8

Chapter 8

Nontraditional Mortgage Products

In This Chapter

Even with all of the mortgage products that lenders offer, some borrowers may still require assistance in order to purchase a home. Fortunately, a variety of nontraditional mortgage products offering different financing options have been developed to meet the needs of these borrowers. A **nontraditional mortgage**, as defined by Regulation H implementing the **SAFE Act**, is *anything other than a 30-year fixed rate mortgage* (12 C.F.R. § 1008.23). The **Interagency Guidance on Nontraditional Mortgage Product Risks**, on the other hand, defines nontraditional mortgage products as *mortgage products that allow borrowers to defer principal and, sometimes, interest.*

When used properly, these products can help borrowers achieve their goals of qualifying for a loan, getting a lower interest rate, having a lower monthly payment, or buying a bigger house. In this chapter, we'll look closely at two financing tools: Buydowns (or discounts) and adjustable rate mortgages (ARMs). Other financing products include subprime loans, structured mortgages, homebuyer assistance programs, and seller financing, including land contracts.

At the end of this chapter, you will be able to:

- Describe the advantages and disadvantages of buydown plans.
- Identify the elements that make up an adjustable rate mortgage.
- Identify characteristics of a reverse mortgage.
- Identify factors that define a subprime loan.
- Discuss agency guidelines on lending and subprime loans.
- Contrast various types of alternative financing.

Key Terms

Adjustable Rate Mortgage (ARM)
Buydown
Caps
Equity Exchange
Estoppel
Index
Land Contract
Lease/Option
Lease/Purchase
Margin
Option
Participation Plan
Points
Rate Adjustment Period
Reverse Mortgage
Subprime Loan
Teaser Rate

The Use of Nontraditional Mortgage Products

Just as there are many different borrower's' goals, there are also many financing tools to help them achieve those goals. With the wide variety of nontraditional mortgage products available in today's real estate market, it's important to understand how they work so you can help customers reach their goals. For example, if the goal is to lower the monthly payment, the borrower can prepay some of the interest at closing as **discount points** to the lender, which buys down the interest rate and, therefore, lowers the required monthly payment.

Another option for a borrower to decrease the initial interest rate on a loan (thereby decreasing monthly payments) is by agreeing to **assume part of the lender's interest rate risk** with an **adjustable rate mortgage**, or ARM. Since the lender is not locked into a fixed interest rate for the loan term, the lender can offer the borrower a lower interest rate as a start rate.

Other times, loans may be structured differently to achieve a borrower's specific goals, for example:

- **Growth Equity Mortgage (GEM).** A **growth equity mortgage** or growing equity mortgage (GEM) is a *fixed rate mortgage set up like a 30-year conventional loan, but payments increase regularly.* With this type of loan, the total monthly payments increase over time with predictable and scheduled escalation. This type of loan allows a borrower to have lower monthly payments early in the loan and is recommended for a borrower whose income is expected to increase simultaneously with the increase in the payment amount. The fixed interest rate allows 100% of the scheduled payment increases to reduce the principal balance.
- **Reduction Option Mortgage.** A **reduction option mortgage** is a *fixed rate loan that gives a borrower a limited opportunity to reduce the interest rate without paying refinancing costs.* For example, the borrower may get a 30-year, fixed rate loan and pay a fee for the option of reducing the interest rate once during the early years of the loan if market interest rates decline a certain percentage. This allows the borrower to take advantage of a drop in interest rates while avoiding certain refinancing costs, such as for an appraisal.
- **Shared Appreciation Mortgage (SAM).** A **shared appreciation mortgage** (SAM) is one for which *the lender charges below-market interest in exchange for a share of the gains the borrower realizes when the property is eventually sold.* This can help a lender or borrower achieve various goals, including shared risks/ rewards on commercial projects.

At the other end of the spectrum is a borrower with less-than-perfect credit or some other risk factor that prevents him from qualifying for a conventional loan. The borrower wants to purchase a home and accepts the lender's offer of an interest rate above that for typical conventional mortgages to achieve this goal. This type of financing is referred to as a **subprime loan**. Subprime loans are rarely available in today's market.

Buydown Plans

Recall from an earlier chapter that a **point** is simply *one percent of the loan amount*. Points may be charged for a variety of reasons, such as to cover the costs of processing or servicing a loan. **Discount points** are *additional funds paid to a lender at the beginning of a loan to lower the note interest rate and, therefore, the monthly payments.* Such a **buydown** could make it easier for a borrower to qualify for the loan.

A buydown can be paid for by the borrower, the seller, an interested third party such as a builder/developer, or even another party such as an employer to help facilitate the move of an employee being transferred. Typically, a borrower pays for a buydown by simply prepaying some interest at closing. Therefore, a buydown in the form of discount points appears on a Good Faith Estimate as a **charge** to the borrower.

Advantages to a buydown plan include:

- The borrower's monthly payment is lower.
- The lender *may* evaluate the borrower for loan qualification on the basis of the reduced payment after the buydown.

While a permanent buydown plan may allow a borrower to lower monthly payments, borrowers must weigh their monthly savings over the life of the loan against what they're paying in upfront points at closing to buy down the interest rate. To determine how many months it would take to recoup those upfront points, divide the payment difference between the two interest rates into the cost of the discount points.

Case in Point

Let's first see how a buydown can help the borrower afford the home. Suppose that a borrower financing $180,000 was quoted an interest rate of 6.5% for a 30-year conventional loan. The payments on that loan would be $1,137.72 per month. At 6.25% for the same $180,000 30-year loan, the payments would be $1,108.29. So by paying discount points up front to buy down the interest rate 1/4%, the borrower pays $29.43 per month less. This may help the borrower qualify for the home loan and make the mortgage payments more attractive.

However, when you consider that a discount point is typically quoted as 1 point per 1/8 rate reduction, the borrower would have likely paid an additional $3,600 at closing to get this interest rate (2 points at $1,800 per point). That means the borrower must stay in the mortgage for at least 123 months ($3,600 / $29.43 = 122.3) to realize the advantages of the buydown. If the borrower refinances or sells the house in the first 10 years of that loan, therefore, he will not recapture what he paid for the upfront discount points.

Another option is for the seller or other interested third party to pay discount points to buy down the interest rate for the borrower. While this means less money in the seller's pocket, it may be necessary to make the deal. The lender determines what the buydown amount is and subtracts that amount from the loan proceeds paid to the seller for the property, reflected on the HUD-1 settlement statement as a charge to the seller. The borrower, however, still signs a note for the full amount but will receive a lower interest rate over the life of the mortgage. The seller just agrees to receive less.

Permanent Buydown

Buydowns can be paid to reduce the borrower's payments early in the loan (temporary buydown) or throughout the life of the loan (permanent buydown).

A **permanent buydown** is when points are paid to a lender to reduce the interest rate and loan payments *for the entire life of the loan.* When a buyer's interest rate is reduced for the life of the loan, the lender will write that lower interest rate into the promissory note. Thus, the nominal rate (or coupon rate) stated in the note will be the actual reduced interest rate.

Temporary Buydown

Here's one way to think of a **temporary buydown**: Whoever pays for the buydown—often the seller or developer, sometimes the borrower—is depositing funds at closing with the lender that will be used to supplement the borrower's reduced monthly out-of-pocket payment. The supplemental funds allow the lender to receive the full payment during the months of the temporary buydown when the borrower's monthly payments are less than what is called for in the note. Once the "deposited" funds run out, in other words, the specified temporary buydown period ends, the borrower must make the full required monthly payment out-of-pocket.

Although the starting interest rate paid by the borrower early in the loan may be discounted, when qualifying a borrower who is using a temporary buydown, underwriters will consider the payments using the **fully indexed rate**, *not* the starting note rate.

Temporary buydown plans can take two forms:

- Level payment
- Graduated payment

Level Payment

A **level payment buydown** is a plan with the *payment reduction remaining constant throughout the buydown period.* For example, the lender makes a 30-year loan for $165,000 at 9% interest rate. The seller agrees to buy down the buyer's interest rate to 7% for three years. The borrower's monthly out-of-pocket payment is

less for those three years, but due to the seller's subsidy, the lender still receives 9% interest as specified in the note during the buydown period (and thereafter).

LEVEL PAYMENT EXAMPLE							
Year	Note Interest Rate	Buydown %	Effective Interest Rate	Monthly Payment at 9%	Actual Monthly Payment	Monthly Subsidy	Annual Subsidy
1	9%	2%	7%	$1,328	$1.098	$230	$2,760
2	9%	2%	7%	$1,328	$1.098	$230	$2,760
3	9%	2%	7%	$1,328	$1.098	$230	$2,760
4	9%	-0-	9%	$1,328	$1.328	-0-	-0-
					TOTAL BUYDOWN: $8,280		

FIGURE 8.1: Level Payment Example.

Graduated Payment

A **graduated payment buydown** is a plan for which *payment subsidies in the early years keep payments low, but payments increase each year as indicated in the note.* Usually there's a definite structure to the loan such that the subsidy may last for only two or three years. Two common types of graduated payment buydown plans are often referred to as 2-1 buydowns and 3-2-1 buydowns.

- **2-1 buydown** is a graduated payment buydown with the payments subsidized for only two years—for example 2.5% below the interest rate in the first year and 1.5% the second year.
- **3-2-1 buydown** is a graduated payment buydown with the payments subsidized for three years—for example, 2.5% below the interest rate the first year, 2% the second year, and 1.5% the third year.

The subsidies for graduated payment buydowns may be a borrower's upfront escrow deposit of extra cash that earns interest, or the subsidy may be from a seller or builder trying to help a buyer with lower payments early in the loan.

For example, the lender makes a 30-year loan for $170,000 at 8.75% interest rate. The builder agrees to do a 3-2-1 buydown of the buyer's interest rate. The lender is still earning 8.75% interest, but the borrower is able to take advantage of the subsidy and pay less out-of-pocket each month for the first three years of the loan.

GRADUATED PAYMENT EXAMPLE							
Year	Note Interest Rate	Buydown %	Effective Interest Rate	Monthly Payment at 8.75%	Actual Monthly Payment	Monthly Subsidy	Annual Subsidy
1	8.75%	3%	5.75%	$1,337	$ 992	$345	$4,140
2	8.75%	2%	6.75%	$1,337	$1,103	$234	$2,808
3	8.75%	1%	7.75%	$1,337	$1,218	$119	$1,428
4	8.75%	-0-	8.75%	$1,337	$1,337	-0-	-0-
					TOTAL BUYDOWN: $8,376		

FIGURE 8.2: Graduated Payment Example.

Real Success

The best way to be completely accurate when determining buydown rates is to prepare a lender's quote. There are many variables lenders consider when determining the relationship between discount points and the interest rate. However, as a rough guide, 3-2-1 buydowns generally cost about 5 points, and 2-1 buydowns generally cost about 2.5 points.

Remember that even though the buyer has smaller payments at the beginning, payments increase later in the loan. Careful consideration is needed to determine whether this may pose a problem. Also remember with 3-2-1 buydowns, the lender may only let the borrower qualify at an interest rate up to 2% below the current market rate, not at the full 3% buydown.

Limits on Interested Party Contributions and Other Considerations

Fannie Mae, Freddie Mac, and the FHA limit points and other **interested party contributions** (IPCs) that can be paid. An interested party may be anyone other than the buyer who has a financial interest in, or can influence the terms and the sale or transfer of, the subject property. Limits are placed on these items so buyers aren't induced into a property they can't afford to keep later.

Fannie Mae/Freddie Mac

Fannie Mae and Freddie Mac guidelines impose limits on discounts, buydowns, and other forms of interested party contributions to help buyers get into homes. These other contributions include finance costs, such as prepaid interest, and escrows for property taxes, hazard insurance, and mortgage insurance.
Contributions by sellers or other interested parties are limited to a percentage of the sale price of a property or its appraised value, *whichever is less.* If the contributions *exceed* Fannie Mae and Freddie Mac guidelines, the contribution amount must be *deducted* from the value or sale price of the property before determining the maximum loan amount. These maximum contributions are based on the type of property and the loan-to-value:

Property Type	LTV/CLTV Ratio	Maximum Contribution
Investment Property	All CLTV ratios	2%
Principal Residence or Second Home	Greater than 90%	3%
	75.01% - 90%	6%
	75% or less	9%

This example reflects FNMA/FHLMC guidelines. Other investors may impose other standards.

√ **Note:** Contributions made by employers or immediate family members usually are ***not*** subject to these limits.

FHA and VA

FHA guidelines also impose limits on discounts points, buydowns, and other forms of seller/interested party contributions to help buyers purchase homes.

FHA does *not* permit underwriting at a temporary buydown rate on fixed rate mortgages. While builders and sellers may offer temporary buydowns, unless the buydown is permanent, the borrower must qualify at the **note rate**. Furthermore, the buydown must not result in a reduction of more than two percentage points below the interest rate on the note.

FHA allows maximum IPCs of 6% (FHA has proposed a reduction to **3%**). If the contribution is more than the allowable limit, FHA, like Fannie Mae and Freddie Mac, deducts the excess from the maximum loan amount. For this rule, remember that seller-paid contributions include any items normally paid by the buyer. Family and employer contributions are excluded here also.

The VA has no set limits.

Mortgage Exercise 8-1

A borrower wants to buy a $150,000 home, and is going to make a $15,000 down payment. The borrower is seeking a conventional loan, but doesn't want to pay more than 6 1/2% interest. The lender agrees to 6 1/2% interest if the loan has three discount points and the loan origination fee is 2%. *See the Appendix for answers to check your work.*

1. What's the total amount of points (in dollars and percentage) that the lender will receive for making this loan?

2. If the seller agrees to pay the discount points, how much will the seller net from the transaction? (Assume the seller pays no other costs.)

3. What will the borrower's note state as the interest rate on the loan? What dollar amount will the note say was borrowed?

4. Can the lender sell this loan to Fannie Mae or Freddie Mac on the secondary market? Why or why not?

Adjustable Rate Mortgages (ARMs)

An **adjustable rate mortgage** (ARM) frees lenders from being locked into a fixed interest rate for the entire life a loan, as interest rates may adjust, according to the terms in the note, to reflect the current cost of money. ARMs are popular alternative financing tools as they may help borrowers qualify more easily for a home loan or for a more expensive home. Many lenders like ARMs because they can pass the risk of fluctuating interest rates on to borrowers.

Because ARMs shift the risk of interest rate fluctuations to the borrower, lenders normally charge a lower start rate for an ARM than for a fixed rate loan. Although the majority of borrowers prefer the security of a fixed rate (provided the rate is not too high), ARMs have maintained a place in the market despite comparatively low mortgage rates. Of course, as interest rates rise, so does ARM popularity.

Terms, rate changes, and many other aspects of ARMs are regulated by several agencies, depending on the type of lender. Any applicable guidelines or requirements of Fannie Mae, Freddie Mac, the FHA, and/or private mortgage insurers must be followed as well.

How ARMs Work

There are several elements to an adjustable rate mortgage:

- Index
- Margin
- Rate adjustment period
- Mortgage payment adjustment period
- Interest rate cap/floor (if any)
- Mortgage payment cap (if any)
- Negative amortization cap (if any)
- Conversion option (if any)

The borrower's interest rate is determined initially by the cost of money when the loan is made. Once the initial interest rate for the loan is set, the rate of the loan is tied to a widely recognized and published index.

Index

When discussing ARMs, the **index** is a *statistic that a consumer can easily examine, such as a published report, that is a generally reliable indicator of the approximate cost of money.* Thus, future interest rate adjustments for ARM loans are based on the up and down movements of the index.

At the time a loan is made, the index preferred by the borrower is selected. Because of market forces, the index fluctuates during the term of the loan, causing the borrower's actual interest rate to increase and decrease. That is why the index is referred to as the variable part of an ARM. The following are among commonly used indexes for adjustable rate mortgage loans:

- **Average One-Year Treasury Constant Maturity Index (TCM).** Average of the 12 most recently published monthly yields on United States Treasury securities, adjusted to a constant maturity of one year; issued monthly.
- **Cost of Funds Index (COFI).** Monthly weighted average cost of funds for savings institutions that are members of the Federal Home Loan Bank System, most often the Eleventh District (the "Bank"). COFI consists of the monthly weighted average cost of savings, borrowings, and bank advances. COFI is becoming more widely used since Fannie Mae uses this when purchasing ARMs.
- **London InterBank Offered Rate (LIBOR).** A reference rate that is computed and published daily, indicating the average rate at which a lending institution can obtain unsecured funding for a given currency. It is also referred to as the British Banker's Association London InterBank Offered Rate (BBALIBOR).
- **Lender's Prime Rate.** At one time, the lender's prime rate was a common index, although now used infrequently and only for commercial and investment property loans.

All of these indexes move in step with other short-term interest rate debt instruments. From the borrower's perspective, it's not as important which index is chosen as long as it is one the lender can't manipulate. The index should be one that is determined and affected by market conditions, and regularly listed in a major publication, such as The Wall Street Journal. Once selected, the index written into the note cannot change, unless for some reason it is no longer available, at which point, a similar type index may be substituted.

Margin

A margin, which is also sometimes referred to as a spread, is the difference between the index value and the interest rate charged on an ARM. The lender adds a margin to the index to ensure sufficient income for administrative expenses and profit. The selected margin remains fixed or constant for the duration of the loan, and is not impacted by the movement of interest rates or other factors in the financial markets.

The index plus the margin equals the adjustable interest rate or fully indexed rate the borrower pays on the loan. For example:

4.25% Current Index Value

+ 2.00% Margin

6.25% Fully Indexed Rate

From the borrower's perspective, this is where comparisons can make a difference. Different lenders have different requirements for the amount of margin charged. While margins for ARMs are usually 2% to 3%, they can vary greatly from one lender to the next, and may even be very different from the same lender, depending on the loan program or the credit risk of the borrower.

In this hypothetical example, a borrower chose Treasury Securities as the index. The loan interest rate runs roughly parallel to the Treasury Securities index, but always a few percentage points above it. This is the margin the lender added to the index.

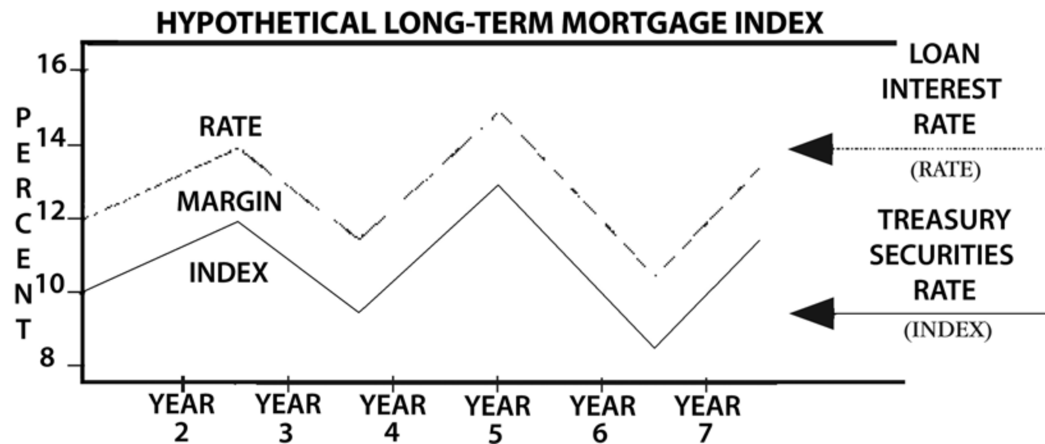

FIGURE 8.3: Hypothetical Long-Term Mortgage Index.

Rate Adjustment Period

The rate adjustment period is the length of time between interest rate changes with ARMs. This interval can range from a few months up to seven years. The most common rate adjustment periods are every six months or one year. ARMs are typically identified by their adjustment period, such as a 1-year ARM or a 3-year ARM. So, for example, with a 1-year ARM, the first adjustment would be made one year after the loan term started, and then every year after that. (In contrast, there are loan products called hybrid ARMs that have a fixed rate for a period of time before the rate adjustment periods begin. These are covered later in this chapter.)

After checking movement in the selected index, the lender will notify the borrower, in writing, of any increase or decrease in the rate. Such notification to the borrower is generally made 45 days prior to the next change.

Mortgage Payment Adjustment Period

The mortgage payment adjustment period is the length of time between payment adjustments with ARMs. Like the rate adjustment period, this payment adjustment interval can range from a period of months up to several years. There are two ways the rate and payment adjustments can be handled:

The lender can adjust the rate periodically, as called for in the loan agreement, and then adjust the mortgage payment to reflect the rate change. In this case, the payments will parallel the index and continue to amortize the loan during the repayment period.

If allowed in the note, the lender can adjust the rate more frequently than the mortgage payment is adjusted. In this case, the two adjustments do not coincide and so the payments will not parallel the index. If the interest rate is adjusted upward before the payment is adjusted, the borrower's payment may be insufficient to cover the accrued interest from the previous month, resulting in negative amortization. If the interest rate is adjusted downward before the payment is adjusted, the borrower will pay more than enough to cover accrued interest, in which case, the excess may be applied to principal.

Teaser Rates

When the initial rate on an ARM, also known as the start rate, is less than the fully indexed rate, it is considered a discounted index rate, sometimes referred to as a teaser rate. Lenders offer teaser rates to make ARMs more attractive to borrowers. The downside to a teaser rate is that it has the potential for a much higher first payment adjustment. Initially, teaser rates were offered without any caps, but industry leaders, especially secondary market investors, began demanding caps on ARMs as a means of protecting borrowers from payment shock, and themselves from portfolio shock—having loans that borrowers no longer had the ability to pay.

Interest Rate Cap

Interest rate caps are used with ARMs to limit the number of percentage points an interest rate can be increased during the term of a loan, helping to eliminate large fluctuations in mortgage payments. More uniform ARM lending practices and a period of self-regulation have resulted in most ARMs having some kind of cap. Rate caps are often shown as two numbers, for example 2/6:

The first number indicates the maximum amount the interest rate can increase (or potentially decrease) from one adjustment period to the next.

The second number indicates the maximum amount the interest rate can increase during the life of the loan.

Some ARMs allow for a higher rate change at the first adjustment, and then apply a periodic adjustment cap to future adjustments. These ARMs are usually identified with three numbers, where the first number is the interest rate cap for the first adjustment, followed by the period adjustment and lifetime interest rate caps. If you see a rate cap described as 5/2/6, for example, the interest rate cannot increase more than:

5% at the first adjustment,

2% for subsequent adjustment periods, and

6% total over the life of the loan.

Note: Just as an ARM may have caps that limit how high an interest rate or payment may increase, some adjustable rate mortgages also have a floor that limits how low an interest rate or payment may decrease. For example, a common floor for an ARM might be the margin indicated in the loan documents. In that case, even if a particular index were to be 0%, the actual rate to the lender would be the margin originally set, providing some risk protection for the lender. Some ARMS may also have a carryover feature, which means that an increase in the rate—not imposed because the rate cap—may be carried over to future rate adjustments. Such interest rate adjustments may also be effective and used for payment adjustment limits (either up or down), if provided for in the note.

Class Activity: ARM Interest Rates

Consider this hypothetical example to illustrate the relationship between interest rate caps and the borrower's interest rate. Let's say that a borrower gets a 1-year ARM loan for $100,000 for 30 years. It has a **5/2/6 interest rate cap**. The current index rate is 4.5%; the margin is 3%; and the discounted start rate is 4%.

As a class, complete the missing data for this particular adjustable rate mortgage example:

	Start / Year 1	Year 2	Year 3	Year 4	Year 5
Index	4.5%	6.5%	4%	7%	8%
Fully Indexed Rate (Index + 3%)	7.5%	9.5%	7%	10%	11%
Borrower' Interest Rate w/ Caps	4% (start)				
Monthly Payment (P&I only)	$536.82	$804.62	$665.30	$804.62	$877.57

Fannie Mae and Freddie Mac Interest Rate Caps. Both Fannie Mae and Freddie Mac have guidelines on ARM interest rate caps. ARMs purchased by Fannie Mae are limited to rate increases of **2%** per year and **6%** over the life of the loan. Freddie Mac rate adjustment guidelines limit rate increases to **2%** per year and **5%** over the life of the loan. While these guidelines do not take the form of regulations, most lenders include these, or even stricter, caps in their loans (particularly if they want to sell them on the secondary market).

FHA Interest Rate Caps. FHA rate adjustment increases are limited to **1%** per year and **5%** over the life of the loan.

VA Interest Rate Caps. VA rate adjustments are limited to 1% annually/5% lifetime on traditional ARMs (adjusts annually), and 2% annually/6% lifetime for their hybrid ARM (fixed for at least five years).

Mortgage Payment Cap

Mortgage payment caps are used with ARMs to *protect a borrower from large payment increases.* This is another way lenders limit the magnitude of payment changes that occur with interest rate adjustments. When there are no limits on the amount mortgage payments can be increased, borrowers are vulnerable to extreme changes in the cost of money. Inevitably, unrestricted increases create hardships for many borrowers. Some lenders only use interest rate caps to limit payment increases; others use both rate and payment caps. Regardless of which policy a lender uses, the objective is the same: To keep payment adjustments within a manageable range for the borrower. Note that if the current interest on the loan exceeds the payment cap, there is a chance for negative amortization.

Negative Amortization Cap

Negative amortization is *when a loan balance grows because payments don't cover the accrued interest due on the loan.* Negative amortization is most likely to occur when there are frequent rate changes (e.g., every six months) and less frequent payment adjustments (e.g., every three years).

A primary motivation for setting a negative amortization cap is to limit the growth of the loan balance beyond a certain point so that the loan-to-value ratio does not exceed the tolerances established by the lender. While negative amortization caps do *not* stop a loan from accruing negative amortization, when the cap is reached, the note usually calls for the lender to adjust, sometimes referred to as **recast**, the monthly payments to prevent any further negative amortization.

The cap is especially important for higher initial LTV loans. One approach is to set the negative amortization cap limit at 110%–125% of the initial loan balance. Another is to set the negative amortization cap limit at 100% of the initial appraised value. Either way, this means that a larger down payment can delay higher payments from re-amortization because it will take longer to reach the negative amortization cap.

Conversion Option

A **conversion option** in an ARM *gives the borrower the right to convert from an adjustable rate loan to a fixed rate loan*. ARMs with a conversion option normally identify the following factors in the note:

- Interest rate (often, the initial rate and converted rate are higher)
- Limited time to convert (e.g., between the first and fifth year)
- Conversion fee (typically about 1%)

For example, a Fannie Mae convertible ARM program may be converted between the 13th and 60th month for a small processing fee paid to the lender. The initial rate on the ARM loan is the same as for other Fannie Mae ARMs but, if converted, the fixed rate is 1/8% higher than the standard fixed rate at the time of conversion. Note that if an ARM is sold to the secondary market, the terms of any built-in conversion option would have to be honored by the secondary market purchaser.

ARM Standardization

The widespread acceptance of ARMs represented a major evolutionary phase in the housing industry. Initially, it was estimated that there were more than 200 different adjustable rate plans. But sharp criticism from confused customers, threats of government regulation, increased dangers of foreclosure, and refusal of secondary markets to buy ARMs led lenders to standardize most ARM programs.

Previously, most lenders underwrote ARMs based on their own standards and kept them as portfolio loans. Now, lenders usually follow secondary market guidelines so they can sell ARMs just as they do fixed rate loans. With uniform ARM underwriting standards, secondary market agencies, such as Freddie Mac, purchase large volumes of ARMs that follow their guidelines.

Loan-to-Value Ratios

ARM loans with loan-to-value ratios (LTVs) of 80%, 90%, and 95% may be available, depending on current conditions in the local market. Loans with higher LTVs, though, are often subject to some restrictions. For example, many lenders refuse to make 90% or 95% ARM loans if there's a possibility of negative amortization. Furthermore, in most cases where borrowers are seeking 90% or 95% ARMs, they're required to occupy the property. Fannie Mae and Freddie Mac have established stricter LTV guidelines for ARMs than for fixed rate loans. Loan-to-value ratios may not exceed 95% for ARMs purchased by Fannie Mae and Freddie Mac. The loan-to-value requirements are based on the potential risk from higher payments when the interest rate is adjusted. Fannie Mae and Freddie Mac also require owner occupancy for all ARMs, since they're considered better risks than non-occupant borrowers. In addition to new LTV restrictions, another recent change has been a tightening of FICO risk scores for some ARM programs, further narrowing the pool of qualified borrowers.

Appraisals on ARM Properties

As an ARM loan already carries some inherent risk, the appraisal is a focal point of any good underwriter. Lenders must insist that the appraisal report accurately reflects an estimate of the true value of the property, uninfluenced by discount rates, subsidy buydowns, or other financing concessions. The terms of the sale must be clearly communicated to the appraiser and identified—preferably in the appraisal report—and the effect of any financing concessions on the value of the property must be fully explained. When underwriting ARMs, the underwriter will carefully review the appraisal report to determine if the appraiser has performed this analysis satisfactorily. If not, the appraisal will be considered deficient because underwriters may subtract the value of any favorable financing from the appraised value in determining the maximum loan for a given LTV.

ARM Qualifying

With the potential risk of an increase in payments that comes with ARM loans, lenders are often stricter in qualifying borrowers to be sure they have sufficient income in the event their payments increase. To do this, lenders often use smaller housing expense and debt-to-income ratios with ARMs, to be conservative,

allowing a smaller portion of a borrower's income to count in qualifying for the loan. If payments do increase later, there's less financial strain on a borrower to pay the loan (and less risk for the lender).

Certain ARMs have features (e.g., no rate or payment caps) that increase the likelihood of mortgage payments increasing to dangerous levels after the first rate adjustment. Likewise, loans with teaser rates or subsidy buydowns that exceed 2% add to the chances of significant payment shock. If an ARM is made with these characteristics, secondary market investors and many private mortgage insurance companies will insist that the traditional income ratios of 28% (for total housing expense) and 36% (for total debt-to-income) be disregarded in favor of lower, more conservative ratios.

ARM Disclosures

Lenders offering residential financing, including ARMs, must comply with federal guidelines under Regulation Z of the Truth in Lending Act that require certain disclosures to borrowers (12 C.F.R. §1026.19). A lender is required to give the loan applicant the **Consumer Handbook on Adjustable Rate Mortgages** (CHARM), prepared by the Federal Reserve Board, within three business days of loan application. The rules also require making certain specific disclosures if relevant to the specific ARM program and disclosing the annual percentage rate (APR).

The following disclosures must be provided to the borrower within three business days of a completed loan application (as appropriate):

- Index used to determine the interest rate
- Location where the borrower may find the index
- Explanation of how the interest rate and payment are determined
- Suggestion that the borrower asks the lender about the current margin and interest rate
- Disclosure of the fact that the initial rate is discounted and a suggestion that the borrower inquire as to the amount of the discount
- Rate and payment adjustment periods
- Rate and payment caps
- Statement that payment caps may result in negative amortization
- Statement that the loan has a demand or call provision
- Description of the information that will be contained in the adjustment notice and when such notices will be provided
- Statement that disclosure forms are available for lender's other ARM loans
- Maximum interest rate and payment
- Initial interest rate and payment
- Conversion option details
- An example, based on a $10,000 loan, showing how the payments and loan balance will be affected by changes in the index used

The lender or servicer must comply with all of the terms of the loan as indicated in the note, including any changes that occur during the life of the loan to the index, the rate, the payment, etc. The note will also indicate specific requirements for disclosing pending changes to the borrower.

Real Success

Mortgage loan originators working with consumers on an adjustable rate mortgage should **never** use the term "fixed rate," even when discussing the period between adjustments during which that interest rate remains unchanged. A consumer will hear "fixed," and that perception could create certain expectations about the loan that are false. Complete disclosure of how an ARM really works and the impact on the borrower is required by law and is simply the ethical behavior expected from all mortgage professionals.

Annual Percentage Rate (APR)

The **annual percentage rate** (APR) is *the relationship between the cost of borrowing money and the total amount financed, represented as a percentage.* Regulation Z disclosures regarding the APR cannot be made based solely on an ARM's initial rate. For an adjustable rate loan, the disclosure of the APR in the federal box on the Truth in Lending Statement (TIL) must reflect the finance charges and fees as well as the **composite annual percentage rate**, which is based on the initial payment rate and the fully indexed rate that could exist for the remaining years on the loan term.

For example, if the initial rate on a 30-year loan is 6% for one year, but then adjusts to COFI (for illustration purposes, let's say it's at 3%) plus 5%, the lender's disclosed payment schedule should reflect a composite APR based on 6% for 12 payments and 8% (3% + 5%) for the remaining 348 payments. The main point is that a lender must disclose more than the low initial rate. A required disclosure under Regulation Z, the APR composite rate is designed to let consumers comparison shop for rates among lenders, since all lenders must calculate APR the same way.

ARM Programs

Lenders may offer multiple types of adjustable rate mortgage programs.

Payment Option ARM

A payment option ARM, sometimes called a "pick-a-payment" loan, is an adjustable rate mortgage that allows borrowers to choose among several payment options each month. The options typically include:

- A **traditional payment of principal and interest**, which reduces the amount owed. Payments are based on a set loan term, such as a 15-, 30-, or 40-year payment schedule.
- An **interest only payment**, which pays the interest due but does not reduce the principal amount owed on the mortgage.
- A **minimum (or limited) payment** that may be less than the amount of interest due that month and may not reduce the amount owed. If a borrower chooses this option, the amount of any interest not paid is added to the principal of the loan, increasing the amount owed, future monthly payments, and the amount of interest paid over the life of the loan. In addition, if a borrower pays only the minimum payment in the last few years of the loan, a balloon payment may be required at the end of the loan term.

Payment option ARMs have a built-in recalculation period, usually every five years (again, lenders may use the term **recast**) and within the same period thereafter. At each recast, the new minimum payment will be a fully amortizing payment and any payment cap ceases to be in force during the current adjustment point, though it may remain in effect at other adjustment points.

√ **Note:** This type of loan has been the focus of much discussion in relation to the current foreclosure crisis. As undisciplined borrowers opted for the lower monthly payment and housing values fell, borrowers quickly owed more than their homes were worth. Additionally, these loans often result in negative amortization, which MLOs are specifically cautioned against under the Interagency Guidance on Nontraditional Mortgage Product Risks. Today, few, if any, lenders offer this type of ARM. When the market recovers, payment option ARMs may become available again.

Hybrid ARMs

A **hybrid mortgage** is a *combination of fixed and adjustable rates,* meaning that the loan has a fixed rate for a specified number of years, and then the interest rate adjusts regularly for the remainder of the loan term according to the terms of the note. A hybrid loan may be used as a "band-aid" or two-step type of loan, meaning that the borrower intends to either refinance or sell before the end of the fixed rate period. These types of loans may be used by subprime lenders to get borrowers into a home at a lower rate and payment upfront. Once borrowers have had a chance to establish more credit or repair their credit, they can look into

qualifying for a mortgage with a better fixed rate. Hybrid mortgages may be designated by the number of years fixed and adjustable, for example:

2/28 Adjustable Rate Mortgage. A 2/28 ARM is a mortgage that has a fixed rate for the first two years, and then the interest rate adjusts at some predetermined interval as indicated in the note—for example, every month, every six months, annually—for the next 28 years.

3/27 Adjustable Rate Mortgage. A 3/27 ARM is a mortgage that has a fixed rate for the first three years, and then the interest rate adjusts at some predetermined interval as indicated in the note—for example, every month, every six months, annually—for the next 27 years. The 3/27 mortgage gives a longer period of fixed payments but would likely come with a slightly higher rate than a 2/28 ARM would, such as 0.1% to 0.25% higher.

Other hybrid ARMs are designated by the fixed period followed by the adjustment period, for example:

3/1, 5/1, 7/1, or 10/1 ARMs. The fixed period on these hybrids is for either three, five, seven, or ten years, and then the interest rate adjusts annually for the remainder of the loan term.

Again, MLOs need to be careful about how they discuss these loans so that consumers aren't confused by the term "fixed."

Mortgage Exercise 8-2

A borrower received a 30-year ARM mortgage loan for $120,000. Rate caps are 3/2/6 (first adjustment/subsequent adjustments/total over the life of the loan). The start rate was 3.50% and the loan adjusts every 12 months for the life of the mortgage. The index used for this mortgage is the LIBOR, which, for this exercise, let's say was 3.00% at the start of the loan, 5.00% at the end of the first year, and 4.50% at the end of the second year. The margin on the loan is 3.00%, which remains the same for the duration of the loan. See the Appendix for answers to check your work.

1. What's the initial rate (start rate) and what is the interest rate after the first year?

2. What is the fully indexed rate after the second year?

3. What is the borrower's interest rate after the second adjustment?

4. What is the maximum interest rate this loan could have?

5. What would the LIBOR have to be to obtain that interest rate?

Real Success

You should always be prepared to answer questions about ARM financing. Ultimately, the answers to these questions will be found in the specific terms of the note. When responding to generic questions about ARMs from potential customers, these points may be helpful:

1. What will my interest rate be?

   Be sure you know the initial ARM interest rates. Monitor local rates because they change regularly. The rates are usually published by lending sources, and be sure to compare these rates with those quoted in the business or home section of the local Sunday newspaper. At first, borrowers will be more concerned with the total rate but, as the home purchase gets closer, a borrower may be interested in more specific information.
2. How often will my interest rate change?

   Rate adjustments will be detailed in the loan papers and disclosures. Depending on the index used, rate changes will occur every six months, once a year, every three years, five years, etc. Six-month or one-year intervals are most common.
3. How often will my payment change?

   To provide an accurate answer, you must be familiar with terms offered by the funding source.
4. Is there any limit to how much my interest rate can be increased?

   Most ARMs have interest rate caps. The most common are 1% to 2%; the most common life-of-the-loan caps are the 5% and 6% limits set by Freddie Mac and Fannie Mae.
5. Is there any limit to how much payments can be increased at any one time?

   Some ARMs have payment caps, while others keep payment increases under control with interest rate caps. If there are payment caps, they're usually in the range of 7 1/2% to 15% of the payment amount—equal to about a 1% to 2% interest rate change.
6. What is the probability of runaway negative amortization?

   Not very likely. Interest rate caps, negative amortization caps, and re-amortization requirements protect both the borrower and lender in this regard. Of course, if interest rates sharply and rapidly increase, there's always a possibility of negative amortization. But with the changing nature of money markets, interest rates have not seen huge increases. They rise and fall, so the borrower's rate will be increased at one interval and reduced at another. If, at one point, there's negative amortization when interest due exceeds interest paid, there's a good chance that index declines will result in accelerated amortization at some point. This up and down pattern, though unpredictable, should continue through the life of the loan.
7. Can my ARM be converted to a fixed rate loan?

   Many ARMs have conversion options allowing borrowers to convert to fixed rate loans, for a fee, at certain periods or points in the loan term. ARMs with conversion options often have higher interest rates than those without. The options would be spelled out in the loan documents and disclosures.

Class Activity: ARM Advantages and Disadvantages

As a class, discuss some of the advantages and disadvantages of adjustable rate mortgages, and list them in the appropriate column:

Advantages	Disadvantages

Subprime Loans

Prime loans are loans made to good customers—the ones with good credit. For prime loans, borrowers can usually get the advertised interest rates. **Subprime loans**, on the other hand, have more *risks than are allowed in the conforming loan market.* The rates, fees, and down payment requirements are a reflection of risks associated with the borrower and the property. Such added risk can come from a variety of sources, for example:

- A borrower who has credit, income, debt, or down payment challenges. Such loans may be referenced as B-C credit loans.
- A borrower who has an acceptable credit score and/or assets but is unable, or reluctant, to provide sufficient documentation. Such loans may be referenced as low-doc, no-doc, SISA (stated income/stated assets), or NINA (no income/no asset verification) loans.

These loans—rare in today's market—filled a niche for certain borrowers for whom a conforming loan was not possible.

When considering risk on residential mortgage loans, lenders look at several factors. The cost of money (long-term), other competing investments, expected inflation rates, length of loan commitment, and other risk factors all impact a lender's computation of mortgage interest rates. Even in the prime market, conventional interest rates are risk based and factors such as property type, occupancy type, down payment, and credit scores are considered. To underwrite a subprime loan, the lender is examining *where* the borrower belongs on the risk scale. Credit scoring is helpful in making this determination, as well as the down payment. Subprime loans, to compensate for riskier credit, rely on the equity in the property, making appraisals very important, as the property may be the lender's only recourse in case of default. It takes an experienced underwriter to evaluate the risk factors and select a rate. Most lenders have developed some sort of risk grade matrix that considers all of the factors to determine the rate.

Some lenders and investors are willing to make these riskier loans because they can get higher interest rates and fees than they can with other real estate loans. Many banks and mortgage companies offer loan programs or have separate divisions that specialize in helping people with bad credit obtain a mortgage via subprime loans.

Alt-A Loans versus A-Minus Loans

Alt-A loans, also called alternative documentation loans, are loans that hold borrowers with good credit to different documentation standards than traditional loans. It's possible that a borrower with excellent credit and a large down payment will not be required to furnish as much documentation as a borrower with average scores and average down payment. The automated underwriting system (AUS) will recognize a good credit risk, and may require a reduced list of documentation, for example, only verbal verification of employment as opposed to two years of W-2s.

A-minus loans, on the other hand, are for borrowers who may have credit record blemishes, such as being 30 days late one or two times over the past year, limited funds for a down payment, high debt-to-income ratio, or a record of bankruptcy and/or foreclosure. These are riskier than prime mortgages, but not as risky as subprime mortgages. The approval can be obtained through an automated underwriting system (AUS). Since the loan is riskier, the interest rate will be higher.

Assessing Risk

A subprime borrower is matched to a series of risk profiles the lender has developed based on past lender and industry experience. For example, an "A" borrower may have good credit, but high debt ratios; or the borrower may have minor delinquencies that are explainable, or perhaps a good previous mortgage track record but other slow debts. A "B" borrower may have only average credit, but can explain lateness to the lender's satisfaction. A "C" borrower may have fair credit with high debt ratios, both of which could be due to health or job problems. Willingness and ability to repay are important here. A "D" borrower may have poor credit and high debt ratios, with little chance of improving either the credit or debt ratios.

These risk profiles are just examples. With subprime lending, criteria for who gets approved—and at what interest rate—vary greatly. Sometimes, larger down payments or secondary financing are required by lenders who want to be sure the collateral can cover the first mortgage loan amount. But for some people, it's the only way they are able to buy a house and re-establish their credit. Once borrowers have proven that they can make their mortgage payments for a given period of time, subprime lenders may offer them a chance to refinance their loans at lower interest rates, assuming their general credit and financial situation will allow them to qualify.

Interagency Guidelines

The federal financial regulatory agencies occasionally issue guidelines, recommendations, and policy statements for their member institutions. We will look at two such communications that were jointly published by the following agencies:

- The Office of the Comptroller of the Currency (OCC)
- The Board of Governors of the Federal Reserve System (Board)
- The Federal Deposit Insurance Corporation (FDIC)
- The Office of Thrift Supervision (OTS)
- The National Credit Union Administration (NCUA)

The final versions of these statements reflect the comments and input from financial institutions, trade associations, consumer and community organizations, state and financial regulatory organizations, and other members of the public.

Guidance on Nontraditional Mortgage Product Risks

In 2006, the federal financial regulatory agencies published the **Interagency Guidance on Nontraditional Mortgage Product Risks.** This Guidance applies to **nontraditional mortgage products**, which they define as *mortgage products that allow borrowers to defer principal and, sometimes, interest.* This includes products with an interest only (IO) feature and products with the potential for negative amortization (including those with flexible payment options). The agencies are primarily concerned about payment shock, competitive pressures, and ceding underwriting standards to third-party originations. While the Interagency Guidance may not explicitly pertain to subprime mortgage lending, it does outline prudent underwriting and consumer protection principles that institutions also should consider, including several guiding principles.

Qualification Standards

An institution's qualifying standards should recognize the potential impact of payment shock and should recognize that nontraditional mortgage loans often are not appropriate for borrowers with high loan-to-value (LTV), high debt-to-income ratios, and low credit scores. The analysis of borrowers' repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate and should avoid "over-reliance" on credit scores.

Collateral-Dependent Loans. Acknowledging that loans to borrowers who do not show capacity to repay the loan from sources other than the collateral are unsafe and unsound, institutions should avoid loan terms that rely on property sale or refinancing once amortization begins.

Risk Layering. Risk layering features—such as low- or no-document loans or simultaneous seconds—should be compensated with risk mitigating features, such as high credit scores, lower LTV, lower debt-to-income ratios, credit enhancements, and mortgage insurance.

Reduced Documentation. While the Statement indicates that lenders should generally be able to readily document income by means such as paystubs, W-2s, or tax returns, it also states that the use of any reduced documentation features should be governed by clear guidelines and accepted only if there are other risk mitigating factors, such as lower LTV.

Simultaneous Second Lien Loans. Loans with minimal owner equity should generally not have a payment structure that allows for delayed or negative amortization.

Introductory Interest Rates. In setting introductory interest rates, institutions should consider ways to minimize the probability of disruptive early recastings or extraordinary payment shock.

Underwriting Standards

The Guidance indicates that mortgage loan underwriting standards should address the effect of a substantial payment increase on the borrower's capacity to repay a nontraditional mortgage loan when amortization begins. For example:

Interest Only. For mortgage loans with an interest only feature, an analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by final maturity at the fully indexed rate (if adjustable rate) or note rate (if fixed rate), assuming a **fully amortizing repayment schedule** based on the term of the mortgage. The fully indexed rate generally equals the index value prevailing at the time of underwriting plus the applicable margin that will apply after the expiration of any introductory interest rate period.

Negative Amortization. For mortgage loans with a negative amortization feature, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision. The balance that may accrue from the negative amortization provision may be calculated by taking the lesser of the negative amortization cap per the mortgage note (the highest percent the loan amount can increase through negative amortization), or the maximum negative amortization percentage that the loan may accrue based on the spread between the introductory or "teaser" rate and the accrual rate before the end of the initial payment option period.

Statement on Subprime Mortgage Lending

In 2007, a **Statement on Subprime Mortgage Lending** was issued by the financial regulatory agencies. The purpose of this interagency statement was to promote consumer protection standards that lenders should follow to ensure that borrowers only obtain loans that they can afford to repay. The statement includes guidelines for defining predatory lending, underwriting standards, establishing control systems, and consumer protection. In particular, the standards are concerned with certain adjustable rate mortgage (ARM) products, typically offered to subprime borrowers, that have one or more of the following characteristics:

- Low initial payments based on a fixed introductory rate that expires after a short period and then adjusts to a variable index rate plus a margin for the remaining term of the loan
- Very high or no limits on how much the payment amount or the interest rate may increase ("payment or rate caps") on reset date
- Limited or no documentation of borrowers' income
- Product features likely to result in frequent refinancing to maintain an affordable monthly payment
- Substantial prepayment penalties and/or prepayment penalties that extend beyond the initial fixed interest rate period

Consumer Protection

The Statement urges lenders to give consumers the facts necessary to understand material terms, costs, and risks of loan products while the consumer is selecting a loan product and before a loan is closed. According to the Statement, MLOs should inform consumers of:

- **Payment Shock.** Potential payment increases, including how the new payment will be calculated when the introductory fixed rate expires
- **Prepayment Penalties.** The existence of any prepayment penalty, how it will be calculated, and when it may be imposed
- **Balloon Payments.** The existence of any balloon payment
- **Cost of Reduced Documentation Loans.** Whether there is a pricing premium attached to a reduced documentation or stated income loan program
- **Responsibility for Taxes and Insurance.** The requirement to make payments for real estate taxes and insurance in addition to their loan payments, if not escrowed, and the fact that taxes and insurance costs can be substantial

Predatory Lending

The Statement defines predatory lending as a loan involving at least one of the following elements:

- Making loans based predominantly on the foreclosure or liquidation value of a borrower's collateral rather than on the borrower's ability to repay the mortgage according to its terms
- Inducing a borrower to repeatedly refinance a loan in order to charge high points and fees each time the loan is refinanced (known as "loan flipping" or "equity skimming")
- Engaging in fraud or deception to conceal the true nature of the mortgage loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower

Reverse Mortgage

Another type of nontraditional mortgage is the **reverse mortgage**. The purpose of a reverse mortgage is to provide a vehicle for a borrower who has substantial equity in a property to convert that accumulated equity—at a cost—to cash and additional debt without selling the property and without making payments to the lender. Seniors, those adults age 62 or older, can use the equity in their home for any use, including, but not limited to, health care, home repairs and upkeep, and/or to maintain a lifestyle that is otherwise unaffordable. A reverse mortgage may also be called a reverse equity mortgage or a reverse annuity mortgage. The most popular reverse mortgage program is FHA's **Home Equity Conversion Mortgage**, or HECM.

To contrast, with a traditional, fully amortizing "forward" mortgage for a purchase, a homebuyer makes a down payment and borrows the rest of the money needed to purchase the home. They then pay off the loan every month over the course of many years. During the life of the loan, the debt decreases, and the home equity increases. Once the final mortgage payment is made, the homeowner owes nothing and, in theory, the home equity equals the value of the home. You can think of this as a "falling debt, rising equity" scenario.

On the other hand, with a typical reverse mortgage, the balance of the loan rises as the borrower receives money from the lender and incurs interest to the outstanding loan balance. Since the borrower is not making any payments, by the time a reverse mortgage becomes due, the borrower may owe a lot of money and have a small amount of equity. It's even possible, depending on the length of the loan and other factors, that there is no equity left when the loan becomes due. For most reverse mortgages, the amount owed grows and the equity shrinks, which creates a "rising debt, falling equity" scenario.

Eligibility Requirements

Reverse mortgages have some very specific requirements, and some less stringent requirements.

Income

With a traditional mortgage, the income of the borrower is critical in determining the terms of the loan, the amount that can be borrowed, etc. A reverse mortgage, on the other hand, has no income requirements to qualify. The lender will, however, consider the borrower's ability to meet continued obligations to pay property taxes, insurance premiums, homeowners association fees (if applicable), and to maintain the property.

Age

In order to qualify for a reverse mortgage, **all persons who have an ownership interest** in the security property must be at least **62 years of age**. If one of the owners does not satisfy this age requirement, the only way to secure a reverse mortgage loan on the property is for the younger owner to relinquish all ownerships interests in the property. This strategy, while solving the age requirement issue, could create other issues related to ownership and survivorship, and so should be taken with caution. Borrowers should always be advised to seek legal advice on such issues.

Home

Although the specific type of reverse mortgage may impose different standards, in general, single-family, one-unit dwellings are considered eligible properties for a reverse mortgage. Depending on the program, condominiums, planned unit developments (PUDs), and manufactured homes may be acceptable. Mobile home and cooperative units are *not* generally eligible, although HUD may approve some types of mobile homes.

Note that, as with a traditional mortgage, the lender will require that the borrower maintain a **homeowners insurance** policy that is sufficient to cover the replacement value of the collateral property. This protects the lender's interest in the event of damage that causes a loss of value, such as a fire, tornado, etc. The lender may also require a separate flood insurance policy. Since borrowers obtaining a reverse mortgage may have had the same insurance policy in place for years, they are urged to review the policy to ensure that the insurance in place provides adequate coverage.

Ownership

To be eligible for a reverse mortgage, the home must be the principal residence, and any debt on the home should be paid off. A borrower is not necessarily prevented from getting a reverse mortgage if there is debt on the home, however, since funds from the reverse mortgage may be used to pay off any remaining debt on the home.

Meeting with a Counselor

Most reverse mortgage programs impose an additional condition on prospective borrowers by requiring them to participate in a consumer counseling session given by an approved counselor. The counselor will be able to explain the costs of the loan and the financial implications, as well as provide guidance and advice in selecting a program and/or a lender. A lender cannot submit an application for an FHA-insured reverse mortgage until the applicant provides proof that this required counseling session took place.

This unbiased, independent counselor can help guide the borrower through what can be a confusing process and a lot of difficult decisions. And at the end of the session, the counselor must provide any required certification of counseling. A counselor may even point the homeowner to other programs or assistance that might be a better solution than a reverse mortgage.

Amount Available with a Reverse Mortgage

Many factors determine how much money a homeowner can receive with a reverse mortgage. For example, a required appraisal will determine the value of the home. The more the home is worth, the more cash that can borrowed with the reverse mortgage. Other factors that could impact the amount of money available include the amount of equity that has been built up, the payment options, the interest rates, the program costs and/ or loan financing fees. And of course, the specific program selected has much to do with determining the impact of these factors. For example, since FHA's HECM is the major reverse mortgage product, the location of the home is critical as that will determine FHA's lending limits.

Age of the Homeowner

Another important factor that figures into the determination of the amount of money available is the **age** of the homeowner. Typically, an older homeowner would have a higher dollar amount available with a reverse mortgage than a younger homeowner since an older person has a shorter life expectancy and, therefore, the loan would be for a shorter term.

For example, Margaret (age 65), Thomas (age 75), and Laura (age 85) own their homes, each of which is valued at $100,000. All three have qualified for a reverse mortgage loan at an interest rate of 8%. All other things being equal, Margaret might be able to borrow only 58% of her home's value; Thomas might be able to borrow up to 70% of his home's value; while Laura might be able to borrow as much as 80% of her home's value.

Note that when the reverse mortgage is in more than one name, it is the age of the youngest that factors into the amount of money available.

Payment Options

The homeowner who takes out a reverse mortgage generally gets to decide how to receive the money. The payment options include:

- **Fixed monthly payments** for either a predetermined period or for as long as the homeowner remains in the home
- A **lump sum** payment up front
- A **line of credit** that allows the homeowner to have access to funds on an "as-needed" basis

A homeowner may also choose to receive some **combination** of these options. However, the payment option that a homeowner chooses could affect the amount of cash they may be eligible to receive from the loan.

Spending Options

Typically, the homeowner who takes out a reverse mortgage also gets to determine how to **spend** the money. It may be that the majority of those who get reverse mortgages do so primarily to supplement a fixed retirement income, cover the costs of healthcare, or make much-needed improvements to their home. But the funds from a reverse mortgage can be used for virtually anything. A homeowner may choose to make that lifelong vacation dream a reality. Another could choose to start a small business, pay off credit card debt, or contribute to a grandchild's college tuition.

Tax Implications

For the most part, the funds paid out with a reverse mortgage are not considered income by the IRS, and so they are not taxed. And unlike a typical house mortgage, the interest that the lender charges on the reverse mortgage can be deducted only at the conclusion of the loan when the loan principal and the interest are repaid. As with anything in life, there are exceptions.

Although the funds paid out from a reverse mortgage are *generally* tax-free, homeowners should get advice from a qualified reverse mortgage counselor and/or attorney to determine whether or not the income received could in any way affect their eligibility for any needs-based public assistance benefits such as Medicaid or Supplemental Social Security.

Repayment

Assuming the borrower upholds the terms of the contract, a typical reverse mortgage becomes due when the last surviving borrower:

- Dies,
- Sells the home, or
- Ceases to live in the home for 12 consecutive months.

At that point, the homeowner or the homeowner's heirs must repay the total loan amount, which includes the money that was paid out as well as any interest, insurance, closing costs, or other fees as stipulated in the terms of the loan.

Of course, it is often the case that the proceeds from the sale of the home are used to repay the reverse mortgage. Any remaining equity belongs to the estate (in event of death) or the homeowner (if they sold or moved).

Non-Recourse Loans

Generally, a lender cannot force a borrower out of his or her home during the life of the loan. Nor can the lender simply sell the home when a reverse mortgage comes due. Usually the lender will allow up to 12 months for payment in the event of death. If the home is not sold or is not deeded to the lender, a formal foreclosure process may be started in the county where the home is located, depending on the terms of the note.

A reverse mortgage is considered a "non-recourse" loan, and so even in the rare instance that the amount of money distributed over the life of the reverse mortgage exceeds the value of the home, the borrower or the borrower's heirs cannot owe more than fair market sale price of the home, minus reasonable sales expenses. The lender has no claims on any other assets that may be held by the borrower or the borrower's heirs.

Accelerating Repayment

As with any mortgage situation, however, there are some circumstances that might cause the lender to require immediate repayment, for example:

- The homeowner fails to make necessary repairs to the property.
- The property is condemned.
- The homeowner does not pay the mandatory property taxes.
- The homeowner ceases to pay the appropriate homeowners insurance premiums.
- A government entity claims eminent domain over the property.
- The borrower ceases to live in the property or it is discovered the property is no longer the borrower's principal residence.

Seller Financing and Other Creative Alternatives

This section presents a brief overview of seller financing and some other forms of creative financing in use today. While the types of transactions discussed here do not require the services of a licensed mortgage loan originator, an awareness of these financing options can be beneficial for the well-rounded MLO.

Alienation Clause

It is imperative that anyone considering any form of seller financing confirm whether any existing mortgage has an **alienation clause**. This clause, sometimes called a **due on sale clause**, gives the lender the *right to exercise certain rights upon transfer of the property.* Most alienation clauses are worded so that the borrower's transfer of ***any ownership interest*** in the property securing the loan without the lender's knowledge or consent would be a **default** under the mortgage. So, for example, the clause would be triggered by the transfer of title, or even by transfer of a significant interest in the property such as with a long-term lease.

An alienation clause may give the lender the right to declare the entire loan balance immediately due and payable (hence, referred to as a due on sale clause), the right to raise the interest rate on the loan, the right to charge an assumption fee, or the right to exercise other rights stated in the contract. Thus, an alienation clause may place the borrower in jeopardy of triggering the acceleration of the loan and possible foreclosure.

It's critical, therefore, in any transaction with an existing mortgage being left in place, to obtain the lender's written consent to the proposed transaction. This may not be necessary if there's no alienation clause in the security instrument (e.g., with some FHA and VA loans). If there is an alienation clause in the mortgage, though, most lenders will insist on renegotiating the loan's interest rate, or demand that the loan be paid off entirely. Only occasionally will a lender consent to a sale without any change in the existing mortgage.

Seller Financing

Seller financing is when a seller extends credit to a buyer to finance the purchase of the property. This can be instead of or in addition to the buyer obtaining a loan from a third party, such as an institutional lender. A seller may help with financing for several reasons, for example, the buyer:

- May be unable to afford the cash necessary for the required down payment for a conventional mortgage.
- May want to take advantage of the low interest rate on the seller's existing mortgage.
- Is not able to qualify for a loan from a lender for various reasons.

In tight money markets, sometimes the only way sellers can make a deal is to finance part of the purchase price themselves. Mortgage money from traditional lenders may be too costly in terms of interest rates or it may be simply unavailable. In any case, sellers can often enhance the salability of their properties by offering complete or partial financing.

Seller financing should not be undertaken without checking the laws of the state in which the property is located. It may be necessary to seek legal advice, as many states have limitations as to the recourse a seller may have if the purchaser defaults, for example.

Purchase Money Mortgage

The term **purchase money mortgage** may be used to describe a *mortgage given by the buyer to the seller for the purchase of real estate.* You may also see this referred to as simply a **seller held mortgage.** The central advantage of this arrangement is that sellers are not bound by institutional policies regarding loan ratios, interest rates, or qualifying standards. To make the sale, a seller may charge a below-market interest rate, or

may offer financing to a buyer who is considered a credit risk by institutional lenders. Whether the seller finances all or part of the purchase, the seller is taking a risk; but the risk may be justified if it allows the sale to proceed or enables the seller to get a higher price for the home. Purchase money financing may take any of the many forms discussed earlier, such as variable interest rates, graduated payments, or partial amortization with balloon payment. It could be in a first lien position or, if the seller is financing only part of the purchase price, it could be a junior lien. The parties must be sure not to violate any laws, such as usury laws limiting the maximum interest rate that can be charged.

Assumption

Assumption of a loan means *one party agrees to take over payments of another party's debt, with terms of the note staying unchanged.* FHA and VA loans permit assumptions (with a credit check of buyers); some conventional mortgages also allow assumptions because they don't have an enforceable alienation clause. (Borrowers should always consult the original lender or a lawyer.) The property is still security for the loan, but the buyer becomes primarily liable for repayment. In the event of foreclosure, the lender may still have recourse against the original party (seller) if the debt isn't fully satisfied. To be relieved of liability, the seller must get a **release** from the lender, which is a document in which a legal right is given up. Here, the lender gives a release, accepting the buyer as the new mortgagor and releasing the seller from all mortgage obligations. If a release is signed by the lender, the lender's only recourse is against the buyer who assumed the loan.

Seller-Sponsored Wraparound Financing

In this situation, *the seller offers the wraparound mortgage, retaining an existing loan on the property while giving the buyer a second loan.* This new total loan is treated as one obligation by the buyer, who makes one payment to the seller for the entire (combined) debt. The seller, in turn, pays the original mortgage lender and keeps the excess. By using a wraparound mortgage sales contract, the seller can extend the benefit of an existing loan at lower-than-market interest rates, even if the buyer is unwilling or unable to assume the loan directly. For wraparound financing to be proper and legal, however, there must be an assumable mortgage with bank approval or no alienation clause in the original mortgage.

Land Contracts

Land contracts are another instrument used to finance the purchase of real estate. A **land contract** is a *real estate installment agreement where the buyer makes payments to the seller in exchange for the right to occupy and use the property, but no deed or title is transferred until all, or a specified portion, of the payments have been made.* Land contracts—also called land installment contracts, installment sales contracts, land sales contracts, real estate contracts, and other names, are much different than mortgages or trust deeds, where the debtor takes possession of the property while the creditor holds a mortgage or trust deed as a security lien against the property. Under a land contract, the seller (**vendor**) actually holds title to the property as security, not just a mortgage lien. The buyer/debtor (**vendee**) has the right to possess and enjoy the land, but is *not* the legal owner. The seller retains legal title to the subject property, while the buyer is only an owner in fact, having possession and **equitable title**, but no actual title and no deed.

Land contracts are a popular form of seller financing in some parts of the country. Land contracts may be structured subject to an existing mortgage or structured to allow the vendee to assume the vendor's mortgage. But this type of financing has many of the same advantages as any other form of seller financing, such as freedom from institutional loan qualifying standards and flexibility of terms. The main disadvantage is that land contracts can't be resold to Fannie Mae, although a few private secondary market investors may be willing to buy land contracts. Because the laws governing land contracts can vary by state, it is important for anyone contemplating a land contract to consult the laws in the jurisdiction where the property is located.

Land contracts usually require the vendor to give the vendee a statement, at least once a year or as requested, showing the amount of payments that have been credited to principal and interest, and the balance due under the contract.

For the vendor, the advantage of a land contract is the right to hold title as security. This lack of ownership is, conversely, the main disadvantage for a vendee since it makes it difficult to later obtain financing based on the equity built up or for improvements, as banks are reluctant to lend to a person without actual legal title to the property.

Estoppel Letter

Estoppel is *a basic legal doctrine that prevents a person (or artificial person such as a lender or company) from asserting rights or facts inconsistent with earlier actions or statements when he or she failed to object (or attempt to stop) another person's actions***.** Here's one example of the doctrine of estoppel: When a party to a land contract sends an estoppel letter to the lender about a land contract arrangement, the lender must object immediately or the lender is estopped (legally prevented) from objecting later. The lender, though, will almost always respond. An estoppel letter, therefore, becomes a lender's written consent to a sale, acknowledging the transfer and waiving any right to accelerate the loan because of the sale.

Other Forms of Creative Financing

These financing alternatives provide additional opportunities for motivated sellers and purchasers to close a transaction.

Lease/Option

A **lease/option** is *when a seller leases property to someone for a specific term, with an option to buy the property at a predetermined price during the lease term.* The lease/option plan is comprised of two elements—a lease and an option. A **lease** is a *contract where one party pays the other rent in exchange for possession of real estate.* An **option** is a *contract giving one party the right to do something within a designated time period, without obligation to do so.* Obviously, the lease/option is *not* the equivalent of a sale, but there exists a good possibility that a sale will take place under its terms. The prospective purchaser is referred to as the **optionee**; the property owner is the **optionor**. Consideration is given by the optionee to the optionor in return for a commitment to sell the property to the optionee at some time in the future. An optionor and optioneer may agree to credit any portion of the rent that is **above the established market rent** for a comparable property toward the down payment, loan amount, or sales price, thus reducing the cost and making it easier to buy the property later.

Lease/Purchase

A **lease/purchase** is *when a seller leases property to someone for a specific term, with the tenant agreeing to buy the property at a set price during or following the lease term*. The lease/purchase plan is comprised of two elements: A lease and a purchase contract. Both contracts must conform to all laws governing real estate contracts. The lease/purchase is the equivalent of a sale, but there are additional considerations to take into account because the sale is delayed until a later date. The purchase agreement locks in a predetermined price for the property and sets a date for the sale transaction to be completed on or by. Here, the buyer is committing to purchasing the property, but can't buy it until certain problems are resolved or other events take place.

Equity Exchanges

An **equity exchange** is *value in one property being traded for value in another property.* This is also called a tax-deferred exchange, tax-free exchange, like-kind exchange, or Section 1031 (from the section number of IRS law). In order to make a tax-deferred equity exchange of real estate, the properties must be like-kind property (real estate for real estate) and the properties must be held for use in a trade or business, or held by the party as an investment. When property is exchanged as part of an equity exchange, the seller defers paying taxes until a capital gain (profit) is actually realized from the transaction. Usually, this means when the property is sold in the future. If the transaction does qualify for tax-free exchange treatment, any gain that is purely a result of the exchange is deferred. **Professional tax advice and legal counsel should always be consulted for any deal involving equity exchanges or tax deferral.**

Participation Plans

In a **participation plan**, also known as an **equity participation mortgage** or a **shared equity plan,** *a borrower and an investor enter into an agreement through which the investor (*who may be the seller, a bank, or any private investor) provides cash for the purchase. Instead of charging interest, the investor in a participation plan

receives a percentage of the equity (the difference between the property's value and the indebtedness secured by the property). The buyer, though, must generally still make principal payments, although these may be deferred. Different investors will have varying requirements as to the percentage of equity to be shared and method of repaying the investment. These issues are a matter of institutional policy or negotiation between buyer and investor. Participation plans can be fairly complex when compared with other creative financing methods, and so a real estate lawyer experienced in participation plans should always be consulted.

Homebuyer Assistance Programs

Homebuyer assistance programs can be down payment assistance programs (sometimes referred to collectively as DAP programs), subsidized mortgage interest rates, help with closing costs, or a combination. These programs may be offered by government or non-profit organizations to promote home ownership, or by lenders as part of their obligation under the Community Reinvestment Act.

Some programs allow people to buy homes with lower down payments than conventional loans, often 3% or less. This may be offered by cities, counties, or the state, and the money may be targeted to specific neighborhoods. Often a portion or all of the required down payment is paid on behalf of the buyer. Money for these programs is usually limited and administered on a first-come, first-served basis. Various bond issues or levies may replenish the funding for the program, but it is hard to predict when money will become available. Some non-profit organizations also provide grants, gifts, or otherwise arrange money for down payment assistance.

Interest rate subsidies may also be obtained from a variety of sources. Bond money is available from time to time, whereby the state issues bonds and uses the funds to subsidize the interest rate paid on mortgages by low-income families. Underwriting requirements may be the same as for FHA loans, but the interest rate is lower than an FHA loan because of the subsidy. Some such programs may even offer both down payment assistance and interest rate subsidies through various agencies.

First Time Homebuyer Loans or **Community Homebuyer Programs** are some of the generic names for the various programs that lenders have created that allow them to offer more flexible financing than that for conforming loans with regard to credit, income, and down payment as a means of supporting the community. The law does not require lenders to make high-risk loans, but loans in the community should be made whenever possible while maintaining the safety of the institution. Borrowers with poor credit may have to complete a course on financial responsibility to qualify for a loan.

All of these government and private sector programs have numerous rules that must be followed for borrowers to qualify for the assistance programs. Nevertheless, the maze of regulations and paperwork can offer hope to some who might not otherwise be able to buy a home on their own. Supporters of these programs applaud the fact that they help more people buy homes; detractors worry about high potential default rates for people with little money to put down on a home or spend on upkeep.

Chapter 8 Summary

1. **Nontraditional mortgage products** are defined by the SAFE Act as anything *other than* 30-year fixed rate loans. The Interagency Guidance on Nontraditional Mortgage Product Risks defines nontraditional mortgage products as mortgage products that allow borrowers to defer principal and, sometimes, interest. Such products can help buyers qualify for larger loans or help them reach other financial goals.
2. **Buydowns** are additional money (discount points) paid to the lender at the start of a loan to lower interest rate and payments. Discount points are paid to the lender to make up the difference between the market interest rate and the rate a borrower gets in the note. A permanent buydown (for life of loan) has a reduced rate stated in the note. A temporary buydown (early in loan) can be level payment or graduated payment. With buydowns, the lowest a buyer can qualify is 2% below market rate. FHA requires buyers to qualify at the note rate, not the buydown rate. Fannie Mae, Freddie Mac, and the FHA limit points and other interested party contributions (IPCs) that can be paid.
3. **Adjustable rate mortgages** (ARMs) have interest rates that may adjust up or down according to the terms of the note. Borrowers select an **index** (statistical report reflecting cost of money), lenders add a **margin** (spread), and this is the **fully indexed rate** paid on the loan. Loan documents must state: Rate, index, margin, and payment adjustment period; caps (if any) on rate, payments or negative amortization; conversion option (if any). Rates that change more frequently than payments may create **negative amortization** (payments insufficient to cover interest due). **Caps** keep loans from growing out of control. Lenders periodically **readjust** or **recast** the loan by recalculating payments based on the loan balance at specific interval. **Conversion options** allow buyers to convert to fixed rate. MLOs must provide CHARM booklet to borrower in addition to other mandated disclosures, including the **annual percentage rate** (APR). For ARMs, it is a composite rate that reflects the lower rate for certain number of years and the higher rate for later years. Lenders cannot disclose only initial low rates.
4. Proceeds from a **reverse mortgage** may be disbursed to eligible borrowers aged 62 or older as a monthly payment, a lump sum of cash, or a line of credit, based on the equity in their homes. Among the events that trigger loan repayment are when the borrower dies, moves out of the house for 12 months, or sells the house.
5. **Structured mortgages** help borrowers reach other financial goals. **Growth equity**: Fixed rate, but payments increase regularly as indicated in the note. **Reduction option**: Buyer can reduce rate one time, with fewer refinancing costs. **Shared appreciation**: Lender shares equity in commercial project.
6. **Subprime** loans (B-C loans, low-doc, SISA, NINA) have more risk than what is allowed by the conventional market. Borrower risk factors determine interest rate and terms. A-minus loans are riskier than prime loans, less risky than subprime loans.
7. **Seller financing** is when seller extends credit to buyer to finance the purchase of property. Seller can extend all or partial credit. This can help a buyer who doesn't have enough cash to buy a property, can't qualify for a conventional loan, or wants or needs a lower-than-market interest rate. Seller gets the benefit of a home that's easier to sell, and often a better price by offering terms. A **purchase money mortgage** or **seller-held mortgage** is given by buyer to seller to secure part or all of the money borrowed to purchase property. Unencumbered property with no liens is best for this transaction; encumbered property with liens needs assumption or wraparound. **Assumption** has the buyer take responsibility for the mortgage, but the seller must get a release from the lender. A **seller-wraparound mortgage** has the seller retain existing mortgage (the buyer makes one larger payment; the seller pays the lender and keeps difference).
8. A **land contract** is a real estate installment agreement. Buyer (vendee) makes payments to seller (vendor) for right to occupy land, but no title is transferred until all, or part of, payments are made. Buyer has **equitable title** under a land contract. States differ in how they treat land contracts. Problems

for the buyer include difficulty in borrowing against equity with a land contract and protecting equity if land contract is not recorded. A lender may consent to the deal using an **estoppel** letter.

9. A **lease/option** has the seller (optionee) lease to a tenant (optionor) who has the right (but not the obligation) to buy the property at a set price within a certain time. An option can be used for profit, speculation, investment, comparison, or to give the optionor time to acquire cash, to qualify, or credit rent toward purchase price. A **lease/purchase** combines a lease with a purchase contract. An **equity exchange** (tax-deferred exchange, Section 1031) is property traded for value in other property. Properties must be exchanged (or delayed exchange), like kind, and held for trade, business, or investment. Capital gains tax is deferred, but boot (unlike property added to balance value) is taxed. Tax-free exchanges are not available for residential property. **Participation plans** have investors/lenders share equity in the property instead of or in addition to receiving interest.

10. **Homebuyer assistance programs** can be down payment assistance programs (DAP), subsidized mortgage interest rates, help with closing costs, or combination. Programs can be offered by government or non-profit groups, or by lenders.

Chapter 8 Quiz

1. ***A borrower is purchasing a home for $100,000. The LTV on the loan is 80%. If the borrower pays a total of 6 points on the loan, how much will the points cost him?***
   A. $2,400
   B. $3,400
   C. $4,800
   D. $6,000

2. ***A buydown plan can reduce the borrower's payments***
   A. early in the loan only, but requires a large balloon payment.
   B. early in the loan or for the entire life of the loan.
   C. for the entire life of a loan, but with an automatic prepayment penalty.
   D. with gradual payment decreases throughout the life of the loan.

3. ***Which statement is true about interest rate buydowns on FHA loans?***
   A. Borrowers may qualify at the buydown rate.
   B. Borrowers must qualify at the note rate.
   C. FHA does not allow builder-paid buydowns.
   D. FHA does not allow seller-paid buydowns.

4. ***Which of the following is NOT an element of an ARM?***
   A. index
   B. margin
   C. positive amortization cap
   D. rate

5. ***What is the adjustable number used to compute the interest rate on an ARM called?***
   A. cap
   B. index
   C. margin
   D. prepayment

6. ***With an ARM, the index is added to the _______ to determine the __________ .***
   A. APR / cost of funds
   B. home value / amount borrowed
   C. margin / interest rate charged
   D. qualifying ratio / maximum monthly mortgage payment

7. ***Negative amortization occurs when***
   A. a borrower suffers payment shock.
   B. each mortgage payment is adjusted more frequently than is the interest rate.
   C. the payment made does not cover the interest due for that period.
   D. all of the above

8. ***How are subprime loans different from conforming loans?***
   A. They allow for lower interest rates.
   B. They allow for more risk.
   C. They are only offered by banks.
   D. They are sold in the secondary market.

9. ***Which scenario best describes a land contract?***
   A. A buyer makes payments to the seller in exchange for the right to occupy, use, and enjoy the property, but no deed or title transfers until a specified portion of payments have been made.
   B. A buyer takes over primary liability for the loan of a seller, usually implying no change in loan terms.
   C. A seller keeps the existing loan and continues to pay on it while giving the buyer another loan.
   D. A seller leases the property with the provision that part of the rent payments be applied to the sale price if the tenant decides to purchase before the lease expires.

10. ***An equity exchange may be treated as a tax-free exchange when property is***
    A. for profit and of like kind.
    B. held for sale by a dealer only.
    C. owner-occupied.
    D. rental only.

11. ***In which federal law would you find the definition of a nontraditional loan?***
    A. Homeowners Equity Protection Act
    B. Real Estate Settlement Procedures Act
    C. Secure and Fair Enforcement for Mortgage Licensing Act
    D. Truth in Lending Act

12. ***During the life of a typical reverse mortgage, which of the following factors is decreased?***

    A. debt
    B. equity
    C. interest
    D. monthly payments

13. ***According to the Interagency Guidance on Nontraditional Mortgage Product Risks, nontraditional mortgage loans may be LEAST risky for borrowers with***

    A. high debt-to-income ratios.
    B. high loan-to-value.
    C. low credit scores.
    D. low debt-to-income ratios.

14. ***Each of these are characteristics that could make a loan nontraditional EXCEPT***

    A. 15-year term.
    B. adjustable rate.
    C. fixed rate.
    D. temporary buydown.

15. ***A borrower has a ARM with a 5/2/6 interest rate cap. The start rate is 4%, the current index is 3%, and the margin is 3%. What is the borrower's interest rate if the index rises to 5% at the time of the first adjustment?***

    A. 5%
    B. 6%
    C. 8%
    D. 9%