

Chapter 3

Nontraditional Mortgage Lending

Chapter Objectives

- Identify features, benefits, and disclosure requirements for adjustable-rate mortgages
- Identify eligibility and requirements for reverse mortgages
- Describe purpose and key features of a construction mortgage, interest-only mortgage, balloon mortgage, 15-year mortgage, and a home equity loan and line
- Explain how FHA and VA mortgage loans provide alternative home lending opportunities for borrowers
- Recall guidance set forth by CSBS/AARMR for managing risks associated with nontraditional mortgage products with a specific focus on underwriting guidance
- Identify alternative forms of financing, including seller financing and homebuyer assistance programs

Traditional vs Non-Traditional

- **Traditional Mortgage Loan**
 - 30-year term
 - Fixed-rate
 - Fully amortizing
- **Nontraditional Mortgage Loan**
 - Any loan other than a 30-year fixed-rate fully amortizing loan

Adjustable-Rate Mortgages

- **ARM Features**
 - Interest rates adjust according to terms in note to reflect current cost of money
 - Lenders normally charge a lower start rate
- **Interest Rate Calculation**
 - Index + Margin = Fully Indexed Interest Rate
- **Index**
 - Cost of money
 - Moves in step with short-term interest rate debt instruments; likely to change each adjustment

Adjustable-Rate Mortgages

- **Margin**

- Spread; lender profit margin over cost of money
- Predetermined fixed number expressed as percentage points; not subject to change
- Range 2% to 3.5%

- **Fully Indexed Rate**

- Index + margin = fully indexed rate (or adjustable interest rate)
- Used to qualify borrowers

Adjustable-Rate Mortgages

- **Rate Adjustment Period**
 - Length of time between interest rate changes
 - Generally fixed; monthly, quarterly, etc.
- **Initial Interest Rate**
 - Start rate, introductory rate, teaser rate
 - Generally lower than fixed interest rates being offered
- **Rate Cap**
 - Limit amount interest rate or payment can change; eliminates large payment fluctuations

Activity 3.1 Knowledge Check

1. What are the advantages of ARMs?

- Lower initial interest rate and payments
- May be easier to qualify for a loan
- Leverage the buyer into a higher-priced home
- Payments may decrease over time
- May be converted to a fixed-rate loan
- Good in times of low inflation or for short-term ownership

Activity 3.1 Knowledge Check

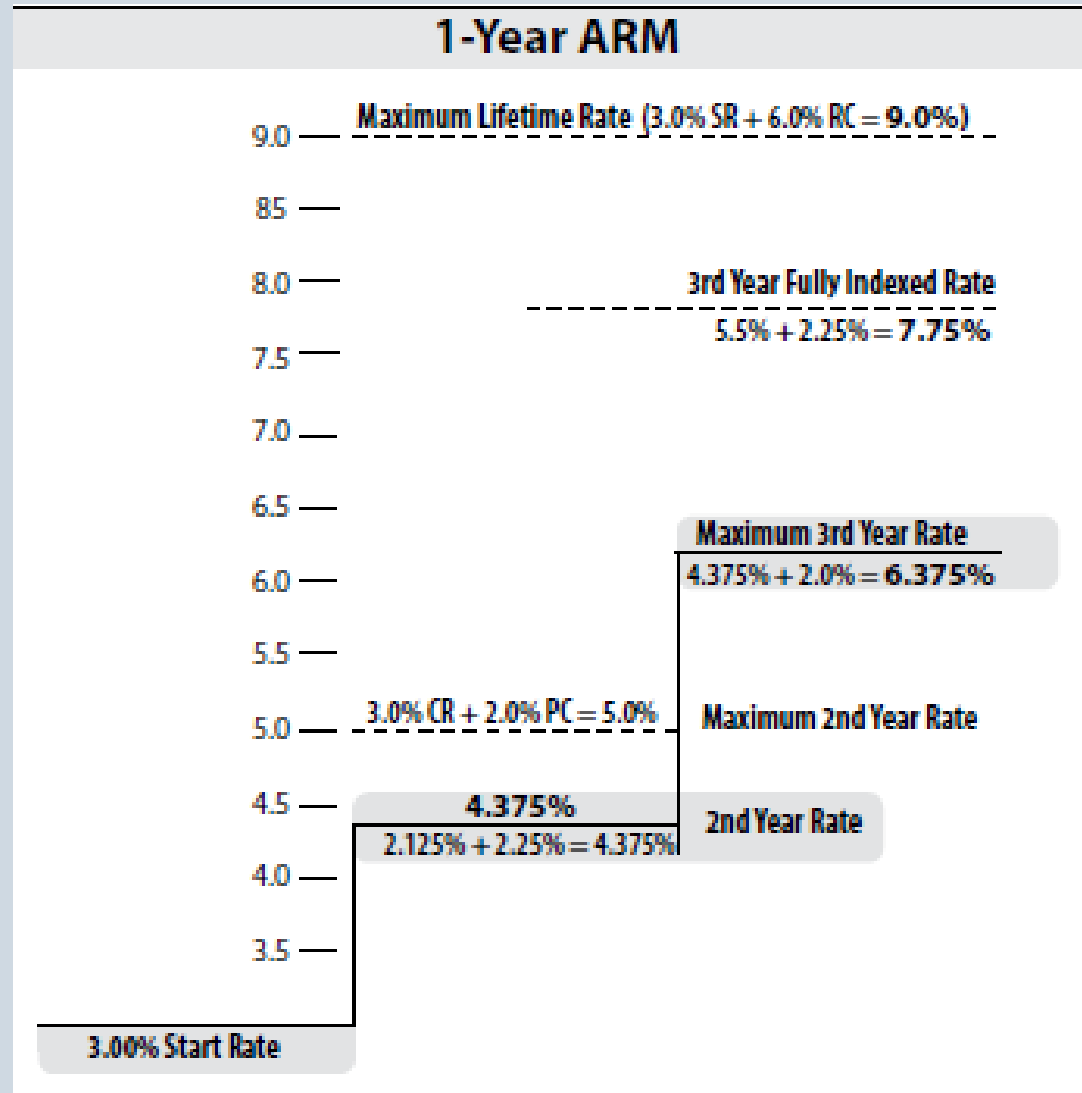
2. Match the term with the correct definition.

index	starting point for the adjustment of an ARM
margin	represents the lender's profit margin over the cost of money
fully indexed rate	interest rate calculated by adding the index and margin
rate adjustment period	length of time between, or frequency of, interest rate changes
rate cap	limits the amount the interest rate or payment on an ARM may change

Adjustable-Rate Mortgages

- **Four Caps**
 - Initial Rate, Periodic Rate, Lifetime Rate, Payment
 - 2/6 – periodic/lifetime
 - 5/2/6 – first adjustment/periodic/lifetime

Adjustable-Rate Mortgages



Activity 3.2 Apply Your Knowledge

1. Using the sample index, calculate the adjustments for an ARM offered at a start rate of 2.5% with a 2% margin and caps of 5/2/6.

1st adjustment = 5%

2nd adjustment = 5.5%

3rd adjustment = 7.5%

4th adjustment = 8.5%

5th adjustment = 8.5%

Activity 3.2 Apply Your Knowledge

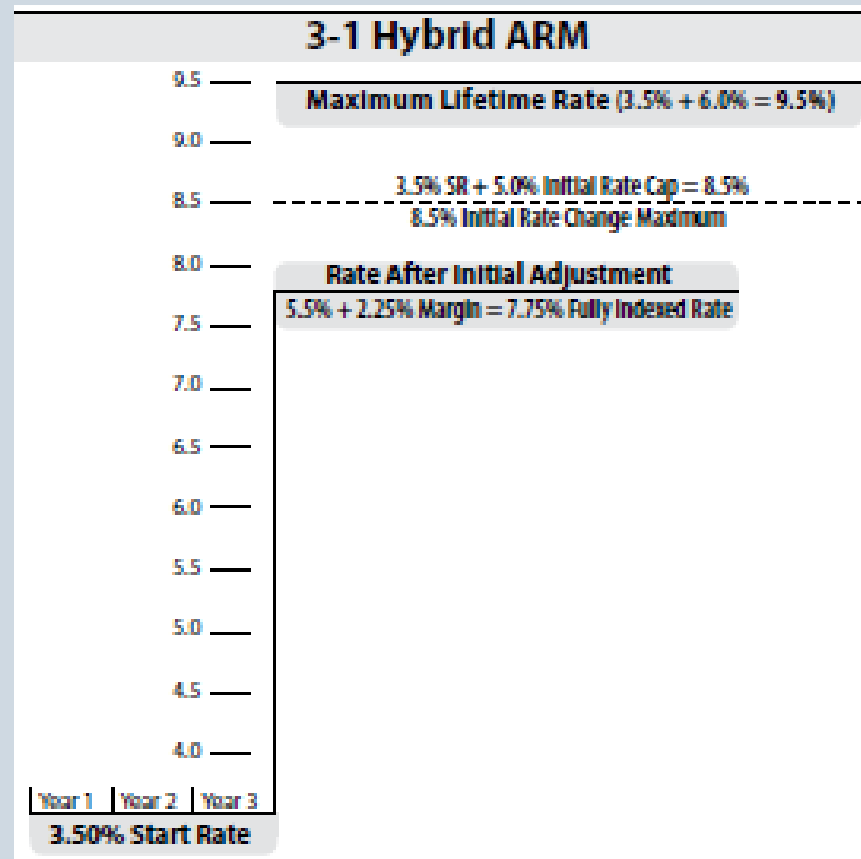
2. Would anything change in the previous example if the rate caps were 2/6 rather than 5/2/6?

Yes. The interest rate at first adjustment would be 4.5% instead of 5%

Adjustable-Rate Mortgages

- **Hybrid ARM**

- Initial fixed-rate period greater than one year (period)



Activity 3.3 Apply Your Knowledge

Assume a borrower gets a 1-year ARM for \$100,000 for 30 years. It has a 5/2/6 interest rate cap. The current index rate is 4.5%, the margin is 3%, and the discounted start rate is 4%.

Determine the interest rates and complete the table entries for years two through five.

- Year 2 = 9%
- Year 3 = 7%
- Year 4 = 9%
- Year 5 = 10%

Adjustable-Rate Mortgages

- **ARM Conversion Option**
 - Gives right to convert to a fixed-rate loan
- **ARM Underwriting Standardization**
 - Must follow secondary market standards to sell
- **MLO ARM Disclosures**
 - Must comply with TILA/Reg Z
 - CHARM; within 3 business days of application
- **Servicer ARM Disclosures**
 - 60 day notice for interest rate change with new payment; 7/8 months before payment is due at new rate

Activity 3.4 Knowledge Check

A lender is required to give the loan applicant the Consumer Handbook on Adjustable Rate Mortgages (CHARM), prepared by the Federal Reserve Board,

- A. at the time of the loan application.
- B. within three business days of loan application.
- C. within three business days of loan consummation.
- D. before or at loan consummation.

Reverse Mortgages

- **Product Description**
 - Convert accumulated equity to cash and additional debt without selling property or making payments
- **HECM Eligibility Requirements**
 - Must adhere to HUD's **initial disbursement** guidelines for HECM's insurance program
 - No **income** requirements; must consider ability to maintain property and pay taxes, insurance premiums, and HOA fees
 - All persons who have ownership interest in security property must be at least 62 years of **age**

Reverse Mortgages

- **Non-Borrower Spouse Succession**
 - Must be spouse at closing and remain spouse for duration of HECM mortgagor's lifetime
 - Must be properly disclosed to mortgagee at origination and specially named as a non-borrowing spouse in HECM documents
 - Must occupy and continue to occupy property as principal residence of the non-borrowing spouse
 - Failure to comply: Immediately due and payable
 - To continue to occupy: Establish legal ownership to the secured property within 90 days and meet all other loan conditions

Reverse Mortgages

- **Eligible Properties**

- Yes: Single-family, one-unit dwellings
- Maybe: Condos, PUDs, and manufactured homes
- Probably Not: Mobile home and cooperative units

- **Insurance and Ownership Requirement**

- Must maintain homeowners insurance policy sufficient to cover replacement value of collateral property
- Must be principal residence; debt on home should be paid off

- **Counseling Requirements**

- Prospective borrowers must participate in session by approved counselor before they apply

Activity 3.5 Knowledge Check

1. Property homeowner Alice must be at least ___ years old to qualify for a reverse mortgage.

- A. 55
- B. 60
- C. 62
- D. 65

Activity 3.5 Knowledge Check

2. HECM programs impose an additional condition on prospective borrowers by requiring them to participate in a consumer counseling session given by an approved counselor

- A. before they can apply for the loan.
- B. within three business days of loan application.
- C. within 10 days of loan consummation.
- D. prior to loan consummation.

Reverse Mortgages

- **HECM Payment Plans**
 - ARMs: Tenure, term, line of credit, modified tenure, modified term
 - Fixed: Single disbursement lump sum payment plan
- **HECM Amount Determining Factors**
 - Age of the youngest borrower or eligible non-borrowing spouse
 - Current interest rate
 - Lesser of appraised value or the HECM FHA mortgage limit or the sales price

Reverse Mortgages

- **HECM Costs**

- Closing costs, origination fee, mortgage insurance, servicing fee

- **Repayment Due**

- Last surviving borrower dies, sells the home, or ceases to live in home for 12 consecutive months
- Lender will allow up to 12 months for payment in the event of death
- Heirs cannot owe more than fair market sale price of home minus reasonable sales expenses

- **Immediate Repayment Circumstances**

Activity 3.6 Knowledge Check

1. Reverse mortgage origination fees paid to the lender for processing the HECM loan are limited to the greater of \$2,500 or 2% of the first \$200,000 of the home's value plus _____ of the amount over \$200,000.

- A. .05%
- B. 1%
- C. 2.5%
- D. 3%

Activity 3.6 Knowledge Check

2. A typical reverse mortgage becomes due when the last surviving borrower dies, sells the home, or ceases to live in the home for _____ consecutive months.

- A. 6
- B. 12
- C. 24
- D. 36

Other Nontraditional Products

- **Construction Mortgage**

- Interim, or short-term, temporary loan used to finance construction of improvements and buildings on land
- Disbursement Plans: Fixed, Voucher, Warrant
- Permanent Financing

- **Interest-Only Mortgage**

- Do not provide for loan amortization for a certain period of time
- Low payments; qualify for larger loan amounts
- Riskier; equity not built up

Other Nontraditional Products

- **Balloon Mortgage**
 - One large payment at the end of the loan term
 - Common feature of interest-only loans
- **15-Year Mortgage**
 - Fully amortizing 15-year fixed-rate mortgage loan
 - Lower rate, less overall interest, higher payments
- **Home Equity Loan**
 - Closed-end loan; regular payments for fixed term
- **HELOC**
 - Open-end loan with specific credit limit; can draw and payback principal only used

Activity 3.7 Knowledge Check

1. With a construction loan, what disbursement plan pays a percentage of funds at a set time?

- A. fixed disbursement plan
- B. voucher system disbursement plan
- C. warrant system disbursement plan

Activity 3.7 Knowledge Check

2. Which of the following statements are TRUE regarding an interest-only mortgage?

- A. Borrowers may only make a payment equal to the monthly accrued interest amount.
- B. Borrowers may want an interest-only mortgage to keep monthly payments low.
- C. Interest-only mortgages do not provide for loan amortization for a certain period of time.
- D. Investors who wish to flip properties may prefer an interest-only mortgage.

Activity 3.7 Knowledge Check

3. Fully amortizing 15-year fixed-rate mortgage loans offer

- A. higher interest rates, more overall interest over the loan term, and higher monthly payments.
- B. higher interest rates, more overall interest over the loan term, and lower monthly payments.
- C. lower interest rates, less overall interest over the loan term, and higher monthly payments.
- D. lower interest rates, less overall interest over the loan term, and lower monthly payments.

Activity 3.7 Knowledge Check

4. A home equity loan is

- A. closed-ended.
- B. open-ended.

FHA Loans

- **FHA-Insured Loan Programs**
 - Insures several different loan programs offered by private lenders
 - 203(b) mortgage insurance program or the Basic Home Mortgage Loan
- **FHA Loan Requirements**
 - FICO® score at least 580 = 3.5% down payment; between 500 and 579 = 10% down payment
 - MIP and DTI < 43%
 - Home borrower's primary residence
 - Steady income and proof of employment

FHA Loans

- **FHA Lending Limits**
 - Maximum loan amount FHA will insure
- **FHA Mortgage Insurance**
 - Both upfront (UFMIP) and annual (MIP) insurance required for all borrowers
 - UFMIP on 15- and 30-year purchase and refinance transactions for case numbers assigned on or after April 9, 2012 is 1.75% of the loan amount

FHA Loans

- Annual MIP

FHA Loans Over 15 Years

Base Loan Amount	LTV	Annual MIP	Duration
≤ \$625,500	≤ 95%	80 bps (0.80%)	11 years
≤ \$625,500	> 95%	85 bps (0.85%)	mortgage term
>\$625,500	≤ 95%	100 bps (1.00%)	11 years
> \$625,500	> 95%	105 bps (1.05%)	mortgage term

FHA Loans Up to 15 Years

Base Loan Amount	LTV	Annual MIP	Duration
≤ \$625,500	≤ 90%	45 bps (0.45%)	11 years
≤ \$625,500	> 90%	70 bps (0.70%)	mortgage term
>\$625,500	≤ 78%	45 bps (.45%)	11 years
>\$625,500	78.01% to 90%	70 bps (.70%)	11 years
> \$625,500	> 90%	95 bps (.95%)	mortgage term

FHA Loans

- **Recent Changes**

- Maximum LTV and CLTV for cash-out refinance reduced to 80%
- Single-unit approval conditions set
- Use of third-party verification services allowed
- Manual underwriting for files combining a score of under 620 and DTI over 43% now required

VA Loans

- **Description**

- Department of VA guarantees a portion of the loans for veterans, current service members, reservists, and their families
- No down payment or PMI, fee and closing cost limitations, no prepayment penalties, assumability

- **Blue Water Navy Act**

- Loan limits are lifted
- Increase in funding fees; waived for Purple Heart recipients
- Authorization for VA-designated appraisers to rely on third-parties for appraisal-related information

Activity 3.8 Knowledge Check

1. Borrower Ed has a FICO® score of 590. To gain the approval of an FHA loan, MLO Kim will need to require a down payment of

- A. 3.5%.
- B. 5%.
- C. 8.5%.
- D. 10%.

Activity 3.8 Knowledge Check

2. Ben is applying for a mortgage loan of \$150,000. His upfront mortgage insurance premium will be

- A. \$2,005.
- B. \$2,265.
- C. \$2,526.
- D. \$2,625.

Activity 3.8 Knowledge Check

3. Effective March 18, 2019, to better mitigate the risks involved with FHA loan files involving a combination of lower credit scores and higher DTIs, the Technology Open to Approved Lenders (TOTAL) Mortgage Scorecard now requires manual underwriting for FHA loan files combining a score of under 620 and DTI over

- A. 40%.
- B. 43%.
- C. 48%.
- D. 53%.

Activity 3.8 Knowledge Check

4. The Blue Water Navy Act, which was signed into law on June 25, 2019, extends disability benefits to military personnel who served on any vessel during the Vietnam War that came within _____ nautical miles of the coastlines of Vietnam.

- A. 8
- B. 10
- C. 12
- D. 14

CSBS/AARMR Guidance

- **Evolution of Popular Mortgage Loan Types**
 - Up to 1930s: Short term interest-only loans with balloon payments
 - 1930s thru early 1970s: 30-year fully amortizing loans
 - 1970s: Rise in ARMs
 - 1980s: Higher risk loan programs
 - 2006: Many mortgage products; low interest rates

CSBS/AARMR Guidance

- **Introduction of Interagency Guidance**
 - Lenders increased risks; borrowers don't understand
 - Resulted in final guidance on nontraditional mortgage product risks (interagency guidance)
- **Risk Management Guidance**
 - Policies
 - Controls
 - Risk Management Practices for Secondary Market
- **Guidance on Consumer Protection Issues**
 - Communications with Consumers
 - Control Systems

CSBS/AARMR Guidance

- **Loan Terms and Underwriting Guidance**
 - Qualifying Borrowers
 - Collateral-Dependent Loans
 - Risk Layering
 - Reduced Documentation
 - Simultaneous Second-Lien Loans
 - Introductory Interest Rates
 - Lending to Subprime Borrowers
 - Non-Owner-Occupied Investor Loans

CSBS/AARMR Guidance

- **Loan Terms and Underwriting Guidance**
 - Be extremely cautious with **reduced documentation loans**; form of underwriting that adds layer of risk
 - Take into account risks associated with **risk layering**; when one or more risk factors are present compensating factors must be present to offset the risk
 - Take into account risks associated lending to **subprime borrowers**; comply with applicable laws and assume responsible attitude

Activity 3.9 Knowledge Check

- 1. Sue Jones applies to Community Mortgage for an interest-only loan. Because she runs her tutoring business out of her home, she is unable to provide income documentation and chooses instead to utilize a stated income program offered by Community Mortgage. The combination of an interest-only loan with stated versus verified income is an example of**
- A. a collateral-dependent loan.**
 - B. fraud.**
 - C. risk layering.**
 - D. simultaneous second.**

Activity 3.9 Knowledge Check

2. What are features of a subprime loan?

- Excessive loan fees
- High interest rates
- Little or no verification of ability to repay the mortgage debt
- Low down payment requirements
- Lower FICO® scores allowed

Alternative Financing

- **Seller Financing**

- Seller extends credit to buyer to finance property purchase
- Dodd-Frank Act requirements
 - For 3 or fewer properties in any 12-month period
 - For 1 property in any 12-month period

- **Land Contracts**

- Real estate installment agreement where buyer makes payments to seller in exchange for right to occupy and use property
- No deed or title is transferred until all, or a specified portion, of payments have been made

Activity 3.10 Knowledge Check

1. Any deviation from the required seller financing guidelines gives the buyer a _____-year right of rescission to rescind the sale and demand all of the funds paid to be returned.

- A. one
- B. two
- C. three
- D. four

Activity 3.10 Knowledge Check

2. It is imperative that anyone considering any form of seller financing confirm that any existing mortgage has a(n)

- A. alienation clause.
- B. defeasance clause.

Alternative Financing

- **Other Forms of Creative Financing**
 - **Lease/Option:** Seller leases property to someone for specific term with option to buy property at predetermined price during the lease term
 - **Lease/Purchase:** Seller leases property for specific term with tenant agreeing to buy property at set price during or following lease term
 - **Equity Exchanges:** Value in one property being traded for value in another property
- **Homebuyer Assistance Programs**
 - Down payment assistance, subsidized interest rates, help with closing costs; offered by government/non-profit organizations or by lenders as part of CRA

Activity 3.11 Knowledge Check

1. A(n) _____ is when a seller leases property to someone for a specific term with the tenant agreeing to buy the property at a set price during or following the lease term.

- A. equity exchange
- B. lease/option
- C. lease/purchase
- D. tenant option

Activity 3.11 Knowledge Check

2. Which statements are TRUE about homebuyer assistance programs?

- A. Programs can include down payment assistance programs, subsidized mortgage interest rates, help with closing costs, or a combination.
- B. Programs may be offered by gov. or non-profit orgs.
- C. Programs may be offered by cities, counties, or states; money may be targeted to specific neighborhoods.
- D. Programs may offer both down payment assistance and interest rate subsidies through various agencies.
- E. Underwriting requirements may be the same as for FHA loans but interest rate is lower than an FHA loan.

Chapter Quiz

1. The Secure and Fair Enforcement for Mortgage Licensing Act defines a nontraditional loan as any loan other than a

- A. 15-year fixed-rate fully amortizing loan.
- B. 15-year variable-rate fully amortizing loan.
- C. 30-year fixed-rate fully amortizing loan.
- D. 30-year variable-rate fully amortizing loan.

Chapter Quiz

2. What limits the amount that the loan payment may change during the adjustment period of an ARM?

- A. initial rate cap
- B. lifetime rate cap
- C. payment cap
- D. periodic rate cap

Chapter Quiz

3. How would you describe a mortgage loan that starts at a 3% interest rate, goes to 5% after 3 years, 6% in year 4, and never goes above 8%?

- A. 3/1 ARM with caps of 1/5
- B. 3/1 ARM with caps of 2/5
- C. 5/1 ARM with caps of 2/5
- D. 5/1 ARM with caps of 2/1/5

Chapter Quiz

4. An ARM loan with a start rate of 3% and 2/5 caps can have a maximum interest rate of _____ over the lifetime of the loan.

- A. 5%
- B. 6%
- C. 7%
- D. 8%

Chapter Quiz

5. The type of mortgage where a borrower receives a monthly check rather than making scheduled payments to a lender is known as a

- A. budget mortgage.
- B. forward mortgage.
- C. fully amortizing loan.
- D. reverse mortgage.

Chapter Quiz

6. All of the following are available payment plans for adjustable rate HECMs EXCEPT

- A. line of credit.
- B. modified term.
- C. single disbursement lump sum.
- D. tenure.

Chapter Quiz

7. The UFMIP on 15- and 30-year purchase and refinance transactions for case numbers assigned on or after April 9, 2012 is _____ of the loan amount.

- A. 1.00%
- B. 1.50%
- C. 1.75%
- D. 2.50%

Chapter Quiz

8. What government agency insures home equity reverse mortgages?

- A. CFPB
- B. FHA
- C. FTC
- D. HUD

Chapter Quiz

9. Michael is a 50-year-old corporate executive earning a substantial income. He plans to retire in the next 10 years and wishes to purchase his last home. After speaking with Michael, MLO Kathy can tell he is fiscally conservative and wishes to retire with as little debt as possible. Which of the following loans should Kathy recommend to him?

- A. 5/1 ARM
- B. 15-year fixed-rate mortgage
- C. 30-year fixed-rate mortgage
- D. interest-only loan

Chapter Quiz

10. With a construction loan, what disbursement plan allows the contractor or borrower to pay her own bills and then submit the receipts to the lender for reimbursement?

- A. bill-paying disbursement plan
- B. fixed disbursement plan
- C. voucher system disbursement plan
- D. warrant system disbursement plan

Chapter Quiz

11. For an FHA loan, borrower Cindy has a FICO® score of 510. MLO Ron will need to require a down payment of

- A. 3.5%.
- B. 5%.
- C. 8.5%.
- D. 10%.

Chapter Quiz

12. Jan is applying for an FHA loan to borrow \$200,000. Her upfront mortgage insurance premium will be

- A. \$3,200.
- B. \$3,300.
- C. \$3,400.
- D. \$3,500.

Chapter Quiz

13. Which of the following loan products does NOT meet the definition of a nontraditional loan under the CSBS/AARMR Guidance on Nontraditional Mortgage Products Risks?

- A. fixed-rate loan
- B. hybrid ARM
- C. interest-only loan
- D. payment option ARM

Chapter Quiz

14. Combining nontraditional loans with reduced documentation is an example of

- A. risk and reward.
- B. risk layering.
- C. risk lending.
- D. risk management.

Chapter Quiz

15. Which scenario **BEST** describes a land contract?

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