.0%	6,000
6 months Interest Payments at 6.5%	6,500
6 months Interest Payments at 7.0%	<u>7,000</u>
Total Payments	\$36,750

In this example, which uses loans available as I write, the adjustable saves at least \$12,500 over the first three years. In practice, the adjustable saves more because the index-plus-margin rate is unlikely to move up 1.25% in three years. The short-term cost savings usually lasts at least five years.

Adjustables offer larger loan amounts because of the risk seesaw. Lower lender risk translates into higher LTV and higher DTI. You would need \$65,000 income to qualify for the \$200,000 fixed-rate Loan #1, but only \$50,000 to qualify for the \$200,000 adjustable-rate Loan #2.

Fixed-rate loans offer long-term security. The interest rate on Loan #2 could go up as high as 11% after 6-1/2 years while Loan #1 will always be 7.5%.

How should you choose? Take this true/false test.

T	F	You qualify for the home you want with a fixed-rate loan.
T	F	You can afford the extra fees of a fixed-rate loan.
T	F	You plan to keep your home for at least four years.
T	F	You think interest rates will rise before you sell.

If any of these statements were false, choose an adjustable over a fixed.

In today's mortgage marketplace, there are choices beyond the plain old fixed and the plain old adjustable. People who want the security of a fixed with rates, fees and underwriting guidelines of an adjustable, can choose from several hybrid loan products that are less risky for the lender:

- **Less Term Risk:** A 15-year fixed with equal monthly payments high enough to pay off the whole loan in 15 years. You will need to be able to qualify to make higher monthly payments.
- **Less Term Risk:** A 30-year fixed due in seven years. The payments are the same as on a normal 30-year fixed, but you need to pay the entire remaining balance (a **balloon payment**) at the end of the seventh year. Skip this unless you are sure you will move or refinance within seven years.
- **Less Interest Risk:** A fixed loan that converts to an adjustable loan after three, five, seven or ten years. You have the same long-term risks as any adjustable, but your initial rate lasts longer. Choose this if you plan to keep the loan through the fixed-rate period, but expect interest rates to rise rapidly during that time.

People who need the rates, fees and underwriting guidelines of an adjustable but crave the security of a fixed also have a hybrid, an adjustable that can be converted to a fixed. Unfortunately, the fixed rate to which you convert is higher than the prevailing fixed rate at the time of conversion, so this option may be no better than

refinancing with a new fixed when you think rates are starting to rise. But the conversion feature would prove useful if the property had dropped in value, you had lost your job, or some other disaster struck, and you could not qualify to refinance in response to the rising rates.

## 6. SHOPPING FOR LOANS

Now that you understand the basics, its time to shop. Here's how to do it.

### Guide 6.A.--Shopping For Loans

- **STEP 1: GET SOME GENERAL HELP FROM A BIG LOCAL LENDER**  
Make an appointment with a loan agent from a big local lender. Bring in your pay stubs or tax returns and have the agent pre-qualify you for several loan products including at least one fixed with tough underwriting guidelines and one adjustable with easy underwriting guidelines. This process will define the high and low limits of your loan qualification strength.
- **STEP 2: SET A SHOPPING STRATEGY** Based on your visit with the big lender, can you qualify for a big enough fixed loan to buy the kind of home you want? If the answer is no, confine your shopping to ARMs. If the answer is yes, or if you are on the border, look back at the comparison in Section 5 and decide whether you want fixed or adjustable.
- **STEP 3: GATHER INFORMATION** Contact as many loan originators as time allows and maybe a loan distributor. Tell each whether you are looking for a fixed or an ARM, and make a list of the terms and guidelines for each loan in your category. Use Section 3 as a checklist.
- **STEP 4: NUMBER CRUNCH** Compare the loans. This will be much simpler with fixeds than with ARMs. If you are shopping for an ARM, add up all the fees and interest for the first five years assuming a fast rising interest rate, a slow rising interest rate, and a stagnant interest rate. Remember to consider the volatility of the index--is it like weather in Boston or San Diego?--when you run the numbers with the fast rising rate. Rank your loan choices from best to worst.
- **STEP 5: PRE-QUALIFY WITH YOUR TOP THREE CHOICES** The terms that are best for you will probably be the most risky for the bank. This means that your favorite loans will probably have the toughest underwriting guidelines. Prequalifying for your top three choices gives you a maximum mortgage size for each loan. Get a letter confirming the prequalification so that you can show it to the seller when you make an offer.

## 7. SELLER FINANCING

If you can't quite satisfy the underwriting guidelines for the type or size of loan you want, one solution might be **seller financing**. Seller financing is a loan made by the seller to the buyer. Like other mortgages, it is secured by a lien on the property, but unlike most, it is usually due in 3-7 years instead of 30-40. Seller financing is generally used together with an institutional mortgage. A buyer makes a down payment of 5-10%, borrows 75-80% from a bank, and another 5-15% from the seller.

### Example 7.A.--Typical Seller Financing Arrangements

#### "Eighty-Ten-Ten"

Bank Mortgage	\$120,000	80%
Seller Financing	15,000	10%
Buyer Down Payment	<u>15,000</u>	10%

Total Price	\$150,000	100%
<b>"Eighty-Fifteen-Five"</b>		
Bank Mortgage	\$120,000	80%
Seller Financing	22,500	15%
Buyer Down Payment	<u>7,500</u>	5%
Total Price	\$150,000	100%

Suppose you have a 5-10% down payment but cannot meet the strict underwriting guidelines for a 90%-95% LTV loan. You may still be able to satisfy the less stringent requirements for an 80% LTV loan and use seller financing to fill the gap.

Here are some other good reasons to consider seller financing.

#### List 7.B.--Advantages of Seller Financing

- **Lower Loan Fees:** Seller financing lowers both the rate and the amount of loan fees. The risk seesaw makes loan fee rates lower on 80% LTV loans than on 90% LTV loans. Often, the fees drop from 2% of the loan amount to only 1%. And every dollar borrowed from the seller is a dollar not borrowed from another lender and therefore a dollar on which no loan fee is paid. Suppose you need to borrow 90% of \$150,000. If you borrow all \$135,000 from a bank, you are likely to pay a fee of 2% or \$2,700. But if you borrow \$15,000 from the seller and \$120,000 from the bank, you are likely to pay a fee of 1% or \$1,200. You save a total of \$1,500 in loan fees, \$1,200 because of the lower fee rate and \$300 because of the lower loan amount.
- **Eliminates PMI:** The risk seesaw makes lenders less likely to require PMI on an 80% LTV loan than on a 90-95% LTV loan. Eliminating PMI will save you at least 1% of the loan amount per year, \$113 per month on that \$135,000 loan.
- **Improve Loan Terms:** The risk seesaw makes loan terms better on an 80% LTV loan than on a 90-95% LTV loan. You save by paying a lower interest rate.
- **Temporarily Defers Seller Taxes:** Sellers do not need to pay income taxes on the portion of the sale price which they finance until the loan is repaid.

The drawback of seller financing is its short term, usually 3-5 years. This means you will need to refinance within that period to repay the seller.

#### About the Author

D. Andrew Sirkin is a recognized expert in fractional ownership and other co-ownership arrangements including shared vacation homes, TICs, equity sharing, co-housing, and legal subdivisions such as condominiums. His practice areas include transaction planning, offering materials, co-ownership agreements and CC&Rs, entity formations, regulatory approvals, fractional lending and mediation. Although based in San Francisco, he regularly works on projects located throughout California, and has also worked on projects in nine other U.S. states, Italy, France, Argentina, Nicaragua, Belize and Mexico. He is an accredited instructor with the California Department of Real Estate, and frequently conducts co-ownership workshops for attorneys, real estate agents, corporations, and prospective home buyers. Andy is the co-author of *The Condominium Bluebook*, published annually by Piedmont Press, and *The Equity Sharing Manual*, first published by John Wiley and Sons in November 1994 ([download the current edition in PDF](#)). He has written numerous articles on related topics, including "Vacation Home Co-Ownership", "Questions and Answers on Tenancy In Common", "Owner-Occupancy and Ellis Evictions", "Condominium Conversion in San Francisco", and "Unmarried Couples and Property Ownership", all of which are available at

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