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FINANCING
TODAY'S CHANGING MARKET
UPDATE 2003

(ELECTIVE COURSE)

HOME STUDY PROGRAM

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CHAPTER 1

TODAY'S CHANGING MARKET

Today's borrower has more options than ever before in terms of available financing options. The issue for a borrower is no longer "will I get a loan" but "what loan can I get and how much."

Good credit, Bad Credit, No credit, Equity, No equity, and Future Equity are all just conditions for where you go for a loan and what the interest rate will be. Shop enough and someone out there will give you a loan.

Loans that at one time were handled only by high-risk funders today are handled by traditional sources.

The goal of this course is bring to light these programs, show how loans are underwritten differently, and precautions that lenders take to prevent loan fraud from occurring. Armed with this knowledge, the average real estate agent will have the basic knowledge to help better serve his/her clients.

FORECASTING THE MORTGAGE MARKET

The Mortgage Bankers Association forecasts that 2003 originations will reach $3 trillion, another significant increase from the historic $2.42 trillion of mortgage originations in 2002. A refinance boom in 1998 propelled originations to $1.4 trillion, a record held through 2001 when mortgage originations hit $2.1 trillion.

Mortgage originations 0f about $3 trillion would make 2003 the third best year ever as the growth in sub-prime lending and second-lien loans partially compensates for a moderating level of rate-term refinance activity.

S&P notes that the domestic residential mortgage-backed securities (RMBS) maintained an impressive level of performance through the fourth quarter of 2002, nearly doubling the activity of 2001's fourth quarter.

Historically the low interest rates of the late 1990s and early 2000s cause housing to be as affordable as it was in the early 1970s. Baby boomers are buying second homes at a record pace and much of the population continues to shun financial assets in favor of investing in their homes.

Homeowners have also become accustomed to using their home's equity for debt consolidation, home improvement, and cash-out refinances. Homes have become a major source of liquidity for the 68% of the population that own homes.

REFINANCES AND THE ECONOMY

According to Economy.com refinances have injected billions in the economy. Nationwide refinancing freed up $172.1 billion in 2002, compared to

- $3.3 billion in 2001
- $1.4 billion in 2000
- $1.7 billion in1999
- $1.8 billion in1998

Where does the cash go?

- Home improvements 42%
- Paying down debt 30%
- Buying car or other items 15%
- Buying appliance, furniture 13%
- Investing 8%
- Education 7%
- Starting a business 3%

HOUSES AS PIGGY BANKS

AS cash strapped homeowners struggle to meet their obligation, home equity borrowing has become the cure-all. Is this judicious use of an asset or the plundering of one's future?

Investment experts talk about "good debt" and "bad debt". Mortgage debt is considered good debt because the interest is low and is tax deductible.

Financial experts often recommend that that families set up a home-equity line of credit, which can be accessed as the need of a financial emergency arises.
It is estimated that in early 2002, homeowners were financed up to 68% of the homes purchase price, compared to 41% two decades ago.

Federal Reserve statistics show that total mortgage debt stood at 44.4 per cent of home values in late 2002, up from 30.1% in late 1982.

Why this rising indebtedness:

- Attitudes to borrowing have changed
- Families move and refinance more frequently

- Using home equity as a savings account to draw from
- Extending loan terms with each refinance
- Lower interest rates making refinancing attractive
- The availability of reverse mortgages

HOME ASSET MANAGEMENT ACCOUNT

What may be the most significant innovation in the American home mortgage field hit the market in late 2002. It is called the "home asset management account."

It grafts a growing equity line of credit onto a standard home mortgage, and essentially makes tax-deductible home equity the centerpiece of a borrower's personal financial affairs.

It in essence turns a home into a bank that is always open-if the homeowner chooses to use it.

An individual applies for a home asset management account instead of a traditional mortgage.

The account consists of:

- A FIRST MORTGAGE OF UP TO $750.000 – the rate on the loan is the same as the prevailing rate in the traditional marketplace.

- AN INITIAL HOME EQUITY LINE OF CREDIT equal to all or most of the initial equity or downpayment. The credit line comes automatically and need not be applied for separately.

- AN ACCOUNT REVIEW STATEMENT is received quarterly, that tells the borrower how much available equity is at the borrower's disposal as a result of principal loan pay downs and the previous use of equity credit line
  To activate the credit line, the borrower has multiple options;
  1. A set of checks
  2. A plastic debit card usable at most ATMs
  3. A toll free access phone number
  4. A special Web site
  5. Walking-in to a teller window, if available

  There is no requirement that the credit line ever be activated or drawn down.

- AN ANNUAL STATEMENT that reports the estimated growth in the home's market value. The estimate is based on a proprietary statistical model that analyses resale pricing patterns in the area. The growth in the value of the real estate equity is added automatically onto the available credit line.

It the estimated home resale value jumped $30,000 during the last 12 months, that amount would be added to the credit line for use anytime during the coming year.
Credit line balances on the account carry a variable interest rate, competitive with prevailing home equity loan rates elsewhere in the market. The credit line can be

switched to a fixed rate equity loan, whenever the borrower thinks the rates are favorable to lock in.

In most cases, payments on all the combined first and second mortgage debts in the account are expected to be tax deductible.

The asset management account can be paid off either in the individual increments of the first and second, or combined, or paid off when the property is sold.

Is this the home financing concept of the future? According to Wells Fargo Home Mortgage, the firm that introduced the program, they certainly feel so. Other major lenders are working on similar concepts to be introduced through-out 2003 and 2004.

BANKS ACCEPT CONSULATE CARDS AS I,D.

With the Hispanic population in the United States rising 58 per cent, to 35 million, from 1990 to 2000, financial institutions are targeting the group and foreign residents for banking services and money wiring fees.

Citigroup, Wells Fargo and other major banks have started accepting identification cards from other countries such as voter registration cards and identification cards issued by consulates, as one of three pieces of required identification. This makes it easier for immigrants to make deposits, get loans and wire funds to their countries.
About 9.9 million was sent in 2002 from other countries to Mexico. Western Union now handles 84 per cent of the world's wire transfer business. In two years Harris Bank deposits from Hispanic customers jumped from $15 million to over $20 billion.

Mexican consulate cards, known as matricula cards, are issued to individuals regardless of an applicant's legal U.S. status. Banks are under no obligation to determine whether a customer is a legal immigrant.

Immigrants want U.S. bank accounts partly to access lower wire transfer fees when sending money to family in their countries and to experience other banking privileges.
As wider acceptance of these new methods of identification become prevalent both the real estate and mortgage industry will feel the impact of this new source of customers.

DIVERSITY IN MORTGAGES

With three out of every five first-time home buyers expected to be racial and ethnic minorities over the remainder of the decade, major suppliers of mortgage money are rolling out new products at a rapid pace so lenders can meet borrower's needs.
Freddie Mac has eliminated a rule that requires borrowers to be U.S. citizens and is offering an improved version of the old lease-purchase program. Now anyone who is a lawful resident of this country can obtain a home loan.

Meanwhile, Fannie Mae is on the market with an interest only loan that can save a borrower with a $150,000 mortgage as much as $100 per month.

Freddie Mac has begun lending up to 105% of the value of the property, accepts cash-on-hand as a source of funds, and allows borrowers to use money from boarders as part of the income needed to qualify for the mortgage.

Freddie Mac is now permitting builders to contribute up to 3% of the purchase price on behalf of the borrower.

IMMIGRANT PATTERNS OF HOMEOWNERSHIP

The majority of immigrants tend to settle in metropolitan areas, such as Chicago, New York, Miami, Huston, Los Angeles and San Francisco.

The Mortgage Bankers Association of America, predicted that 4 million additional home sales will be generated in 20 years by the children of immigrants who are now buying homes

Large home builders, especially those who cater to first-time buyers, have caught on to the potential of the immigrant market and recognize that nationalities tend to cluster in small and large pockets through these major cities.

The current boom is among Spanish-speaking buyers. Peak arrivals of Mexican immigrations followed the amnesty of1989. These individuals have now matured in the workforce. Since It takes 8 to 10 years to become assimilated, they started buying entry-level homes in great numbers starting in 2001.

The message to all builders, real estate practioners, and mortgage lenders is that they better become bilingual. But in what language? Beside buyers of Hispanic language, there are also many from Eastern Europe and Asia.

Fernando Armadia, a real broker, is a native of Mexico and now specialized in helping Hispanics navigate the complexities of home buying. "Many of them have no clue what they're getting into. I have to explain the whole process from beginning to end."

He noted that the homes in Mexico often remain in one family for generations. "Mexicans hardly ever go to a bank for financing a home, though that has started to change in the last 10years."

Armadia said he tells prospective buyers what they have to do to qualify for a mortgage. Only about 50 percent speak English.

"While some immigrants may live here for years, the younger generation in seeing the value of owning a home as an investment, "he said.

"Immigration has now only sustained housing but driven it to new height", said the senior vice president of the National Community Lending center for Fennie Mae, the mortgage giant based in Washington, D.C.

"Immigrants bring with them suspicions and apprehension about government, regulators and big institutions." "Because of their fears, some may keep money in mattresses. They don't always use banks. They are vulnerable to unscrupulous lender who prey on them".

"Predatory lending may result in immigrants not getting the best mortgage rates. If they don't have established credit, they can't get credit scores. But it's possible to establish non-traditional credit if they have paid rent and utilities over a period of time," said the Fannie Mae spoke-man. Additionally, "They must show a history of legally working in the U.S.," he added.

Despite the increased effect of foreign-born homebuyers, the group lags financially behind U.S.-born buyers, according to "Home ownership in the Immigrant Population," a study by George J. Brojas, Pforzheimer professor of policy at Harvard University's John F. Kennedy School of Government.

"In 1998, the typical immigrant worker earned 23 percent less than the typical native worker," the study said. This translates into lower homeownership rates among immigrant households than among native households.

The vice president at the National Association of Home Builders in Washington, D.C., said that immigrant homebuyers filled in for the fewer buyers in the Baby Boom generation, those born roughly between 1965 and 1979.

Builders have recognized the increasing impact of foreign-born buyers and are catering to them.

Lakewood Homes, one of the largest builders in the Chicago area, prints cost calculation information sheets in 12 languages.

Spanish-language buyers are leading the way in volume. "We're seeing a soaring buying power of Hispanics," said Christopher Shaxted, Lakewood's, executive vice president, who added that the builder plans a Spanish version of its Web site.

"We also advertise in Hispanic publications, and have had Hispanic buyers in all our developments. Once a nationality starts to move in, others follow," he said.

In addition to Hispanic's, East Indians, Koreans and Eastern Europeans are buying homes in many suburban communities.
"The phenomenon began in the late 1990s and is still growing. Immigrants tend to be hardworking and driven to homeownership. Foreign-born buyers will continue to be a big driver of the housing market in the next decade," Mankedick said.

CUSTOMS AND TRADITIONS ROLE IN HOMEOWNERSHIP

A priest from the Hindu temple performs a religious ceremony for a new homeowner. Its purpose is to ward off evil spirits and sanctify the ground. Usually, certain mantras are read and water is sprayed around the perimeter of the home.

But, cultural differences don't affect just the house; they also play a role in how it is financed.

Observant American-Muslim families, for instance, require a special housing contract because Islamic religious law prohibits the payment of interest on mortgages and other types of debit, according to Brad German, public relations manager for Freddie Mac, the mortgage giant based in Washington D.C. Contracts through American Finance House-Lariba are available in 15 states, including Illinois. "The American-Muslim population, which ranges from 2.5 million to 6 million households, depending on whose estimate you use, is experiencing strong growth," said German.

While today's immigrants come from around the globe, Mexicans top the list of foreign-born homes buyers in numbers.

COMMUNICATION SOLUTIONS

'Immigrant homebuyers clearly face communication barriers, but there is a move now to provide them with bilingual materials," said the chief economist for the Mortgage Bankers Association of America in Washington, D.C.

Today' s immigrant population come here in quest of opportunity to create better lives for themselves and their children, are as industrious as the native-born and, have a great desire to realize the dream of homeownership.

In the first three-quarters of the 20th Century, Eastern Europeans dominated immigration and effected homeownership patterns. They still comprise a strong homebuyer segment, but the movement has definitely shifted to the Hispanic, Middle Eastern and Asian immigrants.

TEST YOUR KNOWLEDGE QUIZ:

T F 1. The issue for a borrower is no longer "will I get the loan" but "what loan I get and how much."

T F 2. Homes are a major source of liquidity for the 68 per cent of the population that own homes.

T F 3. The major cash borrowed on refinances goes for paying off debt.

T F 4. According to investment counselors mortgage debt is considered "bad debt" because it eats up earned equities for the future.

T F 5. Mortgage debt in relation to home value has risen from 30.1% in 1982 to 44.4% in 2002.

T F 6. The average homeowner finances 68% of the homes purchase price compared to only 41% two decades ago

T F 7. Indebtedness has risen in this country because the average homeowner is less responsible.

T F 8. A Home Asset Management Account turns a home's equity into an always open bank account.

T F 9. Banks do not consider consulate cards, also known as maticula cards, to be a valid form of I.D.

T F 10. Three out of every five first-time home buyers are expected to be racial and ethnic minorities over the remainder of the decade.

T F 11. Cultural differences have no bearing on homeownership selection or types of financing used.

T F 12. Bilingual material by builders, real estate agencies and mortgage lenders are a critical element in dealing with today's buyers.

True: 1, 2, 5, 6, 8, 10, 12

False:

3 Home-improvement
4 Considered "good debt" because of low interest and tax deductibility
7 Attitudes toward borrowing have changed;
9 Today most lenders accept this as a valid I.D.
11 Ethnic, religious background, and views on interest and loans have a tremendous effect

CHAPTER II: MONEY

Money is the conversion of our mental and physical effort into a convenient method of exchange and standard value.

In past societies money was the exchange of goods and services. In more modern societies it is paper money, coins and checks. Money can be anything that is symbolic of value. With the abandonment of the gold and silver standard, today's money is based on confidence. It is simply a promise that there is value behind the symbolic representation. Therefore, economic stability is directly tied in to the supply of money available for exchanging and the cost of obtaining that money.

Thus, the manipulation of the supply and cost of money should result in economic balance. This manipulation is entrusted to The Federal Reserve System, The United States Treasury, and The Federal Home Loan Bank.

These three agencies have a tremendous effect on real estate finance.

THE FEDERAL RESERVE SYSTEM

President Woodrow Wilson established the Federal Reserve System in 1913. The original purpose of The System was to establish facilities for selling or discounting commercial paper and to improve the supervision of banking activities.

The original purpose was expanded over time to include the influencing over the cost and availability of money.

The Federal Reserve System is made up of 12 Districts; each served by a Federal Reserve Bank.

The Federal Reserve Banks are not under the control of any governmental agency, but each reserve bank is responsible to a board of directors made up of nine members.

The entire Federal Reserve System is coordinated by a seven-member board housed in Washington D.C. The "Board of Governors", as they are called, is appointed by the President and approved by the Senate.
All nationally chartered commercial banks must join the Federal Reserve System, state chartered banks may also join the system.

Membership is based on:

- The purchase of capital stock in the district Federal Reserve Bank
- Maintaining enough reserves as set from time to time by the Federal Reserve,
- Clearing checks through the system
- Complying with all other rules and regulations.

Member banks borrow money from the Federal Reserve Bank as needed, as well as, share in the informational system.

THE MAIN FUNCTIONS OF THE FEDERAL RESERVE BANK ARE:

- The issuing of currency in the form of Federal Reserve Notes.
- Supervising and regulating member banks.
- Clearing and collecting member banks' checks.
- Administering selective credit controls.
- Holding the principal checking account for the U.S. Treasury.
- Assisting in the collection and distribution of income taxes.
- Regulating and establishing member banks reserve requirements.
- Determination of discount rate.
- Supervision of the Truth in Lending Act.

THE FED: OUR CENTRAL BANK

Put most simply, the Federal Reserve System is the central bank of the United States. Congress created the Federal Reserve through a law passed in 1913, charging it with a responsibility to foster a sound banking system and a healthy economy. This remains, today, the broad mission of the Fed and its component parts: the 12 Federal Reserve Banks nationwide, each serving a specific region of the country; and the Board of Governors in Washington, D.C., set up to oversee the Fed System.

To accomplish its mission, the Fed serves as:

- A banker's bank
- As the government's bank
- As a regulator of financial institutions
- As the nation's money manager

… and performs a vast array of functions that affect the economy, the financial system, and ultimately, each of us.

Each of the 12 Fed Banks provides services to financial institutions that are similar to the services that banks and thrifts provide to business and individuals. By serving as a "banker's bank" the Fed helps assure the safety and efficiency of the payments system, the critical pipeline through which all financial transactions in the economy flow.

PROCESSING OF FUNDS

Each day the Fed processes millions of payments in the form of both paper checks and electronic transfers. So when you cash a check or have money electronically transferred, there is a good chance that a Fed Bank will handle the transfer of funds from one financial institution to another. Each of the Fed Banks offers these and other

services, on a fee basis, to the depository institutions in its Federal Reserve District. Institutions can choose to use the Fed's services or those offered by other competitors in the marketplace.

Together, the 12 Fed Banks process more than one-third of the checks written in the U.S., a total that exceeds $12 trillion annually. And the dollar volume transferred through the Federal Reserve's electronic network is far greater, approaching $200 trillion or many times our nation's gross national product.

INSTANT PROCESSING OF CHECKS

Still writing checks to pay your bills? A new procedure used by banks will process payments faster by electronically scanning the check or debit card and creating an instant transfer of funds.

Traditionally an individual would mail their check to a P.O. Box address that was actually a bank hired by the creditor to handle its bill payments.

The processing bank, usually through a Federal Reserve clearinghouse, processes the check and the check is sent to the issuer's bank. The processing of checks in this fashion costs banks about 26 cents per transaction.

The new electronic system of instant processing will reduce the cost to an average of 10 cents per transaction and create an instant transfer of funds from the customer's account to the receiving bank.

The nation's largest banks are embracing the system to more quickly process payments for telephone companies, gas companies and other creditors who bill on a monthly basis.

The new technology will permit a retailer to scan a check at the time of services, instantly debit the customer's bank account, have an automatic transfer of funds from the customer's bank account to the merchant's bank account and return the debited check to the customer on the spot. Like wise a merchant receiving a customer's check in the mail, will scan the check through a processing terminal, the debit and credit will occur between banks, and the customers check will be destroyed. There is no returning of canceled checks under this system.

Though the number of electronic payments is increasing. According to the Federal Reserve Americans wrote 49.5 billion checks in 2000 and of all the payments in 2000,
59 percent were checks; by comparison, 77 per cent of payments were checks in 1995.
According to law to employ the new electronic technology the biller has to send customers a letter that they are going to do this. Customers can opt out of the electronic scanning if they wish by contacting the billing company.

The purpose o electronic scanning is to cut down on costs and increase revenue for both banks and the Federal Reserve.

THE FED-THE GOVERNMENT'S BANK
Another important Federal Reserve responsibility is servicing the nation's largest banking customer- the U.S. government. As the government's bank or fiscal agent, the Fed processes a variety of financial transactions involving trillions of dollars.

Just as an individual might keep an account at a bank, the U.S. Treasury keeps a checking account with the Federal Reserve through which incoming federal tax deposits and outgoing government payments are handled. As part of this service relationship, the Fed sells and redeems U.S. government securities such as savings bonds and Treasury bills, notes, and bonds.

PRINTING AND DISTRIBUTION OF CURRENCY
The Federal Reserve also issues the nation's coin and paper currency. The U.S. Treasury, through its Bureau of the Mint and Bureau of Engraving and Printing, actually produces the nation's cash supply; the Fed Bank then distribute it to financial institutions. The currency periodically circulates back to the Fed Bank where it is counted, checked for wear and tear, and examined for counterfeits. If the money is still in good condition, it is eventually sent back into circulation as institutions order new supplies to satisfy the public's need for cash. Worn-out bills, however, are destroyed by shredding. The average $1 bill circulates for approximately 18 months before being destroyed.

SUPERVISOR AND REGULATOR
As part of its mandate to foster a sound banking system, the Federal Reserve supervises and regulates financial institutions,

As a regulator, the Fed formulates rules that govern the conduct of financial institutions. As a supervisor, the Federal Reserve examines and monitors institutions to help ensure that they operate in a safe and sound manner and comply with the laws and rules that apply to them. The Fed's supervisory duties are carried out on a regional basis. Each of the Reserve Banks is responsible for monitoring bank holding companies (organizations that own one or more banks) and state member banks (banks that are chartered by the state and are members of the Federal Reserve System) based in its District.

The Federal Reserve also helps to ensure that banks acting in the public's interest by ruling on applications from banks seeking to merge or from bank holding companies seeking to buy a bank or engage in a non-banking activity. In making these rulings, the Fed takes into consideration how the transaction would affect competition and the local community. The Federal Reserve implements laws-such as Truth-in-Lending, Equal Credit Opportunity, and Home Mortgage Disclosure, all meant to ensure that consumers are treated fairly in financial dealings.

THE LENDER OF LAST RESORTS
Another way the Fed helps maintain a sound banking system is as the "lender of last resort." A financial institution experiencing an unexpected drain on its deposits, for example, can turn to its Reserve Bank if it is unable to borrow money elsewhere. This loan from the Fed would not only enable the institution to get through temporary

difficulties, but most importantly, would prevent problems at one institution from spreading to others. The basic interest rate charged for these loans is called the discount rate.

THE FED'S STRUCTURE

The Federal Reserve System

- Is the nation's central bank
- A regional structure with 12 districts
- Subject to general Congressional authority and oversight
- Operates on its own earnings

Board of Governors

- 7 members serving staggered 14-year terms
- All are appointed by the U.S President and confirmed by the Senate
- Chairman appointed by the President of the United States for a 4 year term
- Oversees System operations
- Makes regulatory decisions
- Sets reserve requirements

Federal Reserve Banks

- 12 regional banks with 25 branches
- Each independently incorporated with a 9-member board of directors from the private sector
- Set discount rate, subject to approval by Board of Governors
- Monitor economy and financial institutions in their districts and provide financial services to the U.S. government and depository institutions

Federal Reserve Banks Locations

- Boston
- New York
- Philadelphia
- Cleveland
- Richmond
- Atlanta
- Chicago
- St. Louis
- Minneapolis
- Kansas City
- Dallas
- San Francisco

FEDERAL OPEN MARKET COMMITTEE

- The System's key monetary policymaking body
- Decisions seek to foster economic growth with price stability by influencing the flow of money and credit

- Comprised of the 7 members of the Board of Governors and 5 Reserve Bank presidents whom serve as voting members on a rotating basis. The president of the Federal Reserve Bank of New York always serves as one of the 5 members

To protect depositors by guaranteeing that their funds will be available when needed, the Federal Reserves requires member banks to maintain on deposit with them a minimum reserve fund. The amount of reserve required is adjusted from time to time and from locality to locality in an effort to control the money available to the public at any given time, and thus control spending. This is the Feds' way of balancing the economy.

THE FED AS A MONEY MANAGER

The most important of the Fed's responsibilities is formulating and carrying out monetary policy. In this role, the Fed acts as the nation's "money manager"-working to balance the flow of money and credit with the need of the economy. Simply stated, too much money in the economy can lead to inflation, while too little can stifle economic growth. As the nation's "money manager," the Fed seeks to strike a balance between these two extremes, or, in other words, to foster economic growth with price stability.

To achieve this goal, the Fed works to control money at its source by affecting the ability of financial institutions to "create" checkbook money through loans or investments. The control lever that the Fed uses in this process is the "reserves" that banks and thrifts must hold.

In general, depository institutions are subject to rules requiring that a certain percentage of their deposits be set aside as reserves and not used for loans or investments. Institutions can meet these requirements by keeping cash in their own vaults and through balances held in a reserve account a Fed bank. These reserve balances and requirements determine the amount of money an institution can create through lending an investing. Through reserves, then, the Fed indirectly affects the flow of money and credit through the economy by controlling the raw materials that institutions use to create money. The Fed has tools for affecting reserves:

RESERVE REQUIREMENTS

Altering the percentage of deposits that institutions must set aside as reserves can have a powerful impact on the flow of money and credit. Lowering reserve requirements can lead to more money being injected into the economy by freeing up funds that were previously set aside. Raising the requirements freezes funds that financial institutions could otherwise pump into the economy. The Fed, however, seldom changes reserve requirements because such changes can have a dramatic effect on institutions and the economy.

The amount of reserve required varies from 1.25% to 22% depending on the type of deposits and the location of the member bank. Checking account reserves are higher because of the short-term need for money, whereas, savings deposits require less reserve because of the longer-term quality of these funds.

DISCOUNT RATE

An increase in the discount rate can inhibit lending and investment activity of financial institutions by making it more expensive for institutions to obtain funds or reserves. But, if funds are readily available from sources other than the Fed's "discount window", a discount rate change won't directly affect the flow of money and credit. Even so, a change in the discount rate can be an important signal of the Fed's policy direction

OPEN MARKET OPERATIONS

The most flexible, and therefore most important, of the monetary policy tools is open market operations-the purchase and sale of government securities by the Fed. When the Fed wants to increase the flow of money and credit, it buys government securities; when it wants to restrict the flow of money and credit, it sells government securities.

As with the other tools, the Fed's open market operation affects the supply of money through the reserves of depository institutions. If, for example, the Federal Reserve wished to increase the supply of money and credit, it might purchase $1 billion in government securities from a security dealer. The Federal Reserve would pay for the security dealer's bank keeps at the Fed and the bank would in turn credit the security dealer's account for that amount. While the dealer's bank must keep a certain percentage of these new funds in reserve, it can lend and invest the remainder. As these funds are spent and re-spent, the stock of money and credit will eventually increase by much more than the original $1 billion addition.

The procedure is reversed to decrease the money supply. If the Fed were to sell $1 billion in government securities to a dealer, that amount would be deducted from the reserve account of the dealer's bank. The bank, in turn, would deduct $1 billion from the account of the dealer. The end result-less money flowing through the economy.

COMMERCIAL DISCOUNT RATE VS PRIME RATE

Banks borrowing money from their district banks receive what is known as a discount rate. This is the rate of interest paid by these banks to their district bank for the use of money. When this money is re lend to a consumer of a business, the rate is known as the prime rate. That is, the rate charged to its' most creditworthy customer.

In Conjunction with the U.S. Treasury, manipulation by the Federal Reserve directly effects mortgages and the real estate industry.

As one can plainly see the monetary system is pretty well based on promises and perceptions of value versus hard, tangible goods. Understanding this will make it easier to understand the buying and selling of mortgages, regardless of the risk factor involved.

TEST YOUR KNOWLEDGE QUIZ:

T F 1. The Federal Reserve System, The United States Treasury, and Federal Home Loan Bank play key roles in the manipulation of the supply and cost of money.

T F 2. Money is the conversion of our mental and physical effort into a convenient method of exchange and standard value.

T F 3. Money can be anything that is symbolic of value.

T F 4. The Federal Reserve System is made up of 12 Districts and 25 Branches.

T F 5. Federal Reserve Banks are under the control of the U.S Treasury.

T F 6. The Federal Reserve System is coordinated by a seven member "Board of Governors."

T F 7. All nationally chartered commercial banks must join the Federal Reserve System.

T F 8. State chartered banks cannot be members of the Federal Reserve System.

T F 9. The main functions of the Federal Reserve are issuing currency, regulating member banks, clearing checks, administering credit controls, supervising the Truth in Lending Act and making sure that banks make a profit.

T F 10. The Federal Reserve is the nation's Central Bank and is known as a "banker's bank"

T F 11. The Federal Reserve processes over 212 trillion dollars in checks and electronic transfers each year free of charge for member banks.

T F 12. Electronic scanning of checks, debit and credit cards creates an instant transfer of funds and decreases bank's processing costs.

T F 13. The Federal Reserve holds the principal checking account for the U.S. Treasury.

T F 14. The Federal Reserve prints our currency based on the gold reserves maintained by the Federal Government.

T F 15. The Federal Reserve regulates and establishes member banks reserve requirements.

T F 16. Adjusting reserve requirements of member banks is a way of balancing the economy.

T F 17. The minimum amount of reserve required of member banks is 35%.

T F 18. Banks borrowing money from their district bank receive what is known as the discount rate.

TRUE: 1, 2, 3, 4, 6, 7, 10, 12, 13,

FALSE:

5 The Federal Reserve is not under the control of any government agency.
8 State chartered banks can be members of the Federal Reserve.
9 All true except "making sure that banks make money"
11 The processing of checks and electronic transfers is a major source of revenue for the Federal Reserve.
14 The Treasury prints the currency and money is issued on the guarantee (promise) of the Federal Government. There are no gold reserves.
17 Bank reserve requirements vary between 1.25% and 22%

CHAPTER III: SECONDARY MORTGAGE MARKET

With the demise and/or re-organization of the thrift industry the secondary mortgage market became the primary player in the making of home loans in this country.

The major players in the Secondary Mortgage Market are the Federal National Mortgage Association (FNMA), Government National Mortgage Corporation (GNMA), and the Federal Home Loan Mortgage Corporation (FHLMC).

Other players in this market place include the Federal Agricultural Mortgage Corporation (FAMC), Municipal Mortgage Enhancement (MUNIE MAE), and many mortgage investment conduits (REMIC'S) that use mortgage-backed securities (MBS) to collateralize their own securities.

The Secondary Mortgage Market buys real estate loans from loan originators and sells them to investors or pools them. When mortgages are purchased from primary lenders this cycle creates new funds for these lenders and thus their money supply is replenished to make new loans.

Today the ability to dispose of loans to the Secondary Market is of paramount importance to a loan funder or originator. Because of this, most originators underwrite loans to the standards of the Secondary Market.

With the disappearance of portfolio type lending, that was once offered by Savings and Loans, and the popularity of the Secondary Mortgage Market, a consumer with specialty type needs had no place to go until the advent of another emerging market, the market that deals with B, C, and D type loans.

FIRREA

As a result of poor lending decisions, poor management and the negative effects of the tax reform act of 1986 on real estate investing, over half of the nations 4,600 thrift institutions (savings and loans) began disappearing or facing bankruptcy since deregulation of the lending industry began in 1988. At that time 57% of all residential loans were originated by savings and loans associations.

To deal with the crisis, Congress enacted the Financial Institutions Reform, Recovery and Enforcement Act on August 9 1989. The Act introduced new capital-requirement thresholds and thus restructured the regulatory levels of the thrift industry. One of the

principal missions of the Act was to close insolvent savings and loan associations and sell or reorganize those on the brink of failure. The Resolution Trust Corporation (RTC) was created as the agency responsible for running the failed institutions and disposing of the leftover real estate and other assets.

FIRREA proved to be a death sentence for the savings and loan industry and an opportunity for banks to take a stronghold in the business of money.

As smaller savings and loans collapsed, they were merged with larger institutions. By absorbing these smaller institutions, the larger institutions eventually became insolvent and were purchased by banks for pennies on the dollar of their real worth.

SUBPRIME LENDING

STARTING WITH THE A, B, C's OF IT

Once the words to a popular song, the words today refer to a new market of mortgage products that deal with non-conforming borrowers who do not meet the standards of the secondary mortgage market.

Once called the " sub-prime market " to cope with today's challenges, many mortgage companies are making a transition to alternative mortgage products, known generally as B/C paper. Once loans that were rejected due to derogatory credit, high debt to income ratios, lack of assets or reserves, or instability of income are now considered viable loan sources for the right price.

Once scattered groups of investors provided funding for these types of loans; thus, the money supply was erratic, unpredictable, short supplied, and expensive.

Today a main stream is being created in the format of the secondary market to have available a continuous flow of investors interested in this type of risk and profit.

Consumers apply for these types of loans for a variety of reasons. Most refinance requests are to provide relief through debt consolidation. These loans also help consumers resolve credit problems. They give borrowers a fresh start by using the loans as a means to improve their credit rating over time, to later qualify for an "A" type loan.

In underwriting B/C type loans the credit risk categories are described through a classification grading system using the following designations:

- "A" minus-two 30 day late payments.
- "B" three 30-day or one 60 day late payments.
- "C" four 30 day, or two 60 day, or one 90 day late payment.
- "D" a 120 day late payment.

In addition to the above categories standards are also set for bankruptcy, foreclosure open judgments, and collections.

Appraisal is the key factor in the approval of a B/C loan. And in some instances two appraisals are required. Once the loan meets the assets test then the loan can be underwritten subjectively using various credit standards for different credit trenches.

The demand for this type loan is high in today's market. Contributing to this demand is the state of the economy, as well as, the financial consequences of divorce, illness, or death of a family member.

Today these products are offered at multiple documentation level options, from full to limited to no income verification options.

Fully amortized fixed rate loans, adjustable loans and loan to values as high as 95% are offered to consumers under the proper qualifications.

As the secondary market expands in this area investors will offer an even higher variety of products to consumers needing B/C loan products to meet their needs.

Although just gaining popularity with main line lenders, the B/C market has been a stable investment vehicle for investors for more than 25 years. Historically, private money, or portfolio companies funded these loans. Today, consumers have more choice than ever before in this market. The interest rate spreads between credit trenches have compressed while loan size and loan to value ratio have expanded.

FANNIE MAE AND THE SUBPRIME MARKET

According to HUD subprime lending has grown steadily since 1995, when it totaled $65 billion. In 2001 the market reached $173 billion, equivalent to a 266% increase. By the year 2000 the subprime market accounted for over 12% of the loans done in the market place.

Fannie Mae loans to non-traditional borrowers in 2002 exceeded $15 billion compared to $9.2 billion in 2001, and $1 billion in 1999. More than 250 lenders nationwide participate in delivering sub-prime loans to Fannie Mae yearly.

With what started out in 1999 as an 18 month polite project, today Fannie Mae has enhanced the program to great diversity. These enhancements include cash out refinances and 5/1 ARMs programs.

The primary reason for entering the subprime field was that mainstream lenders were not often operating in this market place. Fannie Mae is able to lend in this market because of the capabilities of Direct Underwriting. DU looks at a number of variables and identities compensating factors that allow lenders to approve more borrowers, or to approve borrowers with credit blemishes or non-traditional credit history.

Fannie Mae's delinquencies remain under control due to a robust approach to risk management. These controls include strict attention to servicing support, and training and operational efficiencies. Fair lending reviews are also conducted to assure that

proper procedures are followed and that the appropriate laws and regulations are adhered to.

Fannie Mae's feedback from lenders include:

- That the program has been a learning experience for most lenders, enabling them to gain a better understanding of non-traditional borrowers and best practices for origination.

- That Fannie Mae's entry into the market place brings operational efficiencies and makes it easier to do business. The lender's risk is reduced since the lender processes the loans through DU.

- That lenders use the program as a tool for recruiting new originations and to help make inroads with real estate agents, since the lender can now qualify more borrows for home purchases.

- That it improves the lenders efficiency by being able to make quick, on the spot, dependable decisions.

One trend that is for sure is that the largest lenders are retaining servicing and small and medium size lenders tend to sell servicing.

Currently, Fannie Mae represents about 10% of the market.

NICHE LOANS

Another very popular area of loans today is the so- called "niche market". This market normally refers to borrowers with credit scores of 680 or higher who do not meet the standard Fannie/Freddie or jumbo guidelines.

In the past, portfolio lenders only made such loans, often to accommodate the unique needs of their best clients.

Since the mid 1990s, however, the secondary market has undertaken Alt -"A" lending. The result is that a wide variety of standardized fixed and adjustable rate Alt-A products are now available to originators through wholesalers of money.

Generic Alt - A product include such attractive features as:

- 90% LTV investor loans
- Investor loans with cash out refinances
- 90% LTV primary residence cash our refinances
- 95% LTV primary residence to $400,000
- 90% LTV primary residence to $500,000
- No Income Verification Loans
- No Ratio Loans
- International Borrowers
- No Income/No Asset Loans

No Income verification or stated-income loans, which do not require borrowers to document the income stated on the application, account for about one third of all Alt-A lending.

While some ARM programs are available up to 90% LTV, most fixed-rate programs limit primary residences to 80% LTV, second homes to 75% LTV, and investor loans to 70% LTV.

No Ratio Loans ignore income entirely. LTV's are generally limited to 80% for primary residences, 65% for second homes, and 60% for investor loans.

International Borrowers includes the categories of foreign nationals, as well as permanent and non-permanent residents aliens and U.S. citizens who, due to employment abroad, do not have at least two years of established U.S. credit, employment or asset history. Loan to Value is generally limited to 80%.

No Income/No Asset Loans are not as readily accepted by investors, and thus in shorter supply. These loans normally require an LTV of 75%; although, investors can be found that will accept a LTV of as high as 95%.

CREDIT REQUIREMENTS

In general minimum credit requirements include:

- Two years' credit history.
- A minimum of 24 months mortgage or rental history with no late payments.
- No open collections, charge-offs, judgments, liens or other published derogatory records filed within the past 24 months.
- No history of foreclosure, bankruptcy, or notice of default.
- Letters of explanation should address only issues of extraordinary circumstances, such as medical emergency and not be used to justify poor credit.

Most lenders agree that Alt-A products are not underwritten on the basis of ratios but on the basis of a customer's past performance history.

LOANS EXCEEDING PROPERTY VALUE

These formerly eyebrow- raising loans are getting plenty of respect from investors these days. This market, which closed 20 billion in 1998, had a delinquency rate of less than 2%. And has grown to even greater heights, today.

These high LTV loans are in reality not a pure equity loan but a hybrid between a home equity loan and an unsecured loan. Loans exceeding property value have been known to be as high as 175% of value.

For the most part the quality of the loan varies depending on who's originating, servicing, and underwriting the loan.

Taking into account that these type of loans pledge future equity, will a home be mortgaged for more than it is worth when a seller wants to move or conditions force him to move and how does he deal with that dilemma?

The answer is called A PORTABLE SECOND MORTGAGE. For a 2% fee the second mortgage can be transferred to the borrower's next house when he moves. Under these circumstances the LTV can be as high as 135%.

103% LOAN PROGRAM

Early in 1998 secondary mortgage market giant Freddie Mac announced that at it would purchase what it calls the "103 Combo" loan. Designed for people with moderately good credit histories, this program permits the borrower to make a downpayment of 3% from their own cash, and then finance all closing costs and escrows up to another 6% of the home price.

The combination of a 97% LTV, plus a second loan of up to 6% of the home value, produces a 103% combined financing package. The maximum loan limit on the first is $227,150 with a one-ratio guideline of 40% of the borrowers gross monthly income. The program is targeted to borrowers whose income does not exceed 125% of the median income for the area.

NO MONEY DOWN LOAN PROGRAMS

These types of loans are readily available to creditworthy borrowers. Offered through mortgage brokers these loans represent a combination of a first and second mortgage done simultaneously.

Both Fannie Mae with its' "Flexible 97" and Freddie Mac with its' "Alt 97" are offering programs that permit the borrower to obtain his 3% downpayment from either gifts or loans. The loan must be underwritten through both agencies' automated underwriting systems, which use credit scoring as a form of guidance.

WHAT'S YOUR SCORE

Credit scoring is now widely used in determining a borrower's ability to repay. Even though, underwriting has not been eliminated, credit scoring is being used in determining the electronic approval of a buyer by the secondary mortgage market.

Typically in underwriting, concentration is on the borrower's most recent two year credit history; however, scoring takes into consideration a pattern longer than two years, which can conflict with standard lending practices.

If a borrower has an "abusive credit pattern" such as over use of charge cards, often times this is interpreted as a danger sign that the potential of credit abuse is around the corner. Credit scoring is not a new way to underwrite a loan. Consumer lending in the area of automobile and charge cards has used this method of determining creditworthiness in the past. However, credit scoring is relatively new in mortgage lending.

The three most widely recognized credit-scoring programs are Fair Isaac (FICO) and BEACON (Equifax) and Experion. Both create a higher score for an individual with low risk and a lower score for an individual with high risk.

The factors are pre-determined based on factors such as:

- Number of revolving charge cards.
- Number of installment debts.
- Payment history.
- Derogatory credit.
- Public record information.
- Uses of revolving credit (percentage used vs. available credit.
- Raising or lowering of credit limits.
- Number of inquiries.

When a credit report contains a credit score, it lists the risk features that had an impact on the score.

What credit scoring does not take into consideration is:

- The borrower's length of employment
- Length of time in a residence
- Bills paid promptly but not reported to a repository
- The borrower's property
- Loan to value
- Debt to income ratio
- Savings pattern.
- A catastrophic event in someone's life

When an individual does not meet the criteria required under a credit scoring process, then, automated underwriting should be converted to the more traditional form of underwriting which takes into account all of the above outlined factors.

Today an estimated 60% to 70% of all single-family mortgages are originated with some type of credit score.

Credit scoring is a comparison of the subject consumers credit report information against a grouping of similarly modeled consumers to arrive at a conclusion on the probability out-come of the subject consumer, if granted a loan.

The purpose of the scoring system is to distinguish borrowers with future "good" credit from borrowers with future "bad" credit.

At times, a score comes in for someone with delinquencies on his credit report that is higher than for someone with no delinquencies. How can this be?

In the past, most of an underwriter's attention was focused on the number of late pays, foreclosures, and bankruptcies in determining an applicant's credit risk. But scoring models take a much broader approach by examining the correlation among all the financial information on a credit report.

FICO models look at direct and derived financial statistics within five broad categories with the first two having the most power in predicting defaults.

- Past payment performance including defaults and information from public record on bankruptcies, foreclosure, tax liens, etc.

- Debt utilization includes how much credit is in use in relation to the available credit and past history in this area.

- History of credit establishment - how long have the various trade lines been open.

- Pursuit of new credit.

- Type of credit being used-revolving, installment, etc.

Because a consumer's file of information may vary from one credit repository to another, credit scores may also vary.

Under today's standards FICO scores of at least 580 for FHA/VA and 620 for secondary market conventional loans are considered minimum acceptable scores for automated underwriting. Anything less than this must be considered through normal underwriting standards.

CREDIT REPORT VARIATIONS CAN COST POINTS

Were you charged a slightly higher rate on your mortgage or homeowner's insurance because your credit score wasn't quite up to snuff? It's possible nobody bothered to tell you.

But if you did learn about it, do you know which of your score was used to charge you extra? Just about every American adult has three scores, and they can be difficult enough to cost you tens of thousands of dollars, depending on which score is used to "price" you.

According to a national study covering more than 500,000 consumers. FICO scores, one in three Americans has a variation of 50 points or more from his or her high to low score (FICO stands for Fair, Isaac & Co., the developer of the dominant scoring software used in the mortgage market). One in 20 Americans' FICO score varies by 100 points or more; the average variation is 43 points.

Yet mortgage lenders and insurance companies frequently use hair-trigger score cutoffs to price their products. A person with a FICO score just a few points below 620, for example, might be quoted an interest rate one-half of a percentage point higher on 30-years loan than a person with score slightly above 620.

A loan applicant with a score of 575 would be charged more than 2 percent higher on a 30-years fixed-rate loan than an applicant with a credit score of 675, according to a Fair, Isaac-sponsored survey of more than 2,000 lenders.

Rate differentials like that produce huge differences in cumulative payments over the term of the mortgage. Yet no federal or state law requires lenders or insurers to use any one of the scores.

Though many mortgage lenders and brokers use the middle score of applicants to quote rates, lenders are free to price on the lowest score, effectively yielding them a higher interest rate and a more valuable loan for sale to investors.

The independent study of more than 500,000 customers' credit files and scores, conducted by the National Credit Reporting Association and the Consumer Federation of America, concluded that scoring variations and errors in electronic credit files put one in five Americans at risk of being overcharged on home loans. This is especially the case for consumers with bordering scores, where the score range from high to low is 575 to 630.

Why do scores vary so significantly? The simple answer is that the information contained in each of your three national credit reporting files-maintained independent by Equifax, Experian and TransUnion-differs in content from the other, sometimes dramatically. The American credit reporting system is voluntary. No mortgage company, department store, bank or credit card issuer is required to report a consumer's account information or payment behavior to any one of the giant repositories.

National lenders and credit account holders tend to report to all three repositories. Regional or local creditors may only report to one or two. Other national lenders intentionally withhold information on some of their best customers so competitors will not target them with marketing offers. The national scoring study turned up sobering findings on missing credit data:

- 78 percent of consumers' files examined by researchers were missing at least one revolving credit account in good standing.
- 33 percent were missing a mortgage account that had never been late.
- 67 percent were missing non-mortgage installment accounts that had never been late.

Omission of positive information depresses credit scores. A credit bureau file that does not contain records of all your on-time payments to creditors will produce a lower FICO score than a bureau file has them all. That, in turn, could at least partially account for wide swing in a consumer's highest to lowest score.

How can an individual be certain they are not overcharged on a mortgage because the score selected by the lender is not their best score? Consumers should order copies of their full repository file once or twice a year. Examine each to make sure the significant credit accounts (called "trade lines") are included on all three. If they find that the mortgage lender-or more likely, one of the credit card issuers-isn't reporting to one or more of the repositories, contact the lender and demand to know why. Second, be on guard for errors of commission as well as omission in the repository file. The

national credit study found incorrect information "rampant" in the consumer files it examined.

Errors can drag down the scores. Consumers should demand that the creditor correct its mistakes immediately. Consumers can contact the Federal Trade Commission if the information doesn't get corrected promptly. Consumers should not settle for artificially depressed scores. They could cost them big money on their next loan.

TEST YOUR KNOWLEDGE QUIZ:

T F 1. FIRREA restructured the regulatory levels of the thrift industry (Savings and Loans).

T F 2. The Secondary Mortgage Market is the primary source of mortgage money by buying loans from loan originators and selling them to investor or pools of investors.

T F 3. The three major players in the secondary mortgage market are FNMA, GNMA, and FHLMC.

T F 4. Most modern day loan originators do not underwrite loans to the standards of the Secondary Market.

T F 5. The B, C, and D mortgage market deals with loans that conform to traditional loan standards.

T F 6. Subprime type loans are often used to re-establish credit and later refinanced.

T F 7. Appraisals are not a critical element in qualifying for B, C, and D product loans.

T F 8. B, C, and D products are offered at full, limited, and no verification options.

T F 9. According to HUD the "sub-prime" market increased by 266% to a level of $173 billion by the year 2001.

T F 10. Fannie Mae loans to un-traditional sources exceeded $15 billion in 2002

T F 11. "Niche Market" and "Alternate A " refers to borrowers with credit scores of 680 or better.

T F 12. Alternate "A" products are available through the secondary mortgage market and various other wholesalers.

T F 13. Stated Income loans account for one third of the Alternate "A" market.

T F 14. No Ratio Loans require verification of income.

T F 15. Bankruptcy, foreclosure or collections are permitted on Alternate "A" products.

T F 16. Past performance is of primary concern to an underwriter on Alternate "A" products.

T F 17. A "portable second mortgage" is transferable to a borrower's next home.

T F 18. The 103% combo loan does not require a downpayment.

T F 19. "No Money Down" conventional loans are a combination of a first and second mortgage at the same time.

T F 20. A borrower's minimum downpayment of 3% can be borrowed under certain mortgage programs offered in the secondary mortgage market.

T F 21. The electronic approval of a buyer weighs heavily on credit scoring.

T F 22. Past credit abuse does not effect a borrower's credit score.

T F 23. The most widely recognized credit-scoring programs are Fair Isaac (FICO), BEACON (Equifax) and Experian.

T F 24. Credit scoring takes into account the borrower's new property appraisal.

T F 25. The purpose of credit scoring is to predict the borrower's future performance.

T F 26. Today more that 70% of all single family mortgages use credit scoring as a form of review.

T F 27. Credit scores do not vary from one reporting source to another.

T F 28. The average variation in credit scores is 43 points.

T F 29 Errors, causing variations in credit scores, do not effect a borrower's rates and points.

TRUE: 1, 2. 3. 6, 8, 9, 10,11,12,13, 16, 17, 19,20,21,22, 23,25, 26.

FALSE:

4 Most loans are written to the standards of the secondary market in order to insure their marketability at a future date.
5 B, C, D market deals with non-forming, higher risk, or unique type credit or employment situations.
7 Appraisals and property value are often key factors in this type of loan.
14 No ratio loans do not require the verification of income
15 Alternate "a" products require above average credit with no history of serious credit problems
18 103 combo loans require an out of pocket downpayment of 3%, but can finance up 6% of the closing costs into the loan
24 Looks at 5 different factors: past payment history, debt utilization, length of credit, pursuit of new credit, type of credit.
27 Credit scores have proven to vary as much as 100 points between reporting agencies
28 78% of Americans have in-accurate information of some kind in their credit files and in some cases causing higher rates or points.

PART IV:
TRADITIONAL LOAN SOURCES

Loans sold in the secondary mortgage market traditionally come in the format of conventional loans and government guaranteed or insured loans.

CONVENTIONAL FNMA AND FHLMC LOANS

These kinds of loans follow specific guidelines and deviate from these guidelines only when compensating factors are present. The guidelines cover the area of employment, loan to value and income ratios, and credit requirements.

Loans exceeding a loan to value of 80% must have private mortgage insurance (PMI).
Borrower's income ratio cannot exceed 28% of gross monthly income for housing and 36% for total debts.

Buy downs of interest rates are permitted on fixed rate loans.
Seller's contributions to closing costs cannot exceed 6% on LTV's of 90% or less and no more than 3% on LTV's of more than 90%.

Downpayment can be 100% gifted on loans with LTV's of 80% or less and on loans in excess of 80% LTV, borrower must have a minimum of 5% of own funds toward the downpayment.

Gift funds must be verified and must be from a family member.

A two-year employment history is required.

Credit must be fairly perfect with minor exceptions for medical emergencies and situational changes.

Credit scores play a significant role in loan approval and often set aside ratio requirements.

Understanding that residential real estate takes into account one to four units, maximum conforming loan limits for effective January 1, 2003 are as follows:

FIRST MORTGAGES

1 Unit	$322,700
2 Unit	$413,100
3 Unit	$499,300
4 Unit	$620,500

Note: One to four-family mortgages in Alaska, Hawaii, and the U.S. Virgin Islands are 50% higher than the limits for the rest of the country.

SECOND MORTGAGES

Loan Limit is $161,350 except for Alaska, Hawaii, and the U.S. Virgin Islands were the limit is $242,025.

FHA LOANS

FHA insured loans have generally more relaxed guidelines then conventional. Qualifying ratios, employment history, downpayment requirements and past credit problems are all generally addressed in a more liberal way.

FHA has more than 18 different loan programs the most common of which is the 203B loan program.

FHA UNDERWRITING REQUIREMENTS

The following are the current underwriting guidelines for an FHA - Insured loan:

- Minimum legal age as prescribed by state law
- No maximum age limit
- Citizenship not required
- Must be lawful permanent or non-permanent resident authorized to work
- Must have a Social Security number
- Borrower's income ratio cannot exceed 29% of gross monthly income for housing and 41% for total debts.
- Two year primary employment history.
- One year history for any part time employment.
- Good credit history for a minimum of one year.
- Past poor credit permitted with letters of explanation for reasonable cause.
- Past Bankruptcy permitted with 2 years waiting period.
- Allowable closing costs can be financed in the loan to arrive at an acquisition cost.
- Minimum downpayment requirement based on acquisition cost rather than purchase price.
- Downpayment can be entirely gifted by a relative.
- Downpayment can be entirely borrowed when borrowers own assets are used as collateral.
- Maximum LTV's differ depending on loan amount (varies between 2 to 5% down).
- Maximum loan ceilings vary from local to local

FHA LOAN LIMITS:

FHA loan limits are indexed to 75% of Freddie Mac and Fannie Mae loan limits. The FHA loan limits for one to four units effective January 1, 2003 are:

- The basic standard mortgage limits for FHA insured loans are:

One family	Two-family	Three-family	Four-family
$154,896.00	$198,288.00	$239,664,00	$297,840.00

- High cost area limits are subject to a ceiling based on a per-cent of the Freddie Mac Loan limits.
  The ceilings are currently:

One-family	Two-family	Three-family	Four-family
$280,749	$359,397.00	$434,391.00	$539,835.00

- Section 214 of the National Housing Act provides that mortgage limits for Alaska, Guam, Hawaii, and the Virgin Islands may be adjusted up to 150 per-cent of the new ceilings. This results in ceilings for these areas:

One-family	Two=family	Three-family	Four-family
#421,123.00	$539,095.00	$651,586.00	$809,752.00

FHA MORTGAGE INSURANCE PREMIUM (MIP)

When FHA insures a loan the Up-Front premium charge is 1.50% which may be either paid in cash or financed into the loan by the borrower. In addition the borrower must pay an annual premium of .50% on a 30 year term and .25% on 15 year term, payable monthly to be included in the regular payment. The up-front premium portion of the insurance is not required on condos, quad homes, or coach homes.

Annual MIP (paid monthly) will be cancelled when the LTV equals 78% based on the lower of the original sales price or appraisal, provided the mortgagor has paid the annual MIP (paid monthly) for at least five tears on 30 year terms and no minimum amount of years on 15 year term loans (scheduled or actual).

The monthly mortgage insurance premium charged on Condo's and 203(k) programs is paid for the full term of the loan regardless of LTV.

FHA DOWNPAYMENT REQUIREMENTS

The FHA downpayment simplification calculation was made permanent when in 2003 President Bush signed the FHA Downpayment Simplification ACT, S.2239.

The FHA downpayment requirement is computed on the appraised value or acquisition cost. The acquisition cost being the purchase price plus the allowable closing costs.

Two calculations are required to estimate the loan amount. The one that provides the lower loan amount must be used; the acquisition cost minus the maximum allowable loan equals the downpayment.

STATUTORY INVESTMENT
In computing the maximum loan amount it must be determined that the borrower has at least 3% of their funds (can be a gift) invested in the combination of downpayment and closing costs.

INDUCEMENTS TO PURCHASE

Some seller concessions are considered inducements to purchase and in reality a reduction of the purchase price. These concessions, if offered, must be subtracted dollar for dollar from the sale price:

- Decorating allowances
- Moving expenses
- Repair allowances
- Personal property
- Excess rent credit
- Seller payment of borrower's sales commission on a present residence
- A real estate commission on present home that exceeds typical for the area

PERMITTED SELLER OR THIRD PARTY CONTRIBUTIONS
FHA permits sellers or other interested third parties such as real estate agents, builders, etc. to contribute up to six per cent of the property sales price in the following fashion without it being considered a reduction of the sale price.

- Discount points
- Permanent and temporary interest rate buy-downs
- Finance-able closing costs
- Pre-paids
- UFMIP-Up front MIP
- Mortgage payment protection insurance
- Advance on HOA not exceeding one year premium
- Taxes that become due in the first year.

DOWNPAYMENT ASSISTANCE PROGRAMS
FHA recognizes various downpayment assistance programs. These programs are available to qualified individuals and the funds are provided directly to the homebuyer in the form of Gift Funds, which are wired to the Settlement/Closing Agent on the day of the settlement or closing. The gift is up to 5% of the home's purchase price and can be used for the downpayment and/or closing costs.

The way the gift is created, is by the buyer entering into an agreement, as part of the purchase contract with the seller, that the seller will gift a percentage of the sale price, up to 5%, to a pre-established non-profit organization, whom in turn gifts a percentage of the money to the buyer, at closing, to be used toward the downpayment and/or closing costs.

One of the most recognized such program is the Nehemiah Program.

NEHEMIAH PROGRAM

The Nehemiah program is a Private California Non-Profit Organization that offers downpayment assistance programs to qualified homebuyers. The program offers free gift funds to be used towards the downpayment and closing costs for eligible FHA loan programs. Under this program, the funds do not have to be paid back. Nehemiah will gift up to 3% of the final sales price of the home towards the downpayment.

Potential applicants for this program must first get pre-qualified for this home loan grant. Once approved, the applicant will then be referred to an approved Real Estate agent in the applicant's area in order to find a home that qualifies under the program guidelines. Once the home is found, the offer is accepted by the seller, and the loan is ready to close, then the gift funds are wired to the title/ escrow company and the buyer closes on the transaction.

The gift can be up to 5% of the purchase price and can be used for the downpayment and/or closing costs.

Similar to the Nehemiah Program are the:

- American Dream Program
- Partners in Charity (PIC)
- Consumer Debt Solutions (CDS)
- Housing Action Resource Trust (HART)
- Officer Next Door Program
- Teacher Next Door Program

All programs require owner occupancy

TEACHER NEXT DOOR PROGRAM

This program offers teachers a 50% discount on HUD-owned, single family homes in certain designated areas. The homes become available to HUD after homeowners default on their FHA-insured mortgages. HUD will also reduce the downpayment to $100 if a teacher purchases the new home with an FHA-insured mortgage.

To be eligible, teachers must be employed full-time by a public school, private school, or a Federal, State, County, or Municipal educational agency as a State Certified classroom teacher in Grades K through 12. The teacher must agree to make the home their sole residence for three years following the purchase. In addition, teachers must work in the areas in which the homes are located

OFFICER NEXT DOOR PROGRAM

This program offers law enforcement officers a 50% discount on HUD-owned, single family homes in certain designated areas. The homes become available to HUD after homeowners default on their FHA-insured mortgages. HUD will also reduce the downpayment to $100 if a teacher purchases the new home with an FHA-insured mortgage.

To be eligible, law enforcement officers must be employed full-time by a Federal, State, County, or Municipal government and is sworn to uphold the law and make arrests for violations occurring in their agency. The officer must agree to make the home their sole residence for three years following the purchase. Officers are encouraged to purchase a home in the communities they serve.

Since HUD created the officer and teacher programs in 1977 and 2000, respectively, more than 6,000 teachers and officers have benefited from its use.

VA LOANS

VA Guaranteed loans are granted to:

- Individuals with more than 90 days active duty in World War II, Korean Conflict, Vietnam War, Persian Golf War, War with Iraq.
- More than 180 days continues active duty Post World War II (July 26,1947 through June 26tth, 1950).
- Post Korean Conflict (February 1, 1955 to August 4, 1964), Post Vietnam War (May 8th, 1975 to September 6, 1980).
- Two years of continuous active duty during the peacetime period of September 7, 1980, to the present.
- At least six years of continued active duty as a reservist.
- Un-remarried spouse of a veteran.

The VA provides a loan guarantee of up to 25% of the veteran's home loan up to the current limit of $240,000. This enables a veteran to get a loan of up to $240,000 with no downpayment. The VA full entitlement is $60,000 and all or any unused portion may be used to obtain a home loan. The entitlement represents the maximum guarantee the VA will do for that specific veteran.

Examples of this would be:

- Entitlement $60,000 representing 25% of VA GUARANTEE
  Maximum purchase price without a downpayment would be $240.00

- Entitlement $40,000 representing 25% of VA GUARANTEE
  Maximum purchase price without a downpayment would be $160.00

It is possible that a veteran has less than the full current entitlement because he has used a portion of the entitlement for a previous purchase which was not paid off; therefore, that previously used entitlement is deducted from the current maximum entitlement and the balance used toward a new purchase. Keep in mind that the available entitlement represents 25% of the purchase price to be guaranteed by VA.

VA FUNDING FEE

- A Funding Fee is required on All **V.A.** loans (EXCEPT those with Disabilities).
- Fee varies between 1.25% and 3.00% of loan. First time user is normally 2.00%.

- ➢ Funding Fee can be financed into the loan, however loan amount Including Funding Fee cannot exceed maximum loan limit.

VA INCOME RATIO

The ratio for income is up to 41% of the gross monthly income to include the P.I.T.I. and all other monthly re-occurring debts.

Today most loan funding is done through Mortgage Bankers or Mortgage Brokers.

FUNDING SOURCES

Mortgage Bankers provide funding from both their own sources, as well as, from the secondary mortgage market. They are originators, funders, and servicers of loans.

Mortgage Brokers on the other hand are for the most part originators of loans and use Mortgage Bankers as their source of funding loans. They normally have a higher variety of loan choices and in some cases represent the interest of the borrower.

Which source is best, is a question that is often asked?

The answer to that question might be best answered by stating that both have a value depending on the borrower's specific needs.

In summary it might be stated that the Federal Reserve System is the conduit of the "green" paper called money. And that it has the power in conjunction with government sources to control the rise and fall of the value of money in this country.

The Secondary Mortgage Market is the conduit for "white" paper called mortgages. And that in conjunction with Wall Street and other investor sources control the rise and fall of the value of mortgage paper in this country.

TEST YOUR KNOWLEDGE QUIZ:

T F 1. Conventional loans normally have more relaxed guidelines than FHA loans.

T F 2. Loans exceeding a loan to value of 80% require PMI (Private Mortgage Insurance

T F 3. Seller's contributions on conventional loans cannot exceed 3% of the purchase price.

T F 4. Residential real estate includes 1 to 4 unit dwellings.

T F 5. Conventional loans use credit scoring as the predominant source loan approval

T F 6. Citizenship is a "must" requirement of FHA Insured loans.

T F 7. Past poor credit is not permitted on FHA loans.

T F 8. Downpayments can be entirely gifted on FHA loans.

T F 9. FHA loan limits are indexed to 75% of Freddie Mac & Fannie Mae loan limits.

T F 10. Maximum loan limits are the same through-out the United States on FHA loans.

T F 11. FHA loans required MIP insurance.

T F 12. FHA loans require a borrower to have a minimum investment of 3%, including closing costs.

T F 13. Some seller inducements are considered a reduction of the purchase on FHA loans and must be deducted from the purchase price.

T F 14. FHA does not permit seller or third party contributions in the purchase of a home.

T F 15. FHA recognizes various downpayment assistance programs as a legitimate source for a borrower's downpayment.

T F 16. VA loans require a minimum of 3% down and have no ceiling.

TRUE: 1, 2. 4, 5, 8,9, 11,13,14

FALSE:

3 6% on LTV's below 90% and 3% on LTVs at 90% or higher.
6 Citizenship is not required, must be a lawful permanent or non-permanent resident.
7 Past poor credit permitted with letters of explanation and reasonable cause
10 Maximum loan limits vary between high cost and low cost designated areas

14 FHA permits sellers or other interested third parties such as real estate agents, builders, etc. to contribute up to six per cent of the property sales price under specific guidelines.

16 A loans are available with no money down to qualified Veterans and have a ceiling of $240,000 up to the Veteran's maximum entitlement.

CHAPTER V: PREDATORY LENDING

A SYNOPSIS OF PREDATORY LENDING

A relatively new term, predatory lending, refers to mortgages that are particularly burdensome to borrowers because they are unaware of hidden and abusive costs as well as alternative sources of finance. According to Federal Reserve Board, this lending practice typically has some or all of the following characteristics:

- Making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation
- Inducing a borrower to refinance a loan in order to charge high points and fees each time the loan is refinanced; and/or
- Engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrowed.

Predatory lending has become a hot topic in the real estate industry because of low interest rates and more lending activity in the industry. More first time home buyers are purchasing and, perhaps because of their inexperience, are more subject to predatory lending then some one who purchased before. Females, the elderly, and minorities are particular targets of predatory lending.

According to the Mortgage Brokers Association (MBA), conventional home-purchase mortgage lending to low-income borrowers nearly doubled between 1993 and 1999, whereas that to upper-income borrowers rose 56%.

Also over the same period, conventional mortgage lending increased by about 120% to African-American and Hispanic borrowers, compared with an increase of 48% to white borrowers.

The number of sub-prime (less-than-perfect credit borrowers) home equity loans has increased 130%. In addition, buyers sometimes do not use real estate professionals to assist in their purchase and are trying to complete the transaction on their own using the Internet. New lending companies pop up all the time.

Starting in the year 2000, congress began passing legislation that cracked down on unfair lending practices. A number of other federal bills and amendments to existing legislation are now in progress to eliminate predatory lending. In addition, many state governments have recently passed laws to prevent predatory lending.
For example:

- Illinois approved House Bill 2146 that would create a board to set guidelines for mortgage companies.
- Alabama is another state that introduced guidelines centered around high cost fees and counseling for the buyer.
- Washington, D.C. enacted the Protections from Predatory Lending and Mortgage Foreclosure Improvements Act of 2000 to go into effect as of Aug 31, 2001.
- Connecticut recently passed the Abusive Home Loan Lending Practices Act. This Act limits prepaid finance charges on all purchases and refinance transactions and contains specific lines that focuses on " high cost Loans" by definition.

In spite of state regulation, predatory lending is still practiced. This happens because of the influx of new loan officers from other industries. Training and understanding of the business for these new loan officers are limited to attitude of the company for which they work. Some companies monitor the activity of its loan officers and restrict them from any practice of predatory lending.

Predatory lending continues to exists because the public, buyers, borrowers and real estate professionals themselves do not recognize what it is or even which lenders are involved in this illegal and unethical practice. Some red flags for borrowers and their agents should be:

- Unusually high up-front loan fees
- A loan officer guarantees buyer/borrowers that they will get loan

- An out-of-state lender with no local office
- No Good Faith Estimate (GFE) provided-the GFE should explain all lending costs and is supposed to be mailed within three days of application
- A promise of "no closing costs" when what is really meant is that the closing costs will not be paid up-front but rather financed as part of the loan
- A verbal promise to lock in an interest rate
- Bait and switch: a low interest rate is quoted at loan application only to discover at closing that the rate quoted was for an adjustable rate mortgage

In order to help their clients avoid predatory lending, here are some practices that real estate professional can pass along to their buyer-borrowers:

- Buyer/borrowers should go to a recognized lender with a good local reputation.
- Buyer/borrowers should get everything in writing.
- Buyer/borrowers should understand the type of loan that was applied for.
- Buyer/borrowers should receive a Good Faith Estimate form.
- All up-front fees and closing costs requested should be explained.
- Buyer/borrowers should know that there is an option to lock or not to lock. If the loan is locked, have the lock term payment in writing.
- Buyer/borrowers should find out who is going to fund the loan.
- State lending laws should be reviewed and understood by real estate professionals.

Predatory lending has been around as long as currency has existed. However, unethical and illegal lending practices can only flourish where there is ignorance. Real estate educators and their students can significantly influence the practice of predatory lenders if they encourage consumers to seek guidance in obtaining loans and managing their debts.

HUD RULES AIM TO STOP FLIPPING

The Department of Housing and Urban development is taking a major step towards preventing an abusive lending practice known as flipping that has left thousands of unsuspecting home buyers with properties worth far less than what they owe on them.

Effective June 2, 2003 the Federal Housing Administration no longer insures mortgages on properties that have been sold more than once in 90 days. And if a repeat sale occurs between 91 and 180 days, lenders will be required to obtain an additional and independent appraisal.

The new rules are designed to stop "flipping," a maneuver in which speculators buy a rundown property, often at foreclosure, make a few cosmetic repairs, and sell it – sometimes within days-at artificially inflated prices. Sometimes the houses are sold to fictitious buyer and then resold again and again at higher and higher prices until they carry a mortgage far greater than their actual worth. Then, when the monthly payments stop, if they have been made at all, lenders take over the properties and file claims with the FHA, which guarantees to make lenders whole if borrowers fail to meet

their obligations. Often when flipping schemes are discovered, sellers, lenders and appraisers are found to have been working together in the scam.

The new rule is a major step in efforts to eliminate predatory lending practices by HUD.

FHA-insured mortgages are considered the financing of last resort for first –time, low and moderate-income and immigration borrowers who don't meet the requirements set by conventional lenders. Without the FHA to back their loans, they would be forced to either pay higher rates and fees from "subprime" lenders or wait until they can solve their credit issues.

There are some exceptions to the new anti-flipping rules. FHA-insured mortgages will still be available on houses taken back by HUD and then resold as well as on properties purchased by an employer or relocation company.

Otherwise, resales occurring 90 days or less following acquisition will not be eligible for an FHA-insured loan. Repeat sales executed within three months "imply pre-arranged transactions that often prove to be among the most egregious example of predatory lending practices, For resales between 91 and 180 days, HUD requires lenders to provide additional documentation of value if the new purchase price exceeds the old price by more than 50 percent.
According to HUD, this threshold is high enough not to hurt legitimate rehabilitation efforts, but low enough to "still deter unscrupulous sellers, lenders and appraisers from attempting to flip properties and defraud home buyers."

In localities where HUD determines an inordinately high number or substantial pattern of abuses is taking place, a second appraisal will be required if the sales price has increased by 5 percent or more within the previous 12 months. In additions, HUD said buyers will be eligible for FHA-insured mortgages only when they purchase their houses from the owner of record.

COMPLIANCE BY MORTGAGE FIRMS

Mortgage firms are increasingly concerned about meeting the rising amount of anti-predatory regulations as well as the threat of class action lawsuits.

With 19 states and several more municipalities, including the city of Chicago, with laws on the books and more than a dozen additional states with laws in the works, compliance becomes a major priority for mortgage firms.

Compliance is especially important because the wholesale loan buyer can be liable for losses and lawsuits.

Mortgage firms are taking action to avoid being accused of predatory lending. They are examining their procedures and loan programs to make sure that none of the "hot-buttons" of predatory lending are present.

Some of the steps and cautions being taken include:

- If offering single premium life insurance, the insurance is being offered on a monthly premium basis.
- Showing borrowers loan cost with and without insurance.
- Using clearer advertising and marketing materials.
- The use of hypothetical examples is restricted to the use of only clear and concise examples.
- The use of only empirical data (credit scores from outside sources) when risk based underwriting is a determining factor.
- Loan pricing exemptions are restricted to decisions made only by a high level mortgage firm employee.
- Yield spread premiums are being clearly disclosed.
- Offering loans with both prepayment and no prepayment penalties and allow the customer to choose between the two.
- Clearly explaining the pros and cons of loan programs offering prepayment penalties and non-prepayment penalty loans.
- Carefully deal with no-doc loans.
- Restrict negative amortization loans and clearly explain the consequences when used.
- Careful screening by mortgage funders of mortgage brokers, handling their products, to make sure that they are reputable and ethical in their practices.

Since predatory lending has no accepted definition there is always a "gray" area of concern when dealing with unique loan products.

The National Association of Consumer Advocates has listed practices associated with predatory lending as:

- Single premium credit insurance
- Deceptive advertising and sales practices
- Loan Flipping
- Refinancing without a tangible net benefit to the borrower.
- Abusive pricing
- Excessively high "yield spread premiums"
- Negative amortization
- Balloon payments
- Mandatory arbitration in the event of dispute or delinquencies

Because some of these practices can sometimes benefit the consumer, as well as harm the consumer, it is critical that consumers, mortgage firms, real estate brokers and governmental agencies work together to bring defined resolutions to the issue of predatory lending.

TEST YOUR KNOWLEDGE QUIZ:

T F 1. Predatory lending, refers to mortgages that are particularly

burdensome to borrowers because they are unaware of hidden and abusive costs as well as alternative sources of finance.

T F 2. Inducing a borrower to refinance for no good reason is not considered to be predatory lending.

T F 3. Subprime home equity lending has increased over 130% over the last 5 years, causing concern over predatory lending practices.

T F 4. Congress, the federal government, and state organizations have no say so in relation to predatory lending practices.

T F 5. Bait and switch is when a low interest rate is quoted at loan application only to discover that at closing that the rate quoted was for an adjustable rate mortgage.

T F 6. In order to help avoid predatory lending, Buyer/borrowers should go to a recognized lender with a good local reputation.

T F 7. Effective June 2, 2003 the Federal Housing Administration no longer insures mortgages on properties that have been sold more than once in 90 days as a precaution to flipping practices.

T F 8. If a sale occurs between 91 and 180 days, HUD does not require lenders to obtain any additional data or precautionary measures.

T F 9. "Flipping is a maneuver in which speculators buy a rundown or foreclosed property, make a few cosmetic repairs and sell it at an artificially inflated price.

T F 10. Flipping scams very seldom involve colution between sellers, lenders, loan officers, and appraisers.

T F 11. Exceptions to the HUD "flipping" rules are HUD owned properties and relocation or employer purchased homes.

T F 12. FHA-insured mortgages are now only available when the purchase is made from the owner of record.

T F 13. Compliance with predatory laws is important to mortgage brokers and lenders because the wholesale loan buyer can be liable for losses and lawsuits.

T F 14. One of the "hot buttons" of predatory lending is single premium life insurance.

T F 15. Mandatory arbitration in the event of dispute or delinquencies is considered a predatory lending practice.

TRUE: 1, 3, 5, 6, 7, 9, 11, 12, 13, 14, 15

FALSE:

2. Inducing a borrower to refinance a loan in order to charge high points and fees each time the loan is refinanced is unethical and considered predatory lending.

4. Starting in the year 2000, congress began passing legislation that cracked down on unfair lending practices. A number of other federal bills and amendments to existing legislation are now in progress to eliminate predatory lending. In addition, many state governments have recently passed laws to prevent predatory lending.

8. If a repeat sale occurs between 91 and 180 days, lenders are required by HUD to obtain an additional and independent appraisal.

10. Most often flipping is occurring as a result of collusion between the parties involved in the transaction.

CHAPTER VI: FRAUD PROTECTION

QUALITY CONTROL

Quality control is a requirement all lenders must deal with in the processing of loans. A lender must be able to demonstrate that they take proper precautions to prevent fraud. Doing a series of self-audits during the processing and post funding periods does this. Post funding of a loan, either the secondary market owner of the loan or HUD does quality control checks.

At one time, a lender would report suspected incidents of fraud to HUD and then wait on pins and needles to see what action HUD would take against the lender. Actions could include administrative sanctions, indemnification to HUD for any losses resulting from the fraudulent loans, or potentially civil money penalties.

HUD regulations imposed a clear obligation to report fraud, but lenders on the other hand, were hesitant aware of the financial consequences that could follow.

In the fall of 1997 HUD issued a "Quality Assurance Agreement" wherein "reasonable relief measures" could be extended to a lender caught in this dilemma.

Under this agreement the Mortgage Review Board can still:

- Impose administrative sanctions, ranging from a letter of reprimand, placing the lender on probation or suspending or terminating the mortgagee's HUD approval.
- Impose civil money penalties usually in the area of $5000 per individual violation. (To a maximum of $1 million dollars in a twelve month period).
- For larger violations assess treble damages.

LOSS MITIGATION INCENTIVES

For lenders that comply with the requirements of the agreement HUD offers "loss mitigation incentives" that include:

- Abatement of claim losses.
- Flexible repayment plans for losses.
- Waiver of fees and/or late charges
- Waiver of civil money penalties.

The incentives that HUD will offer a mortgagee will be based on:

- the losses suffered by HUD
- past mortgagee performance
- the mortgagee's financial capability
- HUD will also measure the mortgagee's claim and default rate against the rates of other mortgagees making loans in the same geographic areas.

The mortgagee must also co-operate with HUD in pursuing criminal prosecution and administrative sanctions against individuals and companies involved in the fraud.

In order to qualify for HUD's loss mitigation incentives mortgagees must:

- Timely report to HUD any program violations involving insured loans, and false statements that affect the insurability of the mortgage.
- Maintain adequate controls for the origination of insured mortgages.
- Maintain controls to prevent and detect fraud and program violations.
- Co-operate with HUD in connection with legal or administrative action that HUD brings against participants who have committed violations or fraud.

Lenders that enter into this agreement have an absolute obligation to report fraud to HUD and failure to do so will result in severe sanctions against lenders who sign the agreement and than fail to keep up their end of the bargain.

To help lenders detect fraud a checklist has been created to help detect "red flags" for possible fraud.

LOAN APPLICATION RED FLAGS

Although the following do not indicate that a potential fraud is present, they do represent an "alert" to the underwriter that additional "diligence" is required in underwriting the loan.

- No face-to-face interview.
- Buyer currently lives in property (buying from landlord).
- Deposit or downpayment is a promissory note.
- Borrower is buying an investment property but doesn't own current residence.
- IRA is shown as a liquid asset.
- Borrower and co-borrower work for same employer.
- Same telephone number for home and work.
- Personal property exceeds one year's salary.
- Unrealistic or significant commute distance to work.
- Number of family members compared to size of house being purchased is not consistent.
- Date of application and dates of verification forms are not consistent.

- Borrower's age and the number of years employed are not consistent.
- New housing expense exceeds 150% of current housing expense.
- Unreasonable accumulation of assets compared to income.
- Lack of accumulation of assets compared to income.
- Years of school are not congruent to profession.
- Excessive real estate currently owned.
- Initial fee check returned "NSF".
- Buyer down sizing from larger to smaller home.
- Borrower intends to rent or sell current residence with no documentation.
- Stocks and bonds not publicly traded.
- Significant or contradictory changes from handwritten to typed application.

VERIFICATION OF DEPOSIT (VOD) RED FLAGS

- Even dollar amounts.
- Significant change in balance over prior two months.
- Original VOD is not creased.
- Evidence of whiteouts or strikeovers.
- Account was opened on a Sunday or holiday.
- No date stamp by depository.
- Recently opened account.
- Illegible signatures with no further identification.
- Excessive balance in checking accounts vs. savings account.
- Young borrower's with substantial cash in bank.
- Is entire verification typed with same typewriter or same handwriting?
- Is VOD addressed to a P.O. Box or mail drop?
- Source of funds consists of unverified note, equity exchange.
- Borrower has no bank account.
- High-income borrower with little or no cash.
- Borrower's funds are security for a loan.

VERIFICATION OF EMPLOYMENT (VOE) RED FLAGS

- Is the entire verification typed with the same typewriter or same handwriting and ink?
- Is the employer's address the same as the property being purchased?
- Was the VOE prepared/signed by the originator on the same date as completed and signed by the employer.
- Even dollar amounts.
- VOE addressed to a particular person's attention other than personnel manager.
- Employer's address is a P.O. Box.
- Evidence of whiteout or strikeovers.
- Numbers that appear to be squeezed.
- Employer's signature dated less than one day after originator's signature.
- Illegible signatures with no further identification.
- Inappropriate verification source, (secretary, relative, etc.).
- Overtime or bonus exceeds 50% of base pay.
- Income not appropriate for location or type of employment.
- Borrower self employed and verifying own earnings.

- Excessive praise in remarks section.
- Date of hire was holiday.
- Overlaps in current and prior employment dates.
- Drastic change from previous position or profession to current employment status.

CREDIT REPORT RED FLAGS

- All accounts paid in full recently possible new consolidation.
- Employment information history varies from loan application.
- No credit-possible use of alias name.
- Variance in employment or residence data from other sources.
- Recent inquiries from other mortgage lenders.
- Invalid social security number.
- Limited credit history for income and age.

GIFTS RED FLAGS

- Unable to verify source of funds by donor.
- Discrepancies between signatures on gift letter and donor check.
- Variation of phone numbers given by donor and number listed in phone directory.

TAX RETURN RED FLAGS

- Is borrower's income consistent with job description?
- If borrower has stock assets, is dividend income shown on return?
- If borrower shows large savings, is interest income shown on return?
- Does return show quarterly tax deposits made?
- Is the tax form prepared by borrower or a tax preparer?
- Use the IRS Teletax service to verify any tax refunds.
- Examine cancelled checks for estimated quarterly tax payments.

EXAMINING THE 1040 FORM

- Tax computation does not agree with tax table.
- Evidence of erasures, cross-outs, squeezed-in entries.
- Type or handwriting not consistent throughout the return.
- Paid preparer signs taxpayer's copy.
- Borrower files Schedule G (used for income averaging thus reflecting fluctuating income).

W2 WAGE FORMS RED FLAGS

- Invalid employer identification number.
- FICA wages/taxes and local taxes exceed ceilings or set percentages.
- Even dollar year-end figure.
- Different type or print within the form.
- Be suspect of copies of W-2 submitted other than "employee's copies"
- Employer's address different than on VOE.

PAY STUBS RED FLAGS

- Even dollar amount on paycheck.
- Company name not imprinted on check.
- Handwritten pay stub.

APPRAISAL RED FLAGS

- Is appraiser from out of area?
- Missing information.
- Ordered considerably earlier than sales contract.
- Comparables used are more than nine months old.
- Comparables are more than one mile from subject property.
- Line adjustments are more than 10%.
- Overall adjustments are in excess of 25%.
- Land value constitutes a large percentage of value.
- Erasures, cross-outs, squeezed in characters.
- Sales contract as dated after appraisal.
- Appraisal ordered by a party to the transaction (seller, buyer, real estate agent).
- Photographs do not match description.
- For rent sign on property.

SALES CONTRACT RED FLAGS

- Seller is the real estate agent.
- Power of Attorney is used to sign contract.
- Sale is subject to seller acquiring title.
- Buyer is required to use a specific lender or broker.
- Odd amounts used as earnest money.
- Seller secondary financing is an element of the contract.

RESOLVING DISCREPENCIES & FRAUD

If fraud is discovered during the loan processing period and merely involves the stretching of the truth by a zealous borrower, the problem may be solved easy enough by suggesting a different loan program to better suit the customers needs.

When fraud is discovered post funding and after being sold in the secondary market, a lender has no choice but to report the fraud and each must deal with the consequences.

TEST YOUR KNOWLEDGE QUIZ

T F 1. Quality control is not required of lenders who have less than 2% foreclosure rate.

T F 2. When fraud is discovered in a quality control check, a lender is required to report the fraud to HUD and suffer the consequences for their lack of diligence.

T F 3. Lenders reporting fraud to HUD could suffer financial consequences imposed by HUD.

T F 4. Under a "Quality Assurance Agreement" with HUD a lender can only be fined a maximum of $1 million dollars in any 12-month period.

T F 5. In a fraud case, a lender is not obligated to co-operate with HUD in pursuing criminal prosecution of an accused.

T F 6. A Loan application "red flag" is an unreasonable accumulation of assets compared to income.

T F 7. A significant change in balance over the previous two months is reason to further investigate a verification of funds.

T F 8. Numbers that appeared to be squeezed on a verification of employment are reason for further investigation by an underwriter.

T F 9. Quantities of recent credit inquiries are of no concern to an underwriter.

T F 10. When FICA wages exceed ceilings on W-2 forms, further investigation should be undertaken.

T F 11. A credit report showing recent inquiries by other mortgage lenders is of no concern for further investigation.

T F 12. Tax return observations should include if borrower's income is consistent with job description.

T F 13. Handwritten pay stubs are acceptable and do not require further investigation.

T F 14. A sales contract" underwriting alert" is required if the seller is also the real estate agent.

TRUE: 2, 3, 4, 6, 7, 8, 10, 12, 14

FALSE:

1. Quality control is required of all lenders
5. A lender is required to cooperate with HUD in all investigations
9. Recent credit inquiries indicate potential new credit and must be explained
11. FHA has more relaxed guidelines regarding credit and employment
13. Hand written pay stubs are cause to further investigate the authenticity of the information.

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