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Large mortgage companies with substantial assets may make loans without a forward loan commitment, choosing instead to finance their operations through the issuance of commercial paper or by operating a conduit (described in Chapter 1). The mortgage companies can hold loans temporarily in their own portfolio or, more commonly, pledge them with a commercial bank on a warehouse line of credit. When a suitable buyer is found, the mortgage company can sell loans that have already been made on an **immediate commitment** basis. "Immediate" means that the loans do exist and can be delivered without delay. However, industry practice allows up to 60 days for delivery. The advantage of an immediate type of sale is that the purchaser's yield requirements will be slightly less (the purchaser's money is put to work right away) than for a forward commitment, which allows the mortgage company a little better margin of return.

Representative or Correspondent Basis

Insurance companies, pension funds, and other loan purchasers sometimes specialize in handling certain kinds of property loans, such as those for hotels or shopping centers. Rather than deal with a variety of loan originators, these companies often work through selected representatives throughout the country. These representatives, sometimes identified as agents and sometimes as correspondents, are commercial loan companies that understand the special requirements of each loan purchaser or investor. If a mortgage company customer is seeking a hotel loan, for example, the mortgage company will handle the contact with a secondary-market investor most interested in that particular kind of loan. In a situation such as this, the mortgage company serves as a loan broker, negotiating the loan for an investor. The investor then funds the loan at closing and usually handles the servicing.

Selling Mortgage-Backed Securities

These sales involve converting mortgage loans into mortgage-backed securities, which enjoy a broader market that is not practical for smaller mortgage companies. Prior to the mortgage crisis, most loan originators sold their loans to large loan poolers—like investment bankers—such as like Morgan Stanley & Company, Inc., Goldman Sachs, or to Government-Sponsored Enterprises such as Fannie Mae, which are more capable of dealing with financial market needs. However, a few of the larger mortgage companies had been successful in tapping financial markets for this purpose. One method is to place a multimillion dollar block of mortgage loans in the care of a trustee, such as an authorized bank. Then the mortgage company issues a series of certificates backed by the block of loans, which is the collateral for the securities. The certificates are sold to investors and the money received from these certificates is used to reimburse the mortgage company. This procedure is often identified as *securitizing mortgages*. As the mortgage company that originally made the loans services them, it sends the principal and interest payments each month to the trustee. The trustee then passes these payments on to holders of the securities. The expression *pass-through securities* developed to describe this practice. When privately issued, as described here, mortgage-backed securities may or may not be guaranteed. Investment bankers entered the field of mortgage securities with a number of variations that will be discussed more fully in the next chapter.

Mortgage Company Income

Profit margins are narrow in handling mortgage loans. Mortgage companies make little, if any, money from the discount, since that amount passes to the loan purchaser as part of the cost of money. While the borrower measures the discount in a specific number of points, in practice the mortgage company originator does not receive that precise amount. What the mortgage company is really doing is buying a piece of paper—the mortgage note—when it funds the loan at closing. Then the note is sold to a secondary-market purchaser. The difference between what is funded at closing and what the mortgage company sells the note for is the amount it earns, measured in dollars. If the mortgage company has handled its commitments carefully, the margin covers its origination fee and maybe a small cushion. And if it makes a mistake or misjudges the secondary-market yield requirements, losses can result. Some lenders will charge a higher interest rate than market rates to add additional profits rather than charging discount points; this additional spread is called “yield spread premium.”

The dependable income for loan originators comes from various fees: application fees, origination fees, yield spread premium, and servicing fees. These are more fully explained in the following section. When mortgage originators are at their most competitive in marketing, their firms may only break-even when comparing their origination expenses, fee income, and yield spread premium, and may not realize a profit until after selling the servicing rights on each mortgage into the secondary market.

Application Fee

Loan originators normally charge a nonrefundable **application fee** at the time an application is taken. In the jargon of the industry, lenders will “entertain an application” for a loan if the application is in general conformance with the kind of loan the lenders make. The application fee covers certain costs incurred in screening an application, such as those involved in obtaining a credit report and a property appraisal, as well as that represented by the time it takes a loan officer to review the information. The fee is not regulated (except for HUD/FHA and VA) and is charged by almost all originators, not just mortgage companies. For residential loans, the fee is in the \$150 to \$500 range, while fees for

commercial loans are often based on the size of the loan rather than on the work involved.

Origination Fee

An **origination fee** is sometimes combined with an application fee. However, in most cases, it is a separate charge amounting to one to two percent of the loan amount, payable if and when the loan closes. It is a charge incurred for assembling a loan package and making the decision to accept or reject the loan. The charge is for services rendered but is tax deductible for the borrower if certain rules are followed. It is a separate charge from the discount, which is also tax deductible, but the two are not always differentiated when loan costs are quoted. Mortgage personnel should disclose the distinction to borrowers so they may make more accurate comparisons of charges between lenders.

Mortgage companies usually split the origination fee, with about half going to the loan representative who contacts the borrower and takes the loan application. This fee is considered the “commission” earned by the representative and is not paid if the loan fails to close. In contrast, most savings associations and banks pay their loan officers on a salaried basis rather than on commission, with some paying bonuses based on a minimum level of monthly production and profitability.

Yield spread premium, or YSP, is the fee paid by the lender to the broker in exchange for a higher interest rate negotiated with the borrower at an above-wholesale rate. Though the borrower may qualify for a certain rate, the broker can charge this fee and give the borrower a slightly higher rate to make a higher commission. This practice was originally intended as a way to avoid charging the borrower any out-of-pocket fees. It can be abused, however, and used to charge inexperienced borrowers excessive fees for services rendered. Recent changes to the Real Estate Settlement Procedures Act occurred with the passage of the Mortgage Disclosure Improvement Act of 2008, or “**MDIA**.” MDIA requires that any yield spread premium be fully disclosed on the newly revised Loan Estimate disclosure form, pointing out this fee that was often hidden from consumers in the past. The method of disclosing mortgage broker compensation, including yield spread premium, continued to be a concern and was addressed in the Dodd-Frank Act. The CFPB has finalized new disclosure rules under the Truth-in-Lending Act that became effective in 2013 and will be

modified under the new Qualified Mortgage (QM) rules, also part of the Dodd-Frank Act. This will be covered more fully in Chapter 16.

Servicing Fee

In mortgage lending, a **servicing fee** is the charge made for handling the loan after it has been funded. Services involve collecting and accounting for periodic loan payments, handling the escrow portion of the payments, and following up on delinquent accounts. The fee amounts to 0.25% to 0.50% of the loan balance and is collected by all loan servicers—mortgage companies, savings associations, banks, and others. Servicing charges are normally added to the interest rate for the loan and are not distinguishable to the average borrower. In the terminology of secondary-market investors, a yield requirement quoted as “net basis” means one that does not include a servicing fee; the loan originator must add that to the rate. Net basis rates are sometimes identified as the “wholesale rate.” For example, the rate delivered to a loan purchaser might be 8.5%, while the charge to the borrower would be 8.75%; the 0.25% difference is the service fee.

Because the servicing of large blocks of mortgage loans can be a lucrative business by itself, specialized companies have developed in recent years to perform just this function. Sometimes a loan originator accumulates several billion dollars in loans to service and will sell a portion of the block to acquire cash. For example, if a \$100 million block of loans is paying 0.25% in servicing fees, the total fees paid amount to \$250,000 per year. The profit potential and cash flow could make the servicing alone worth \$750,000 to \$1.5 million in a sale.

The Great Recession or Financial Crisis from 2007 to 2009 led to the rise of a new breed of third-party mortgage loan servicing operation. These are known as special servicers or default servicers. Special servicers can be free-standing firms specializing in servicing hedge funds, mortgage assets, and those for other master servicers like Selene Finance LP, owned by Ranieri Partners. Another new type of mortgage loan special servicer is Carrington Mortgage Services, LLC. Carrington describes itself as a privately managed investment management company that provides integrated full life cycle mortgage loan servicing support to borrowers and investors. These new special servicers and default servicers have a much higher fee structure than more traditional mortgage servicing operations.

Loan Servicing Disclosure Notice

As the residential mortgage market has expanded and changed, the older practice of making monthly payments to a loan originator has given way to a new trend. The servicing function may be transferred to a distant collection company that specializes in computer management of the cash flows. The ease with which a lender can now ask a borrower to send monthly checks to a new servicing agent has created an opportunity for some abuse. Scam artists using unauthorized or stolen lists of borrowers can direct payments to a post office box, skim the collections for perhaps a month or two, and disappear with the money.

To help give borrowers/consumers some protection from this kind of theft, Congress amended the Real Estate Settlement Procedures Act (RESPA). As of April 20, 1991, the Cranston-Gonzalez National Affordable Housing Act required loan originators to provide borrowers with a servicing disclosure notice. The notice must include an explanation of two points: (1) the possibility that loan servicing may be transferred to another company, and (2) the rights of a borrower, should such a transfer occur. The loan originator must provide a borrower with an estimate, expressed as a percentage, of the possibility of transfer. Furthermore, a notice of transfer must be sent to the borrower not less than 15 days prior to any transfer, and the new servicing company must confirm the change within 15 days after the date of transfer. A toll-free or collect telephone number must be provided for the borrower to contact the servicing company. Borrowers may collect damages and costs from companies that violate the requirements.

AUTOMATED LOAN UNDERWRITING

Since 1995, an explosive growth in mortgage originations has led to the use of computer programs using artificial intelligence in the analysis, and even the final approval, of residential loans. While it did not originate the idea, HUD has encouraged the greater use of computerized loan underwriting, as it can lower costs and provide more unbiased analysis. This method has brought an increase in the use of credit scoring and offers ways to expedite appraisals. Because of the many advances in technology, it is now possible for an individual to negotiate a mortgage loan on the Internet. At this time, the vast majority of Internet-based loan originators

are fully focused on easy-to close-refinances. A later chapter will discuss the active use of and continuing advances in automated loan underwriting.

Where Are We Now?

What Is Automated Underwriting?

According to Freddie Mac, “automated underwriting is a technology-based tool that combines historical loan performance, statistical models, and mortgage lending factors to determine whether a loan can be sold into the secondary market. The most widely used automated underwriting services are Freddie Mac’s Loan Prospector® and Fannie Mae’s Desktop Underwriter®¹⁰.

Mortgage originators use automated underwriting to help them

- Determine the terms under which the loan can be sold into the secondary market
- Evaluate the credit, collateral, and capacity of borrowers to make their monthly mortgage payments
- Identify the appropriate type of loan for the borrower
- As the Freddie Mac website notes, “Automated underwriting improves the mortgage process by providing lower costs, expanded markets, and faster, fairer lending decisions.
- “Automated underwriting also helps originators shed old guidelines that excluded too many borrowers from home ownership. By combining flexible, objective underwriting with a broad array of mortgage programs, originators can offer borrowers lowest-cost financing. This makes automated underwriting a big weapon against predatory lending.”¹¹

OTHER PRIMARY MARKET LENDERS

The opening of the secondary market and the wide acceptance of mortgage-backed securities as sound investments have encouraged many newcomers

¹⁰Freddie Mac. “Automated Underwriting.” Accessed July 10, 2015 at <https://stmpartners.com/manual/cor/general/1.04aus.pdf>

¹¹Ibid.

to enter the loan origination market. The next section discusses the major players in this field, who are not subject to banking regulations.

Nonbank Lenders

Companies with long experience in handling loan qualification and funding for other kinds of consumer-type loans have entered the mortgage market. These include such major operators as ING Group, Ally Financial, Honda Financial Services, GM Financial, and the retail finance division of GE Capital.

Investment Bankers

As many investment bankers expand into handling various money market accounts, retirement funds, and even checking accounts, some have entered mortgage loan origination. Edward D. Jones, Charles Schwab Company, Merrill Lynch, and Raymond James & Associates are all examples of this kind of lender.

Finance Companies

Many small loan companies such as HSBC Finance Corporation that formerly made mostly unsecured personal loans have expanded into mortgage lending as a better method of securing their loans. Other firms such as Discover—the credit card issuer—have now diversified into personal lending and online mortgage lending (e.g., Discover® Home Loans).

Home Builders

Several large home builders, including KB Home, Pulte Homes, D. R. Horton and others, have entered the origination market through subsidiaries that process loans and sell them into mortgage pools. By exercising some control over the mortgage money, home builders are able to structure loans that better suit their buyers' needs, thus enhancing sales potential.

Real Estate Brokerage Firms

Companies that have developed national real estate brokerage operations through direct acquisitions or franchise networks have entered the loan origination business. Such companies as Century 21 and Prudential Real Estate are now able to offer mortgage loan services in their own offices.

Internet

The newest method of negotiating a mortgage loan is through contacting a mortgage loan site on the Internet. An individual who may have a tarnished credit record and wants to remain anonymous, a person living in a rural area who wants to avoid traveling a long distance, or maybe even someone with an excellent credit record who feels more comfortable with an impersonal interview are all lured to the Internet. There are some downsides to this method of loan application, of course. Waiting periods are still necessary for certain verifications, fees and interest rates are about the same, and there is no real person to assist in the process. Also, the Internet has its share of shady operators who may be harder to distinguish from legitimate mortgage professionals in cyberspace.

Computerized Loan Origination (CLO)

As a forerunner to computerized loan analysis, computers were first used as a means of transmitting loan information to a human underwriter who did the analysis work and, after proper verifications, approved or rejected loan applications. This process involves computer network ties between independent agents and major money sources. Today, CLO is one method used by real estate brokers to assist buyers in negotiating a loan to purchase a property. Current HUD rules allow a person or company who initiates the loan and assists in helping a borrower furnish the necessary information to earn a fee that is reasonably commensurate with the work performed. Now with new consumer disclosure requirements, the next generation of CLOs currently supports regulatory reporting as well. The procedure is further discussed in Chapter 14.

Pension Funds

During the past decade, **pension funds** have become large investors in mortgage loans. By far, the most common method is through the purchase of mortgage-backed securities. In this way, investors avoid the management problems associated with individual mortgage loans and are able to treat such investments as just another kind of security.

However, a few pension groups, particularly those operated by state agencies and by labor unions, offer home loan programs as primary lenders. Some funds restrict participation to their own members, and some offer such loans to the general public if qualifying standards are met. Most of these direct loans are available to middle- and low-income families and offer attractive interest rates.

Real Estate Investment Trusts (REITs)

In 1960, when mortgage money was derived mostly from savings accounts, Congress passed the Real Estate Investment Trust Act. The intent was to make it more profitable and tax efficient for the small investor to enter the real estate market, thus increasing available capital. To achieve this purpose, **Real Estate Investment Trusts (REITs)** are subject to strict qualifications and restrictions, as demonstrated in Figure 4-1.

The points in Figure 4-1 are general business observations of REIT structure. There can be harsh penalties for not meeting the required qualifications, including the loss of REIT status. Interested REIT holders or REIT licensees should always contact the IRS for the most current tax law involving REITs.

Two kinds of REITs developed. One made equity investments in real estate and derived its income from operation of properties. The other arranged for mortgage loans, a lucrative business when interest rates were reaching peak levels. Both kinds of activity declined in the 1980s as the real estate market lost much of its luster. The 1990s saw the return of equity-type REITs as a sound method of raising investment capital.

In the mid-1990s, REITs began a large-scale operation of selling stock on the public markets. The stock was of interest to investors because of its tax advantages and the required distribution of any profit. REITs backed by the public markets were stronger than earlier REITs. Many showed

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- A REIT must be structured as a corporation, trust, or association and be managed by a board of director or trustees
 - REITs must have transferable shares or certificates of interest
 - REITs must be formed as an entity that is taxable as a corporation
 - Financial institutions and insurance companies cannot be formed as REITs
 - Joint ownership must be a key component, with at least 100 persons owning the REIT's stock
 - Additionally, a REIT must not have more than 50 percent of its shares held by five or fewer individuals during the last half of each taxable year
 - REITs must have at least 75 percent of total investment assets in real estate or in real estate-backed assets such as equity mortgage-backed securities
 - REITs must generate at least 75 percent of their gross income from rents on real property or mortgage interest
 - No more than 25 percent of a REIT's assets may consist of stock in taxable REIT subsidiaries
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FIGURE 4-1 Real Estate Investment Trusts

equity of around 70% of capital, while earlier ones operated on about 30% equity with the rest borrowed. Now evolving as popular REIT alternatives are REITs with timberland or land with mineral interests. These might yield considerable income using the framework of pass-through special-purpose entities that build out the infrastructure for oil and gas production, as opposed to having a pure royalty income structure.

With cash raised in the public markets, REITs began buying real estate, ranging from prisons to apartment buildings. In 1997, REITs made several big hotel deals; the purchase of ITT (Sheraton Hotels) and LaQuinta Inns were two such deals. Because of an overload of stock on the market, the price stalled. In 1998, the Federal Reserve warned its banks to raise its credit standards on loans to REITs because such loans were dependent on real property, which could fluctuate downward. Unfortunately, the Fed did not give the same guidance on residential mortgage-backed securities, and these continued to flourish well into the current financial crisis.

Interestingly, more than a dozen new residential mortgage-backed security REITs have been formed since 2007, mainly secured by ARM loan portfolios of MBS freshly issued by Fannie Mae, Freddie Mac, and Ginnie Mae. Some of these new REITs, with names such as Invesco Mortgage Capital, Inc., Hatteras Financial Corp., and Two Harbors Investment Corp., have built their balance sheet assets to total holdings of over \$20 billion in less than three years. The total new ARM RMBS put into these new and existing mortgage REITs, such as Capstead Mortgage Corporation, Annaly Capital Management, Inc., and MFA Financial, Inc., has been more than a quarter trillion dollars from January 2008 to December 2010. Much of this growth of the existing and new mortgage REITs was financed by U.S. Treasury's Troubled Asset Relief Program monies, private investors, and loans from the Federal Reserve's Term Asset-Backed Securities Loan Facility. The range in size of market capitalization of publicly traded mortgage REITs was \$29.2 billion at the end of 2006 (a high at that time) to a low of \$14.3 billion at year-end 2008, and by the end of 2013, they were \$62.1 billion.¹²

A Public-Private Investment Program (PPIP) has two parts, addressing both the legacy loans and legacy securities that are clogging the balance sheets of financial firms by using \$75 to \$100 billion in TARP capital

¹²National Association of Real Estate Investment Trusts. "US REIT Industry Equity Market Cap." Accessed Dec. 26, 2014 at <https://www.reit.com/investing/industry-data-research/us-reit-industry-equity-market-cap>

and capital from private investors. PPIPs are expected to generate \$500 billion in purchasing power to buy legacy assets, with the potential to expand to \$1 trillion over time, helping investors buy new RMBS securities with refinanced ARMs. This process allows those mortgage assets that were interest-only or option ARMs set at unaffordable pay rates for otherwise creditworthy borrowers to be reset. This reset has also allowed a limited number of potentially toxic mortgage assets to change characteristics and become performing assets.

In the past 10 years, the growth in specialized REITs has become a factor in this market. Some REITs concentrate their holdings specifically in one type of real estate, such as shopping centers, while others concentrate in a particular region of the country. Two examples of such specialized REITs are Associated Estates Realty Corp. and Post Properties, Inc., both of which are involved in the development, ownership, management, and sale for profit of upscale or luxury multi-family apartment communities.

There are also non-exchange traded REITs that must still make filings with the SEC. These non-exchange traded or private REITs are not freely traded, as they were never registered with the SEC. They differ from publicly traded REITs in the sense that investors pay a fixed price for each unit in a private REIT and anticipate receiving regular dividends from income produced by rents or mortgage interest. Investors in private REITs must be aware that these entities only trade during certain windows. It is only during these particular periods of time that investors can redeem units back to the issuer on terms set by the private REIT. Moreover, private REITs can and have suspended redemptions. The biggest downside to private REITs is the fact that they do not have the disclosure requirements of other REITs, and there is typically no public or independent source of performance data on them available to investors.

Individuals

Individuals do not come under the legal restrictions and reporting requirements of institutional lenders. Therefore, good statistics on individual participation in the mortgage market are not readily available. However, many individuals make mortgage loans, albeit sometimes with considerable reluctance.

As a general rule, the individual lender has motives other than profiting from the loan itself. Most common is when a second mortgage (or a first mortgage) is accepted for the primary purpose of consummating a

house sale. In some cases, the motivation is to help a family member or perhaps to assist a valued employee in acquiring suitable housing.

Another area that individuals sometimes participate in is the second- and third-mortgage market for investment. The attraction is that junior mortgages offer higher yields than do first mortgages. The high yields are often obtained through substantial discounts that are due to the greater risk involved in junior mortgages, as prior lienholders must be satisfied first in the event of foreclosure. These loans have been a major source of investment losses for investors who made such second and third mortgages at the recent top of the residential real estate bubble.

MISCELLANEOUS OTHER SOURCES

In different parts of the country, various types of companies, institutions, and even state housing agencies have established themselves as sources of mortgage funds, usually limiting the geographic area in which they will loan money. As a general rule, this type of lender does little or no advertising because lending money is not its primary business. The following paragraphs identify the most important of these sources.

Title Companies

Because title companies have a close association with, and considerable knowledge of, the mortgage industry, these affiliated companies may act as primary sources in lending their own funds. They may also raise money from the sale of mortgage bonds or serve as correspondents or agents for other major lenders.

Endowment Funds Managed by Universities, Colleges, and Hospitals

As a group, endowment funds prefer to maintain their assets in high-grade stocks and bonds that have a good record for security, are considered more liquid and, most importantly, require less administrative attention than a portfolio of mortgage loans. However, many endowments take the form of land and other real property, and these may require more expertise in the mortgage loan field.

Foundations

Foundations are established primarily by corporations or wealthy families as a means of continuing charitable or other activities through the use of income earned from the foundations' investments. Like endowment

funds, foundations are primarily interested in high-grade stocks and bonds as investments but are not averse to mortgage loans, particularly if a purpose of special interest to the foundation can be served.

Fraternal, Benevolent, and Religious Associations

These funds are generally little known and very seldom advertised. Administration is usually handled on a careful, conservative basis with the security of the loan of greater importance than the yield. Some of these organizations limit lending to their own members and will provide low-cost loans to qualified members in good standing.

Foreign Lenders

Foreign sources of investments are many, taking the forms of direct loans made to commercial real estate developers, investors by banks, or direct investments by foreign sovereign wealth funds. A good example is the Government Pension Fund Global of Norway, managed by Norges Bank Investment Management, an arm of the Central Bank of Norway. This firm has five percent of its investments in real estate and was the second largest investor in U.S. Commercial Real Estate in 2014.¹³ Most the Norges Bank investments were leveraged to maximize investment returns by borrowings made from Nordic and other European banks. Many times, banks will form syndicates to make loans to REITs backed by commercial real estate in the U.S. and other locales. A good example is the recent syndicated loan made by Sumitomo Mitsui Banking Corporation; Mizuho Bank, Ltd.; Aozora Bank, Ltd.; Shinsei Bank, Limited; The Bank of Tokyo-Mitsubishi UFJ, Ltd.; and Resona Bank, Limited to the Ichigo Real Estate Investment Corporation in two loans of ¥5.5 million in December of 2014.¹⁴ Aegon Levensverzekering and Aegon Hypotheken are 100% indirect subsidiaries of Aegon N.V. ("Aegon NV"), an international life insurance, pension, and asset management company based in The Hague, the Netherlands, with businesses in over 20 markets in the Americas, Europe and Asia. Historical performance of Aegon's total residential mortgage loan portfolio has been stable over the last 10 years when

¹³ "Norway jumps to second-biggest foreign buyer of U.S. real estate." Bloomberg News, Sept. 24, 2014.

¹⁴ "Ichigo Real Estate Investment: New Loans and Interest Rate Swap." 4-traders.com, Dec. 8, 2014. Accessed Dec. 27, 2014 at <http://www.4-traders.com/ICHIGO-REAL-ESTATE-INVEST-6498170/news/Ichigo-Real-Estate-Investment--New-Loans-and-Interest-Rate-Swap-19508493/>

many other countries' mortgage markets were in disarray. Aegon NV also manages pension funds in the U.S. through some of its subsidiaries, such as Transamerica Retirement Solutions Corporation, and has purchased whole mortgages and mortgage-backed securities of single-family residential mortgages, and financed commercial real estate as well.

GOVERNMENT LOAN PROGRAMS

While most government programs involved with mortgage financing are designed to encourage private lenders to make loans (a topic further discussed in Chapter 5), there are some programs that handle direct loans to borrowers—that is, the agencies work in the primary market. However, to avoid the appearance of direct competition with private business, many such programs require that the loan applicant first attempt to borrow the money from private sources. This is true of the Small Business Administration and the Rural Housing Service, or “RHS” (formerly known as Farmers Home Administration, or “FmHA”), an agency of the U.S. Department of Agriculture that offers a wide range of programs under the USDA's Rural Mission. The Rural Housing Service has taken over the loan programs formerly offered by the Farmers Home Administration. In 2009, the American Recovery and Reinvestment Act was passed, further expanding the role and mission of the USDA's Rural Development agency.

Direct mortgage loan programs offered by the federal government are almost all farm related. State- and municipal-sponsored loan programs are mostly housing related and are usually handled by one or more local housing authorities. Because of its earlier importance in the mortgage credit structure of the country, we will first consider the federal Farm Credit System.

Farm Credit System

The **Farm Credit System (FCS)** dates back to 1916 and the passage of the Federal Farm Loan Act. Since that time, other federal agencies have become involved with farm credit and are now under the supervision of one agency. Today, the Farm Credit System is an elaborate cooperative (or borrower-owned) network of farm lending banks under the supervision, examination, and coordination of the **Farm Credit Administration (FCA)**, an independent federal agency. Administratively, the FCS is composed of five regional farm credit districts (reduced to four in 2011)

owned by over a million American farmers and 5,000 of their marketing and business services cooperatives. The system makes long-term mortgage loans and short-term production or crop loans through different organizations.

The FCS funds its loans and other assets primarily through the sale of system-wide consolidated securities. Most of the financing is handled through the sale of six- to nine-month securities, and some with two- to five-year coupon notes. The interest rates charged to borrowers are determined periodically based on the FCS's average cost of system funds.

Three different FCS organizations were originally involved in making direct loans to the farming community: Federal Land Banks, Federal Intermediate Credit Banks, and Banks for Cooperatives. Their functions have been absorbed, consolidated, or replaced by the five cooperative credit organizations owned by local member/borrowers that make long-term machinery and livestock loans. The local associations assist members in need of loans, screen and approve acceptable loan applications, and forward the applications to one of the banks listed below for funding. Approved loans are guaranteed by the local associations, a practice that makes all members liable and encourages peer pressure and assistance in loan repayments. The Federal Land Banks, Federal Intermediate Credit Banks, and Banks for the Cooperatives have merged and are now known as:

1. AgriBank, FCB, 30 E. 7th St., Suite 1600, St. Paul, MN 55101
2. Farm Credit Bank of Texas, P.O. Box 202590, Austin, TX 78720
3. AgFirst Farm Credit Bank, P.O. Box 1499, Columbia, SC 29202
4. CoBank, ACB, 5500 S. Quebec St., Greenwood Village, CO 80111

Generally, loans are limited to 85% of the appraised value of the property, with a term of not less than five years and not more than 40 years. Interest rates for most loans apply a variable-rate plan, allowing interest to be adjusted periodically. Rates are based on the FCS cost of funds.

UNITED STATES DEPARTMENT OF AGRICULTURAL DEVELOPMENT

The Farm Credit System holds \$199 billion in farm debt. The **Rural Development Housing and Community Facilities Programs**, also known as the Rural Housing Service (RHS), holds another \$181 billion of the debt owed by farmers. The Farmers Home Administration (FmHA) was established in 1946 as part of the Department of Agriculture for the pur-

pose of making and insuring loans to farmers and ranchers. In 1995, FmHA was eliminated and its essential programs were transferred to the Rural Development Service, also under the Department of Agriculture. The scope of RHS activities extended well beyond farm and home loans into financing for parks, camping facilities, hunting preserves, access roads, and waste disposal systems, as well as to making loans in designated disaster areas.

Rural Development provides loan guarantees to help local lenders extend credit needed for the growth and preservation of jobs. It has expanded its traditional lending base to include towns of up to 50,000 but gives priority to towns of less than 25,000. Suburbs and urbanizing areas that surround towns of over 50,000 citizens are not eligible. Eligibility for loan assistance requires that the loan be used for the purpose of saving existing jobs, expanding existing business, and new plant location or business start-up. There is no minimum loan size, and the maximum size is based on existing program priorities from year to year.

Home Ownership Loans

The Rural Development Service's home loan program is limited to rural areas and to low- and moderate-income families who are unable to qualify for home financing in the private market. The USDA Rural Development's Section 501 Direct Loan Program can be made for up to 100% of the appraised value of a house for a maximum term of 33 years (38 years for those with incomes below 60% of AMI and who cannot afford 33-year terms). The term is 30 years for manufactured homes. Eligibility is limited to those with very low income, defined as below 50% of the area median income (AMI); low income is between 50% and 80% of AMI; moderate income is 80% to 100% of AMI. One can visit <http://www.rd.usda.gov/files/RD-DirectLimitMap.pdf> and scroll through the list of states to find the Metropolitan Statistical Area, or "MSA," nearest one's location to learn current income limits listed by family size. Alternately, the Rural Development county supervisor can determine an applicant's eligibility.

Adjusted Income Limits that vary in different sections of the country based on the difference in cost of living in different areas. A typical limit for a single person might be \$19,250. For a family of four, it could be \$27,500, with higher limits for larger families. Calculation of the qualifying income follows HUD standards generally, with certain additional limitations.

Evaluation of the 10-page loan application (Form RD 410-4) is handled in a manner similar to that of other lending agencies and requires

a complete financial statement, a history of family income, and a credit report. Each loan is reviewed periodically to determine if the borrower's financial condition has improved to the extent that the loan could be handled by a private lending institution.

For single-family housing, Rural Development will make loans on new or existing structures. However, there are maximum allowable amounts listed by county and income limits that can be found at <http://www.rd.usda.gov/files/RD-GRHLimitMap.pdf>. The final maximum amount of a loan permitted is determined by the applicant's ability to repay the loan.

For RHS-guaranteed loan programs, applicants may have an income of up to 115% of the median income for the area. These limits can be found at <http://www.rd.usda.gov/files/RD-GRHLimitMap.pdf>. Families must be without adequate housing but be able to afford the mortgage payments, including property taxes and homeowner insurance. In addition, applicants must have reasonable credit histories. Loans can be made in amounts up to 100% of the value of the home for up to 30 years and are subject to the same loan limits as described in the section above on the RHS direct loan program.

State and Local Government Programs

This book does not attempt to cover all the specific unique state housing agencies, such as the Texas Veterans Land Board, or state-specific residential mortgage lending. Because of the opportunity to assist home buyers, and perhaps some political advantage for the officials involved, many state and local housing agencies have developed since the mid-1970s. Some offer direct loans to qualified buyers. It is worth pointing out, however, that over the past 10 years, states have universally adopted **down payment assistance programs**. It is theorized that with an in-depth understanding of the needs of local housing markets, housing agencies are uniquely situated to sensibly underwrite mortgages. This local understanding is key in programs that often offer down payment assistance for low-income, first-time home buyers and to finance the development of multi-family, affordable rental housing. State-designated entities are often called agencies, authorities, or development corporations. These programs are funded by state bond programs backed by mortgages. Many analysts considered these housing finance agencies' loans to be of higher quality than many low down payment loans, since buyers must take classes in home finance in order to obtain these loans. Since

the financial crisis, some state housing finance agencies have experienced trouble issuing the bonds they have used in the past to help home buyers with down payment assistance and mortgages. States including West Virginia, Ohio, Wisconsin, and California have suspended all or part of their mortgage and down payment assistance programs financed through bond issues.

Many consumers and real estate professionals are not as familiar with the various programs that are available. A good source for state by state levels of housing agency funding can be found at the website of the First Home Advisor organization. See link at <http://www.firsthomeadvisor.com/index.php/first-time-home-buyer-loan-mortgage/state-bond/>. Real Estate professionals should not look at this link as a complete picture of all the funding available, as it doesn't have all the city/county specific programs that recently have targeted redevelopment and rehabilitation.