

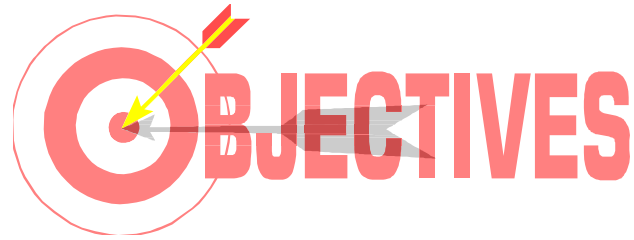
# LESSON SEVEN

## ALTERNATIVE REAL ESTATE LOAN INSTRUMENTS



# STUDENT LEARNING OUTCOMES

(SLOs):



- 1. List and define five basic types of alternative rate real estate loan instruments.*
- 2. Give three reasons for using adjustable rate mortgages.*
- 3. Identify the common purpose behind the GPM, ROM, and SAM loan types.*
- 4. Explain the meaning and use of negative amortization.*
- 5. Explain what is meant by lenders "borrowing short and lending long."*

# I. Adjustable Rate Mortgage (ARM)

A. Adjustable = Variable

B. Types of Adjustable or Variable Rate Plans

1. ARM – adjustable rate mortgage

a. GPM – graduated payment mortgage

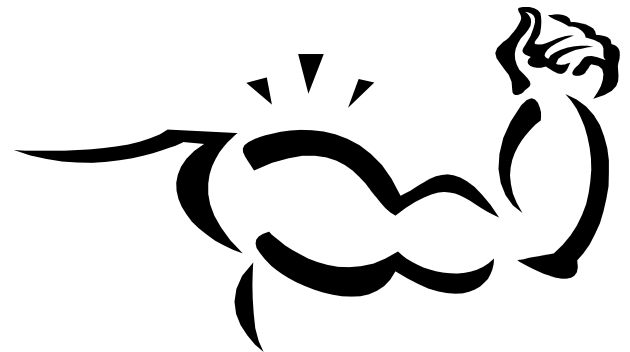
2. **AML** – adjustable mortgage loan

3. ROM – rollover mortgage

4. GPARM – graduated-adjustable rate mortgage

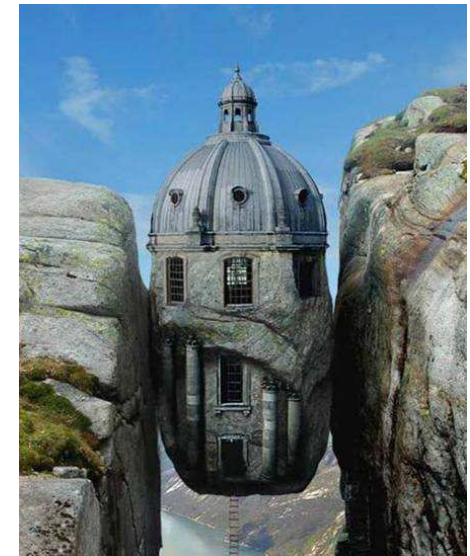
5. Two-Step

6. VIR – variable interest rate



# Adjustables:

1. Interest rate **tied to** some index
2. Amount of payment
3. Outstanding principal loan balance, includes negative amortization
4. **Term** of loan
5. Maximum LTV ratio
6. Any **combination** of the variables.





## C. Cal-Vet

- The California Department of Veterans Affairs that has used adjustable rates for its Cal-Vet home and farm loan programs almost since its inception
- Veteran benefits have been expanded to include eligibility for war-time and peacetime home loan programs.

## II. Why Use Adjustable/Variable Interest Rates?

### A. Variables/Adjustments

1. Rapid changes in rates
2. Reduced availability of money

### B. Dilemma: lender lends for long term and borrows for short periods, called “borrowing short & lending long”





## C. General Features

### 1. Notification

- a. Borrowers notified at least 60 days prior, but
- b. Not less than 45 days prior to any change in the contract interest rate

### 2. Indexing – “cost of money”

- a. COFI

### 3. Rate changes

- a. Up
- b. Down
- c. Cap – **Annual** and **lifetime** interest rate cap
- d. Deferred interest – **increase** in loan balance

# III What is Negative Amortization?

- A. The loan payment is first applied to the interest, and any remainder applied to the principal.
- ❖ Interest only = straight note. No principal paid
  - ❖ Deferred interest. Payment is less than the interest that is currently due. Increases loan balance.
  - ❖ Negative amortization. When unpaid interest is added to loan balance.



# Negative Amortization

- B. Negative amortization used for graduated payment mortgages.
  - 1. Owner unable to make larger payment when the increase occurs
  - 2. Property value has not kept up with increase in negative loan balance.

## IV. Adjustable Rate Mortgage (ARM)

- A. Assists buyers (especially first-time home buyers) in qualifying through **lower payments** at the beginning of the loan.
- B.
  1. Allows lender to make **changes** in rate at periodic, agreed upon intervals.
  2. Requires lender to provide borrower example of how payment could change, based on **actual** historical data or on the index.
  3. Borrower given annual **notification**
  4. VRM & VIR replaced by ARM

## Advantages of ARMs

1. The initial rate is usually lower when compared to fixed-rate loans.
2. Loan charges are usually less than those of fixed-rate loans.
3. It is easier to qualify for home loans because of initially lower payments.
4. When rates decline, there is no need to refinance.
5. Usually more attractive terms, such as lower origination charges, no prepayment penalties, and assumption rights.

## Disadvantages of ARMs

1. The rate of growth in property value may not keep up with the rate of increase in the interest rate.
2. The risk of rising interest rates is borne by the borrower.
3. Buyer's income may not increase at the same rate as the increase in loan payments.
4. Excessively high payments may cause default and possible foreclosure.
5. Possibility of negative amortization which may reduce the equity created by market appreciation and / or past payments.

# ARMs

## V. Renegotiable Rate Mortgage (**RRM**)

- A. Allows lender to make short term real estate loans at **fixed** rates.
- B. 1. Guaranteed **renewable**  
2. Benefits borrower & lender  
3. Rollover mortgage (ROM)





## VI. Graduated Payment Mortgage (GPM)

- A. Allows borrower to tailor loan payments to expected increases in future income.
- B.
  1. Payments start low, increase at predetermined % and time
  2. Borrower selects from plans: increase 2 1/2%, 5%, 7% at 5 to 10 years
  3. Borrower qualifies for loan that gets them more house.
  4. Attractive for first-time home buyers
  5. Popular with FHA 245 program
  6. Fully amortized
  7. Borrower knows in advance of changes

## VII. Graduated Payment Adjustable Rate Mortgage (GPARM)

- A. Provides partially defined payments of principal at start of the loan. Increases in future years.
- B. 1. Assists borrowers with future incomes that are expected to grow  
2. both interest rate & monthly payment fluctuates.



## VIII. What is a BALLOON PAYMENT MORTGAGE (BPM)?

- A. For lenders who want to recover the loan principal faster.
- B.
  1. Straight loan or term loan
  2. 1-15 year loan, **amortized** over 40 yrs
  3. Unpaid loan balance due at pre- agreed period, i.e. 15 years
  4. No guarantee of renewal
  5. Interest **rate fixed**, may be a variable rate balloon



# IX. SHARED APPRECIATION MORTGAGE (SAM)

- A. Long-term, **fully amortized** loan with below-market interest rate where lender participates in the property **appreciation**.
- B. 1. shared-equity mortgage used for
- commercial & income property
  - Home finance during tight money or excessively high interest rates

## 2. Assists buyers who

- cannot qualify at market rate
- Want a subsidized rate and will make the trade-off for lender participation in the future growth

# X. TWO-STEP MORTGAGE

- A. Allows home buyer to qualify based on **lower** interest rate; **lower** payments
- B. 1. **fixed** interest **rate** that is lower than a 30 year loan, but only for the first 5-7 yrs
2. Payments amortized over 30 years
3. After the initial fixed rate

- the current prevailing rate
- Lifetime ceiling set at loan origination
- The balloon will come from the same lender, only at a different rate at time of conversion (5-7 years)

4. Loan limit set by Fannie Mae

5. Fannie Mae requires **10%** down payment; new rate based on 10-yr Treasury Bond Index, with interest cap of 6 points above initial rate; no additional fees; new rate cannot change for the balance of the loan period (25 or 23 yrs).





## IX. REVERSE ANNUITY MORTGAGE (RAM)

- A. For retired or nearly-retired homeowners who use the **equity** in their home to provide income.
- B.
  1. Lender pays home owner a fixed annuity based on % of appraised value & home owner age from insurance actuarial table.
  2. Based on home **equity** not borrower income
  3. payments may be: **annuity, lump-sum, combination**, or line of credit.
  4. Repayment at time of sale or death
  5. Does not affect social security, medicare or retirement benefits. Ram not included as income receipt.

## XII ACCELERATED PAYMENT PLANS

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

