Nontraditional Mortgages – Fixed Rate Products

Overview

This course summarizes a broad selection of non-traditional primarily fixed rate mortgages that have been introduced over the last 30 years. The mortgage types we will talk about include Buydowns, Construction permanent mortgages, Balloons, HELOCs and Reverse Mortgages.

© MortgageEducation.com | All Rights Reserved

Outline

I. Introduction

II. Buydown Mortgage

- A. Buydown Mortgage Features
  1. Temporary Buydown
  2. Permanent Buydown

III. Balloon Mortgage

- A. Balloon Mortgage Advantages
- B. Balloon Mortgage Potential Pitfall
  1. Payment Shock
  2. Market Risk
  3. Refinance Risk
  4. Interest Rate Risk

IV. Second Lien Loans, Second Mortgages

- A. Second Mortgage or Home Equity Loan
- B. Home Equity Lines of Credit
- C. Piggyback Mortgage
  1. Reduce Mortgage Insurance
  2. Reduce Overall Interest Rate

V. Construction Loan

- A Terms
- B. Construction-to-Permanent
- C. Rate-Lock

VI. Reverse Mortgage

- A. Types of Reverse Mortgages
  1. Single-purpose
  2. Federally-insured
  3. Proprietary
- B. Reverse Loan Features

VII. Payment Alternatives

- A. Term Loans
- B. Bi-Weekly Loan Plan

© MortgageEducation.com | All Rights Reserved

I. Introduction

This course discusses a number of products that are generally nontraditional fixed-rate products, though it is important to keep in mind that some of the products presented can be structured as or combined with an adjustable rate mortgage.

We will cover several different types of mortgages and discuss their construction and their pros and cons. The mortgage types we will talk about include:

- Buydowns
- Construction permanent mortgages
- Balloons
- HELOCs
- Reverse Mortgages
- Loans with Alternative Payment Structures

The SAFE Act defines a Nontraditional Mortgage Product as a mortgage loan that differs from a 30-year fixed-rate mortgage, what we will call an "FRM." Generally, the differentiating factor will be either (a) interest rate structure, (b) monthly or periodic payments, and/or (c) the terms of repayment.

A fixed rate mortgage has two unique characteristics.

a) It maintains a constant interest rate throughout its life (term). This means that when principal and interest are added together, the monthly payment is the same throughout the term.
b) The most common term is 30 years, but there are other terms available ranging from 10 years to 40 years.

The fixed interest rate is determined by the supply and demand for long term funds on a global basis, but is affected most directly by the U.S. Treasury's 10-year bond rate. A fixed rate mortgage (FRM) is designed to fully amortize (or pay off) the total amount borrowed by the end of its term. It also uses a calculation to determine a level monthly payment consisting of an amount to repay the principal and a separate amount to pay the interest that accrues on the borrowed amount.

Since each month the principal balance on the loan is reduced by a portion of the monthly payment, the interest that accrues on the loan in the following month is also reduced.

© MortgageEducation.com | All Rights Reserved

Therefore, in each subsequent month, a slightly smaller portion of the fixed monthly payment is needed to pay interest, so a larger portion of the monthly payment can be used to pay down the principal balance. The total monthly payment for the sum of principal and interest always stays level, but each month the interest portion drops and the principal portion rises by that same amount.

In the early months of a fully amortizing loan, a relatively small portion of the monthly payment is used to reduce the principal balance because a relatively large portion is needed to pay the interest charge. The total monthly payment stays level, but each month, the portion that goes toward the interest charge is reduced and the balance of the monthly payment is used to pay down the principal balance.

© MortgageEducation.com | All Rights Reserved

Standard Fixed Rate Loan Example

Assume a 30-year fixed rate loan (considered traditional according to the SAFE Act) for $100,000 carries a 6% annual interest rate, and the level monthly payment is $599.55. The monthly payment is determined using readily available software or a financial calculator.

In the first month, the interest cost is equal to $500.
(Because, **$100,000 x 6% / 12 months = $500**.)
Therefore, in the first month the amount used to pay down the principal balance is $99.55
(Because **$599.55 - $500 = $99.55**)
The new principal balance is $99,900.45
(Because **$100,000 - $99.55 = $99,900.45**)

In the second month, the interest cost is equal to $499.50
(Because **$99,900.45 x 6% / 12 months = $499.50**)
Therefore, in the second month the amount used to pay down the principal balance is $100.05
(Because **$599.55 - $499.50 = $100.05**)
The new principal balance is $99,800.40
(Because **$99,900.45 - $100.05 = $99,800.40**)

This process continues for the life of the loan. Each month the interest portion of the monthly payment is reduced, so the amount left to apply to the principal balance increases. The monthly payment stays level. The principal balance is gradually reduced.

© MortgageEducation.com | All Rights Reserved

II. Buydown Mortgage

A. Buydown Mortgage Features

The mortgage rate on a buydown is a fixed rate and it stays the same during the entire term of the loan. However, additional funds can be paid upfront when the loan is closed into an escrow account to lower the borrower's interest payment, which is stated at market rate. There are two general types of Buydowns:

TEMPORARY BUYDOWN

A temporary buydown lowers interest rates in the first 2-3 years. On a loan with an interest rate of 8%, a 2-1 buydown of 1% will lower first year rate to 6% the second to 7%. On the third year, the rate will return to 8%. A 3-2-1 buydown of 1% will lower the first year rate to 5%, the second to 6%, the third to 7%, while in the fourth year the rate will return to 8%.

A temporary Buydown can allow another party to help reduce the borrower’s initial mortgage payment, lowering the DTI ratio and thus helping the borrower to qualify for a loan. The lender, the borrower, the seller or some interested party who wants to make a gift to the borrower can all pay for the buydown. Sometimes lenders will lose money in the buydown process since they want to attract business and are eager to receive money upfront.

PERMANENT BUY-DOWN

A permanent buy-down lowers the interest rate permanently by allowing the borrower to pay a specific amount (often referenced as a “Discount Point”) to lower the interest payment on the loan. Few people actually keep a mortgage for 30 years. The question then is how long does it take to earn back the money paid to buydown the interest rate? In the case we discuss below, payback would come after five years and five months. After that, monthly savings turns into pure profit on the initial buydown. As long as a borrower plans to keep the home for a long period of time, using the buydown tends to be a better saving scheme than using the same buydown amount to instead reduce the outstanding principal. One thing to consider is that lower interest payment may lower the income tax deduction. The borrower should consult a tax specialist.

© MortgageEducation.com | All Rights Reserved

The basic monthly payment on a 30-year loan for $100,000 at 5.5 percent interest, excluding taxes, insurance, assessments or fees, would be $567. That covers only interest and principal. If a borrower could lower the rate by one-quarter of 1 percent, down to 5.25 percent, by paying one point or $1,000, the new payment would be $552.

Savings would be approximately $16 a month. That might not seem like a large amount until considered in the long term. If the borrower kept the loan for the full 30 years at 5.5 percent, he would pay a total of $104,403 in interest. At a 5.25 percent interest rate, the total interest would be $98,795, for a savings of $5,608 over 30 years. After subtracting the initial payment of $1,000, the net savings would be $4,608. It is important to remember that the borrower only achieves this level of savings if the borrower keeps the mortgage for 30 years.

© MortgageEducation.com | All Rights Reserved

III. Balloon Mortgage

A. Description

A balloon loan looks very similar to a 30-year FRM except that it matures much more quickly. At first, the payment on interest and principal is the same as an FRM. However, the mortgage is scheduled to mature after a specified period, usually 5-7 years. At this maturity date, this mortgage repayment includes the entire outstanding principal.

In mid 2000, a 15-year Balloon Loan became a popular way for borrowers to get a second lien mortgage so that they could pay less down to buy a house. Also, it allowed circumvention of the Private Mortgage Insurance ("PMI") payment.

B. Balloon Mortgage Advantages

The benefit of a Balloon Mortgage is that the interest rate is usually cheaper than a 30 year FRM and even an ARM. This is because the borrower is taking the refinance risk and more interest rate risk. Remember, "Higher Risk, Higher Potential Return."

Also, a borrower of a Balloon Mortgage can perhaps shop around to get better rates from another lender in the future or the borrower might get better rates in the future due to home price appreciation or improvement in credit quality

C. Balloon Mortgage Potential Pitfalls

Payment Shock. In the case of a 10 year Balloon Mortgage, at the maturity of the loan, the borrower might be faced with the possibility of paying back the entire principal at once if the borrower can't sell the house or can't refinance. For a $300,000 mortgage, at 4% interest, at the end of the 10th year, the principal due is about $240,000. It is not likely that a borrower will be able to repay the principal all at once. A Balloon Mortgage is risky for these reasons.

Market Risk. As discussed above, the borrower might need to sell the house in order to pay back the $240,000 principal. If the value of the house has fallen, the homebuyer might

© MortgageEducation.com | All Rights Reserved

not even be able to retrieve $240,000 from the sale of the house, thus having lost all of his initial investment. The borrower takes the risk that in 10 years he may have to pay the mortgage in full instead of paying it off in a 30-year repayment term.

Refinance Risk. Although the lender is subject to obligation to refinance the borrower, if the borrower's credit deteriorates or he has had late payments in the past, the lender can refuse to refinance the house.

Interest Rate Risk. In most balloon mortgage cases, the lender has an obligation to refinance the borrower. The refinance of the balloon mortgage usually would be priced at the current prevailing interest rate. Thus, if the interest rate has risen, the homeowner might face a much higher monthly mortgage payment. Note also that if the interest rate rises much higher than the original interest rate, then the lender might be permitted to re-qualify the borrower, which again means that the borrower has refinance risk.

© MortgageEducation.com | All Rights Reserved

IV. Second Lien Loans, Second Mortgages

This lesson deals with second liens. Second lien loans are secured by the value of the house, just like the primary mortgage. However, lenders who are in the first position have the primary lien against the property. They would be able to foreclose on the property should a borrower default because of their primary lien position. The second lien position relates to the amount of money loaned and that second position.

Second Mortgages represent two types of related risks.

(1) A secondary lien holder would find it much more difficult to foreclose on the property. This is why second mortgage interest rates are typically much higher than first mortgage rates, to compensate for the higher risk.
(2) Mortgages with small down payments represent a greater risk to the lender because a borrower with a lesser vested interest in the property may simply walk away (default) in the event of severe financial trouble.

Some second mortgages are for a fixed dollar amount paid out at one time, in the same way as a first mortgage. As with first mortgages, such second mortgages may be fixed-rate or adjustable-rate. Below are some categories of Second Lien Loans.

A. Second Mortgage or Home Equity Loan

Equity is the difference between how much the house is worth and how much the borrower owes on the mortgage. A mortgage secured by the difference between value of the house and value of the first mortgage is sometimes called a Home Equity Loan (HEL) or, equivalently, a second mortgage.

There are many reasons for borrowers to get a second mortgage including:

- Capitalizing on the fact that their home value has increased
- Implementing home improvements
- Using the money for other investments

© MortgageEducation.com | All Rights Reserved

- Consolidating costlier debt such as credit card debt
- Using the extra cash to manage a small business.
- Funding the down payment for the house. Note that this type of second lien loans is typically referred to as Piggyback Mortgage.

B. Home Equity Lines of Credit (HELOC)

Some second mortgages are structured as a line of credit rather than the fixed dollar amount used for HELs. These mortgages appeared in 1980s and are still offered today. With a Home Equity Line of Credit (HELOC), borrowers can draw up to a certain amount on the loan when and as they please. HELOCs always use an adjustable rate and tend to have short maturities. Homeowners with a HELOC run the risk of the bank not renewing the line.

C. Piggyback Mortgage

A piggyback mortgage is actually a package of two loans, one added on top of the other. For residential properties, that usually means a first mortgage which covers 80% of the value of the property, plus a second lien which covers 10%, 15% or even the whole remaining 20% of the value of the home. The second loan -- which can be either fixed- or adjustable-rate -- is 'piggybacked' on top of the first loan. Typical loans are 80-10-10 and 80-15-5, indicating the percent first lien, percent second lien and down payment. For example, an 80-15-5 would have a 5% down payment, with 80% of the debt in a first lien and 15% in a second lien.

The second lien will likely amortize in 10, 15 or 20 years, or may be packaged as a "balloon."

Pros of Piggyback Loans

Avoid Private Mortgage Insurance (“PMI”). PMI helps to indemnify the lender by covering a portion of the value of the property. If the borrower defaults, the MI will usually cover the costs of foreclosing on and repairing the property, as well as the costs for selling it. MI is generally required for a loan with an LTV above 80% and the premiums are not tax deductible.

With a Piggyback Mortgage, the homeowner can avoid paying for PMI. If the first lien on a home is 80% LTV that loan will no longer need MI. A second lien will replace the amount

© MortgageEducation.com | All Rights Reserved

borrowed above the 80% LTV amount and this second lien does not require MI. Though nothing is free and the second lien interest rate will be high, the additional interest is also tax-deductible, providing another benefit.

Reduce Overall Interest Rate. Typically, if the lender must accept more risk, the borrower will have to pay a "risk premium" in the form of a higher rate, higher fees, or both. Twenty years ago, lenders were not eager to make loans in excess of an 80% Loan-to-Value ratio, since they couldn't easily be sold to the secondary market. Lenders would have to keep the loan and all of the risk of delinquency or default for the entire term. Instead of paying the one-eighth to one-quarter percent premium typically found on a jumbo mortgage's price, the borrower instead receives a lower interest rate for much of his loan and only a small portion carries a higher interest rate. A jumbo loan is defined as any loan with a loan amount that exceeds the conforming loan limit. This amount can change annually or at any time as communicated by Fannie Mae or Freddie Mac. Currently the conforming loan limit is $417,000.

© MortgageEducation.com | All Rights Reserved

V. Construction Loan

Borrowers will sometimes commission someone to build a house or they may purchase one that is already under construction. In that parameter there is a construction-permanent mortgage program available.

Construction loans are Story loans. That means that the lender has to know the story behind the planned construction before they are willing to lend money. Since a construction loan is a story loan, the loan is not standardized like mortgage loans underwritten to Freddie Mac or Fannie Mae guidelines. Loans may be structured as a one-time close or as a construction to permanent mortgage that will allow approval of not only the construction loan but also the end loan or permanent mortgage. These loans are approved based on Freddie Mac or Fannie Mae credit underwriting guidelines (more on Construction-Perm discussed later in text).

Terms

Construction loans typically require interest-only payments during construction and become due upon completion. Completion for homeowners means that the house has its certificate of occupancy. Construction loans are usually variable-rate loans priced at a spread to the prime rate or some other short-term interest rate. The contractor (same as the borrower in this case) and the lender establish a draw schedule based on stages of construction and interest is charged on the amount of money disbursed to date.

A construction loan, unlike a mortgage, isn't meant to be around for a long time. During the construction period, because of the IO feature, delay caused by construction is not too costly for homebuyers. The term of a construction loan can range from 5 to 30 years. Construction loans can be an adjustable or fixed-rate mortgage.

Another variable in construction loans is how much of the project cost the lender is willing to lend. If the borrower already owns the land, then that land can be considered as equity on the construction loan. Unlike the purchase of an existing home, a lender considering a construction loan takes into account the FUTURE value of the house to determine LTV. Therefore, information such as contractor approval, material cost, building material and permit costs are used by the appraiser to make determination of the post-completion value.

Note: to fix up a run down property, there is also a government sponsored rehabilitation program which provides up to 96.5% financing of the cost to purchase or refinance a

© MortgageEducation.com | All Rights Reserved

primary residence. Constructions of many types can qualify for such loan except that the foundation of the house should remain unchanged. LTV will be based on future value of the property.

These loans are offered by the Federal Housing Administration and are called FHA 203k loans they are available for purchase or refinance of a primary residence. They can be a "full" loan where expenses eligible to be included in the cost of rehabilitation are materials, labor, contingency reserve, overhead and construction profit, up to six (6) months of mortgage payments, plus expenses related to the rehabilitation such as permits, fees, inspection fees by a qualified home inspector, licenses and consultant and/or architectural/engineering fees. Or a "streamline" loan where the maximum rehabilitation costs are $35,000 and no structural repairs are made. All rehabilitation additions or construction must comply with cost effective energy conservation standards and have smoke detectors in each sleeping area.

There are many details to know and understand in originating 203k loans and you are advised to research this product and the guidelines before offering it to consumers. [1]

Construction-to-Permanent

Many homeowners use construction-to-permanent financing programs where the construction loan is converted to a mortgage loan after the certificate of occupancy is issued. The advantage is that the contractor only needs one application and has one closing. Some construction loans packages also include Lot Purchase; i.e. - buying the land. Borrowers sign only one set of loan documents and do not have to worry about re-qualifying, re-appraisals, additional closing costs or signing additional loan documents.

Rate-Lock

The borrower can purchase a rate-lock agreement valid through the expected completion of the construction. The use of a rate-lock will depend on the borrower's view on interest rate trends; however, the borrower should also take into account inevitable construction delays. It may be beneficial for a borrower to pay a higher rate on the construction loan if he is doing construction-to-permanent financing and can get better mortgage terms or a longer, better rate lock from that lender.

[1] http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/203k

© MortgageEducation.com | All Rights Reserved

VI. Reverse Mortgage

Whether they are seeking money to finance a home improvement, pay off a current mortgage, supplement their retirement income, pay for healthcare expenses or even utilize equity to purchase a new home, some older Americans utilize "reverse" mortgages. These mortgages allow older homeowners to convert part of the equity in their homes into cash without having to sell their homes or take on additional monthly expenses.

In a regular mortgage, borrowers make monthly payments to the lender. In a "reverse" mortgage, borrowers receive money from the lender and generally do not have to pay it back for as long as they live in their home. Instead, the loan must be repaid when they either die, sell their home, do not maintain residence for 12 consecutive months, do not provide necessary repairs or do not pay applicable real estate taxes and insurance. Reverse mortgages can help homeowners who are house-rich but cash-poor stay in their homes and still meet their financial obligations.

To qualify for most reverse mortgages, the borrower and all other persons on the title must be at least 62 and live in their home (Owner Occupied Only). The proceeds of a reverse mortgage (without other features, like an annuity) are generally tax-free, and many reverse mortgages have no income restrictions.

A. Types of Reverse Mortgages

Single-purpose reverse mortgages. Offered by some state and local government agencies and nonprofit organizations

Single-purpose reverse mortgages generally have very low costs; However, they are not available everywhere and they only can be used for one purpose specified by the governmental agency or nonprofit lender, for example, to pay for home repairs, improvements, or property taxes. In most cases, borrower(s) can qualify for these loans only if their income is low or moderate.

Federally-insured reverse mortgages. Known as Home Equity Conversion Mortgages (HECMs), (See Below) and are backed by the U. S. Department of Housing and Urban Development (HUD)

HECMs and proprietary (see below) reverse mortgages tend to be more costly than other home loans. The up-front costs can be high, so they are generally the most expensive if the

© MortgageEducation.com | All Rights Reserved

Borrower(s) stay in their home for just a short time. They are widely available, have no income or medical requirements, and can be used for any purpose.

Before applying for a HECM, the borrower must meet with a counselor from an independent government-approved housing counseling agency (HUD only). The counselor must explain the loan's costs, financial implications, and alternatives. For example, counselors would tell the borrowers about government or nonprofit programs for which they may qualify, and any single-purpose or proprietary reverse mortgages available in their area.

The amount of money the borrower can borrow with an HECM or proprietary reverse mortgage depends on several factors, including their age, the type of reverse mortgage they select, the appraised value of their home, current interest rates, and where they live. In general, the older they are, the more valuable their home, and the less they owe on it, the more money they can borrow.

The HECM gives a borrower choices in how the loan is paid to them. They can select fixed monthly cash advances for a specific period or for as long as they live in their home. Or they can opt for a line of credit, which allows them to draw on the loan proceeds at any time in amounts that they would choose. They also can get a combination of monthly payments plus a line of credit.

In the HECM program, the loan is not due and payable until either:

- The borrower no longer occupies the property for 12 consecutive months
- The borrower fails to pay either property taxes or hazard insurance
- The home is not maintained in an acceptable condition
- The borrower dies

Proprietary Reverse Mortgages. Private loans backed by the companies that develop them.

Private Reverse Mortgages are structured similarly to HECMs. HECMs generally provide larger loan advances at a lower total cost compared with proprietary loans. But owners of higher-valued homes may receive bigger loan advances from a proprietary reverse mortgage. That is, if Borrower(s) have a higher appraised value without a large mortgage, then they may likely qualify for higher Loan Amounts.

B. Reverse Loan Features

© MortgageEducation.com | All Rights Reserved

Reverse mortgage loan advances are non-taxable, and generally do not affect Social Security or Medicare benefits. The borrower retains the title to their home and does not have to make monthly repayments. The loan must be eliminated (this could mean the loan is repaid or that title is transferred) when the last surviving borrower dies, sells the home, or no longer lives in the home as a principal residence.

When originating reverse mortgages, MLOs must be aware that:

- Lenders generally charge origination fees and other closing costs for a reverse mortgage. Lenders also may charge servicing fees during the term of the mortgage. The lender generally sets these fees and costs.

- The amount the borrower owes on a reverse mortgage generally grows over time. Interest is charged on the outstanding balance and added to the amount a borrower owes each month. That means that total debt increases over time as loan funds are advanced and interest accrues on the loan. In addition, for Home Equity Conversion Mortgages (HECM), the outstanding principal balance will also grow with the mortgage insurance that is required for the life of the loan.

- Reverse mortgages may have fixed or variable interest rates. Most have variable rates that are tied to a financial index and a margin is added by the lender and will likely change according to market conditions.

- Reverse mortgages can use up all or some of the equity in a borrowers home, leaving fewer assets for them and their heirs. A “non recourse” clause, found in most reverse mortgages, prevents either the borrower or their estate from owing more than the value of their home (collateral) when the loan is repaid.

- Because the borrower retains title to his or her home, they remain responsible for property taxes, insurance, utilities, fuel, maintenance, and other expenses. So, for example, if they don’t pay property taxes or maintain homeowner’s insurance, the borrower will risk the loan becoming due and payable.

- Interest on reverse mortgages is not deductible on income tax returns until the loan is paid off in part or whole.

© MortgageEducation.com | All Rights Reserved

VII. Payment Alternatives

In this session we have discussed various alternative mortgages types. One thing to realize is that, though many of the products we've mentioned have standard terms associated with them, there are additional variant terms and payment structures that can be tailored toward a borrower. We briefly discuss two different scenarios below.

A. Term Loans

These were the first types of home loans offered prior to the 1930's and are for shorter periods of 3 to 10 years. They require monthly interest-only payments. They are non-amortizing so the beginning loan balance is the same at the end of the loan. In order to qualify a borrower generally had to demonstrate the ability to pay off the full balance by the end of the loan.

Payment Shock. Not surprisingly, similar to the case of a Balloon Mortgage, there is significant payment shock associated with paying the balance off in full at maturity. Additionally there is a risk that the homeowner has significant difficulty refinancing or, at worst, face foreclosure in an instance where the house has lost equity and does not have the funds to fill the equity gap.

B. Bi-Weekly Loan Plan

A Bi-Weekly loan plan is an arrangement where borrowers make ½ of the normal monthly payment every other week instead of once each month. Because there are 52 weeks in a year, or 26 bi-weekly payments of ½ the monthly amount, the borrower actually makes the equivalent of 13 full payments per year.

This extra payment each year means that a borrower can pay off a standard 30-year amortized loan 7 to 8 years sooner. The main reason the loan is paid off much sooner is due to the extra payment per year. A second, lesser, effect is the fact that there is a small reduction in accrued interest from the borrower making multiple payments per month.

© MortgageEducation.com | All Rights Reserved

Fraud. While a bi-weekly loan plan is a valid concept, it has been hampered by a number of scams and by misinformation. Few lenders offer a true bi-weekly loan product but rather charge a fee to accept the bi-weekly payment and then place it in an escrow account. They use these funds to make the normal monthly payment. The result is that the borrower is still paying off the loan in a normal time-frame but may not know it.

There are third parties, as well, that will offer to make a bi-weekly loan plan, but do this similarly by placing funds in an escrow and only making a full additional monthly payment once a year when there are sufficient accumulated funds. This may help borrowers who want to manage their cash flow, but also may be a service that is not even needed or desired.

If a borrower wants to pursue this type of payment method, clear representation and explanation is critical. One way to accomplish this structure is for the borrower to make sure the lender will accept additional principal payments (without a prepayment penalty) and then submit an extra check **marked for principal reduction** when the funds are available.

© MortgageEducation.com | All Rights Reserved