Mortgage Basics

Types of Mortgages

- Types of Collateral:
  - Residential
    - 1 to 4 family homes (up to 4 units)
  - Commercial
    - Larger apartments & non-residential
- Permanent vs. Construction
  - Perm on completed existing buildings
  - Construction loans finance development projects

Government Involvement

- Government-Insured (FHA, VA)
  - Include “mortgage insurance”, allows higher L/V ratio
  - More “red tape”, longer approval process
  - No “due-on-sale” clause, may be assumable
- Conventional
  - Normally max L/V=80%, unless private mortgage insurance (PMI)
  - Majority of all loans

Terminology

- <u>Owner</u> begins with "O", so: "...or" ===> Owner
- "Lessor" is Owner (Landlord), "Lessee" is Renter.
- "Mortgagor" is Owner (Borrower), "Mortgagee" is Lender.

Legal Structure of Mortgages

- Mortgages have 2 parts (documents):
  - **Promissory Note**: Contract establishing debt.
  - **Mortgage Deed**: Secures debt with real property collateral (potentially conveys title).
- Two legal bases of mortgages:
  - "Lien Theory" (most states): borrower holds title, lender gets lien.
  - "Title Theory" (a few states): Lender holds title.

TYPICAL COVENANTS & CLAUSES

1) **Promise to Pay**

   Specifies principal, interest, penalties, etc., along with date, names, etc.

2) **Covenant to Avoid Liens w Priority over the Mortgage**

   For example, if borrower fails to pay property tax, she is in default of mortgage too, because property tax lien has priority over mortgage lien.

3) Hazard Insurance

Borrower must insure value of the property (at least up to mortgage amount) against fire, storm, etc.

4) Mortgage Insurance

Borrower must hold mortgage insurance (usually only if loan is not Govt insured and Loan/Value ratio > 80%). In essence, mortgage insurance will pay lender the difference between foreclosure sale proceeds and the debt owed to lender, if any. In effect, Govt (FHA, VA) loans automatically have mortgage insurance from the Govt.

5) Escrow

Borrower required to pay insurance and property tax installments to lender in advance, who holds funds in escrow until due to insurer and property tax authority, when lender pays these bills for the borrower.

6) Order of Application of Payments

First to penalties and expenses, then to interest, then to principal balance. (This implements the “4 Rules”.)

7) Good Repair Clause

Borrower must maintain property in good repair.

8) Lender's Right to Inspect

Lender has right to enter property, with prior notice and at the owner’s convenience, to verify that borrower is keeping property in good repair.

9) Joint & Several Liability

Each party signing the mortgage is individually completely liable for the entire mortgage debt.

10) Acceleration Clauses

Allow lender to make the entire outstanding loan balance due immediately under certain conditions. Normally applied to default (to enable lender to sue for entire loan balance in foreclosure) and to implement a “due-on-sale” clause.

11) "Due-on-Sale" Clause

Lender may accelerate loan when/if borrower transfers a substantial beneficial interest in the property to another party. This normally prevents mortgage from being “assumed” by a buyer of the property. Govt insured loans (FHA, VA) usually do not have this clause, but most conventional residential mortgages do. Results in “demographic prepayment” (as distinguished from “financial prepayment”) of residential mortgages.

12) Borrower's Right to Reinstate

Allows borrower to stop the “acceleration” of the loan under default, up to time of court decree, upon curing of the default (payment of all back payments and penalties and expenses required under the loan terms).

13) Lender in Possession

Provision giving lender automatic right of possession of the property in the event of default on the loan. Enables lender to control leasing and care & maintenance of the building prior to completion of the foreclosure process.

14) Release Clauses

States the conditions for freeing the real property collateral from the loan security (e.g., when debt is paid off the lender must release the property by returning the mortgage deed and extinguishing the lien or returning the title to the borrower). More complicated release provisions are involved in loans in which the collateral will be sold of gradually in parts or parcels.

15) Estoppel Clause

Requires borrower to provide lender with a statement of the remaining outstanding balance on the loan. This provision is necessary to enable loan to be sold in the secondary market, as the identity of the “lender” (that is, the current owner or holder of the mortgage asset) will change as the mortgage is sold in the secondary market.

16) Prepayment Clause

Provision giving the borrower the right (without obligation) to pay the loan off prior to maturity, like “callable” bonds. This effectively gives the borrower a call option on a bond, where the bond has cash flows equivalent to the remaining cash flows on the mortgage, and the exercise price of the option is the outstanding loan balance (plus prepayment penalties) on the mortgage (i.e., what one would have to pay to retire the debt).

17) Lender's Right to Notice (Jr Loans)

A provision in junior loans requiring the borrower to notify the lender if a foreclosure action is being brought against the borrower by any other lien-holder. Junior lien-holders may wish to help to cure the default or help work out a solution short of foreclosure, because junior lien-holders will stand to lose much more in the foreclosure process than the senior lien-holder.

18) Subordination Clause

A provision making the loan subordinate to (that is, lower in claim priority in the event of foreclosure than) other loans which the borrower obtains subsequent to the loan in question. Often used in seller loans and subsidized financing, to enable the recipient of such financing to still obtain a regular first mortgage from normal commercial sources.

19) Future Advances

Provision for some or all of the contracted principal of the loan to be disbursed to the borrower at future points in time subsequent to the establishment (and recording) of the loan. This is common in construction loans, where the cash is disbursed as the project is built.

20) Covenant against Removal

Borrower (property owner) is not permitted to remove from the property any part of the collateral, such as fixtures attached to the building.

21) Personal Property Clauses

Provisions including in the collateral specified items of personal property (as opposed to the real property that is automatically included in the mortgage deed). “Real property” includes land and any structures and fixtures attached to the land. “Personal property” includes movable, non-fixed items such as furniture, most appliances, cars, boats, etc.

22) Owner Occupancy Clause

Requires borrower to live in the house.

23) Sale in One Parcel Clause

Prevents the collateral property from being broken up into parcels sold separately.

24) Exculpatory Clause

Removes the borrower from responsibility for the debt, giving the lender “no recourse” beyond taking possession of the collateral which secures the loan. Without an exculpatory clause, the lender can obtain a “deficiency judgment” and sue the borrower for any remaining debt owed after the foreclosure sale.

etc., etc. . . .

Anything the borrower and lender mutually agree on to include in the contract.