Chapter 16: Financing

An * in the left margin indicates a change in the statute, rule or text since the last publication of the manual.

I. Introduction

Financing is the linchpin for most real estate transactions. Over the years institutional lenders have increased the amount of loan in relation to value of security and have made loans for a longer term under a program of monthly amortization of the principal. Real estate loans in the 1920s and early 30s were normally not amortized, the full amount of principal being payable at expiration of loan term, usually from three to ten years. Many homeowners lost their property during the depression because they were unable to make full payment of the loan.

A loan may be considered the renting of a certain sum of money by a lender to a borrower to be repaid with or without interest. A real estate loan secures the repayment with real property.

Nearly all real estate transactions require some form of financing. Larger loan-to-value ratios enable buyers to purchase with smaller equity, thereby allowing more individuals to become property owners. Also, there is less need for second mortgages. Elimination of second mortgages allows sellers to obtain their entire equity at the time of sale and permits a more orderly repayment program for the buyer. The reduced equity requirements have encouraged the purchase of property.

One method of financing is for the purchaser to **assume** and agree to pay a loan that already encumbers the property. In such a case the broker should examine the trust deed or mortgage to see if there are any limiting provisions concerning the lender's right to change the terms of the loan. The broker should also advise the seller that they might remain personally responsible for the loan if the purchaser defaults. Sometimes a lender will release a seller from personal responsibility if the assumer of the loan is an acceptable credit risk.

However, new financing is the most frequent necessity in a real estate sale. Although private lenders occasionally make loans, most involve established lending institutions. The buyer normally makes a written application and the lender orders an appraisal of the property, evaluates the applicant's credit rating and the merchantability of title. If the lender offers a loan "commitment," Colorado law requires that such commitment be in writing. The lender must also provide a good faith estimate of loan costs and fees to the borrower, the seller, and any third party who will be liable on the loan.

Specific terms and requirements of different lending institutions vary widely. Such variables may involve a prohibition against (or a penalty for) prepayment of the mortgage; prohibition or limitation of the right to sell the property without the consent of the lender; requirements for the amount and nature of insurance required; requirements that escrow payments be made for anticipated property taxes and insurance premiums; limitations on the right to borrow additional funds on the property from another source; limitations on the use of the property; etc.

II. Categories of Real Estate Loans

Real estate loans are categorized into three general types. They are Veterans Administration (VA) guaranteed and direct loans; Federal Housing Administration (FHA) insured loans; and conventional loans that are not guaranteed or insured by any federal or state agency. In Colorado, the Colorado Housing Finance Authority (CHFA) also sponsors loans to low and moderate-income buyers.

A. Veterans Administration

To qualify for the benefits of the Veterans Administration loan program, a person must have served in a branch of the Armed Forces and have been released from service with other than a dishonorable discharge or undesirable separation. Members of the Armed Services have been awarded veterans loan benefits for active service during certain periods of service. Certain widows may also be eligible for VA loans.

The Veterans Administration Loan Guaranty Program was instituted primarily to provide protection to veterans in the form of: (a) valuation of housing (Certificate of Reasonable Value or CRV); (b) moderate interest rate; (c) minimum or no down payment; (d) extended payment period (usually 30 years); and (e) prepayment of loan without penalty.

VA loans are available on one-to-four family units and are secured by a first mortgage on the property. The government guarantees repayment of the loan for a percentage of the reducing loan balance. This government guarantee induces the lender to loan with a minimal or no down payment. If the veteran should default and the lender takes a loss, the Veterans Administration will pay the guaranty to the lender. In such an event, the veteran borrower may be required to repay the amount paid by VA and would not be eligible for another VA loan until the amount is repaid.

Veterans may pay a price above the CRV as long as they certify that they understand that they are doing so and as long as they pay the excess and their closing costs in cash. Secondary financing is not permitted. The loan amount may not exceed the CRV and the property must be occupied by the veteran owner/borrower.

Interest rates on VA loans are determined in the market place. Borrowers must pay a VA funding fee at closing and are permitted to pay discount fees (points) charged by the lender. VA loans are assumable by both veterans and non-veterans, but buyers must qualify to assume any VA loan originated after March 1, 1988. There is no prepayment fee if the loan is paid off early. In the case of an assumption, the veteran borrower remains liable on the loan unless a release is obtained from VA.

See http://www.va.gov/ for more information.

B. Federal Housing Administration

The Federal Housing Administration (FHA) is a branch of the Department of Housing and Urban Development (HUD). FHA mortgages are distinguishable in that the mortgagee is **insured** against loss in the event of foreclosure of the mortgage. The Federal Housing Administration is not a lender. Approved private lenders are the mortgagees, and only those loans that meet certain requirements of the FHA are insured by the agency. The insurance feature enables approved lending institutions to lend a higher percentage of the appraised value of the property than they would otherwise.

FHA sets maximum loan amounts for different areas of the country. A purchaser may pay a price in excess of the FHA appraised value when set forth in the contract according to FHA guidelines.

The Commission-approved Contract to Buy and Sell Real Estate (Residential) Section 6 includes specific appraisal provisions giving a buyer the option of terminating the contract without penalty, or proceeding with the contract if the FHA appraised value is less than a stated amount. It further states that HUD never warrants property condition or value, and that the buyer must satisfy him/herself as to these items.

FHA insured loans are available for owner-occupied properties. FHA sets down payment requirements. Borrowers may be required to pay both a loan origination fee and discount fee or points charged by the lender. A buyer must qualify to assume an FHA loan. The original borrower remains liable on loans assumed by subsequent buyers. FHA loans may be prepaid without penalty, but the lender must be advised at least 30 days in advance.

Very precise instructions concerning the proration of the pre-paid FHA mortgage insurance premium must be set out in the contract and the buyer advised as accurately as possible of the approximate cost to the buyer at closing.

Terms of both FHA and VA loans are controlled by regulation and legislative action, and modified from time to time. Therefore specific terms are not included in this text. Information on specific terms of these loans is available from the Veterans Administration or FHA or at: http://www.hudclips.org/cgi/index.cgi.

C. Conventional Loans

A conventional loan is one made to the borrower without government insurance or guarantee. The lender determines the amount of funds loaned and secured by deed of trust or mortgage on a property.

In a conventional loan, the borrower must meet the policy requirements of the lender. These requirements are not standard and vary with different lenders. The requirements for borrowers in most cases are related to the ability of the borrower to repay the loan.

The general principle which governs loans is that the greater the risk to the lender, the higher will be the interest rate, the shorter the loan term and the lower the ratio of loan-to-value. These factors are also affected by the supply of mortgage funds and supply and demand in the real estate market.

Private mortgage insurance (P.M.I.) companies generally insure conventional loans. Such insurance allows lenders to make higher loan-to-value loans, often up to 90-95% of a property's appraised value. The borrower pays cost of the insurance.

III. Sources of Funds

Lenders who make loans directly to the consumer comprise the primary mortgage market. There are several major types of institutional lenders in the primary market. Their operating policies permit long-term lending, making real estate an attractive investment option. With longer-term loans up to 40 years, these investors know that their money may be immobilized for long periods. In some cases, these institutions deal through companies known as mortgage bankers or mortgage brokers.

A. Commercial Banks

A commercial bank creates real estate loans for its own account and for the use of its trust department. In some cases, commercial banks may represent other institutional investors, thereby assuming the function of a mortgage banker. Commercial banks also create subsidiary mortgage companies that operate nationwide as a source of mortgage funds.

The U.S. Comptroller of Currency and state banking commissions regulate banks. National banks are restricted by law as to the amount that they may lend on real estate, and as to the time limit of such loans. The Federal Deposit Insurance Corporation (FDIC) insures accounts in commercial banks up to $100,000 per depositor.

B. Savings and Loan Associations

Savings and loan associations primarily loan money secured by residential property and have typically enjoyed the most flexible criteria for loan approval. Either the state (Division of Financial Services) or federal (Office of Thrift Supervision) government now charter S&Ls due to a wide-scale lending scandal in the 1980s. Savings and loan associations must be members of S.A.I.F. (Savings Association Insurance Fund), a branch of the FDIC, which insures accounts up to a maximum of $100,000 per depositor.

C. Mutual Savings Banks

A substantial number of deposits in mutual savings banks are used for real estate loans. Mutual savings banks are concentrated on the eastern seaboard, most particularly in the northeastern part of the United States. They are the oldest form of institution in the U.S. primarily concerned with savings. Mutual savings banks are represented in most cases by mortgage bankers or mortgage brokers.

Like savings and loan associations, mutual savings banks make most of their mortgage loans on one-to-four family dwellings. Most real estate loans outside of a mutual savings bank's domicile state are made up of FHA and VA loans.

D. Life Insurance Companies

Life insurance companies need to invest funds they hold in trust for the benefit of policyholders and beneficiaries. The investments made by life insurance companies are diversified. The investment portfolio includes government bonds, obligations of states and municipalities, real estate and corporate securities of many types. In general, life insurance companies are in a position to make loans on almost any type of improved real estate, but specialize in larger commercial and industrial loans.

Statutes of the state in which the company is domiciled determine the amount insurance companies can loan in relation to the value of the property pledged as security. In most cases mortgage bankers or mortgage brokers represent insurance companies, but some operate direct mortgage loan field offices in larger cities.

E. Mortgage Bankers and Mortgage Brokers

The distinction between mortgage bankers and mortgage brokers has blurred in recent years. Mortgage bankers traditionally have originated loans from their own funds, sold the loan, and retained servicing rights to the loan. Today, many mortgage bankers operate as subsidiary agents for large institutional lenders or as independent mortgage brokers who

retain servicing rights. Fees are earned through both origination fees paid by the borrower and servicing fees paid by the loan holder.

Mortgage brokers act as intermediaries, arranging loans between lenders and borrowers, often working with a regular clientele of institutional lenders. They process loan applications for a lender but usually do not actually approve or service the loan. Fees are earned through origination fees paid by the borrower.

Mortgage bankers and mortgage brokers represent a broad spectrum of lenders and can be a source for every type of real estate loan. Neither mortgage bankers nor mortgage brokers are regulated in Colorado.

F. Pension Funds

Pension funds act as trustees for retirement funds. They invest most of their resources in the secondary mortgage and securities market, but are a potentially rich source of mortgage funds. Most pension fund loans are placed through mortgage bankers and mortgage brokers.

G. Credit Unions

Credit unions deal mostly in consumer credit loans with their members, but may also make real estate loans. Credit unions are also a source for secondary financing and home equity loans.

H. Federal Land Bank

Congress established The Federal Land Bank as a farmers' cooperative credit system in 1917. It is regulated by the Farm Credit Administration which also supervises similar sister organizations.

The Federal Land Bank system consists of 12 regional banks owned by the various land bank associations throughout the country. A borrower must belong to an association to be eligible for a loan.

I. The Farm Service Agency (FSA)

This agency, formerly known as the Farmers Home Administration (FMHA), is an agency of the United States Department of Agriculture. FSA makes and insures farm ownership loans accompanied by technical management assistance to farmers and ranchers who are or will become operators of family farms. Ownership loans are available only to those who are unable to obtain the credit they need from other sources. The FSA provides assistance to rural and agricultural businesses and industry through the Rural Business and Cooperative Development Service.

Besides a home ownership program there is a financial assistance program for small towns and rural groups and also rental housing programs. Additionally, loans are available for certain high-risk borrowers and for disaster relief. For more information, see: http://www.fsa.usda.gov/.

J. Real Estate Investments Trusts (REIT)

Federal legislation in the 1960s allowed for the creation of unincorporated trusts to encourage the pooling of small savings for investment in real estate. REITs are similar to

mutual funds for real estate and generally invest in larger commercial and industrial projects. They must be registered as securities.

K. Owners

Sellers of property are often prime sources of real estate financing. Owner equity in real estate represents the largest potential pool of funds available to purchasers of real estate in this country. “Owner carry” transactions can often be structured to the benefit of both buyer and seller, but sellers must always be advised to seek competent legal and professional assistance.

IV. The Secondary Mortgage Market

The secondary mortgage market consists of institutions and investors who purchase loans from lenders in the primary market who originally funded the loans. The secondary market allows for liquidity, stability and geographical flexibility in the primary market. Funds for the secondary market are largely obtained through the sale of mortgage-backed securities, which are investments secured by real estate mortgages. The secondary market was created and is still largely controlled by the federal government. The initial action to create the secondary mortgage market was passage of the National Housing Act.

The National Housing Act was enacted June 27, 1934, to help reverse the slump of housing construction in the depression of the early 1930s. The legislation focused on such national problems as lack of housing, excessive foreclosures and a defunct building industry. The act was the authority for the creation of the Federal Housing Administration, the Federal Home Loan Bank, the Federal Public Housing Authority, Federal National Mortgage Association (FNMA), and the Federal Savings and Loan Insurance Corporation.

FNMA, often called **“Fannie Mae,”** was created as a secondary market to buy and sell FHA-insured, VA-guaranteed and conventional mortgages. FNMA stabilizes and improves distribution of home mortgage funds. Through the auction process, FNMA agrees to buy acceptable mortgages. It is now a quasi-governmental public corporation.

The Government National Mortgage Association (GNMA), or **“Ginnie Mae,”** raises funds to support the mortgage market by guarantee of pass through mortgage securities. They guarantee the mortgage securities of FHA-insured and VA-guaranteed home loans with the full faith and credit of the United States. The yields compare favorably with high-grade corporate bonds and pay interest and principal payments each month.

GNMA supports the mortgage market by buying VA, FHA and conventional mortgages from private lenders at prices favorable to the sellers of the mortgages. GNMA also sells the mortgages or commitments at prevailing market prices and absorbs any difference between its committed prices and market price. This is normally for special program loans. GNMA is an agency of HUD.

Congress created the Federal Home Loan Mortgage Corporation (FHLMC), known as **“Freddie Mac,”** in 1970 to help savings institutions when their deposits became low or they found themselves over-committed. Freddie Mac is currently under the control of the Federal Home Loan Bank Board (FHLBB).

Any financial institution whose deposits are insured by an agency of the Federal government can sell mortgages to Freddie Mac. The mortgages must meet the standards

imposed on the lending institution. Although Freddie Mac deals primarily with conventional loans, it can purchase VA or FHA mortgages.

Real Estate Investment Conduits (ERICs) are mortgage-backed securities, which can be issued by both private and governmental entities. Authorized by the Tax Reform Act of 1986, ERICs allow pooling of funds from smaller investors for reinvestment in the secondary mortgage market.

V. Discount Points

A discount point is an up-front payment of a percentage of the loan amount required by a lender to obtain the same yield that may have been received on a higher interest rate loan. Advance payment of a discount thus allows the lender to offer a lower interest rate, and lower payments, over the life of the loan. The word “points” is often used to express the discount. FHA allows anyone to pay the borrower’s discount points. Loan discount points should not be confused with loan origination fees and should be specifically provided for in a sales contract.

VI. Types of Mortgages

A. Fully Amortized Mortgage

A mortgage that provides for repayment over a specified time by regular equal payments at stated intervals (e.g., monthly, quarterly, etc.) to reduce the principal amount of the loan and to pay interest as it is due. This is the most common type of residential mortgage.

B. Adjustable Rate Mortgage (ARM)

In an ARM, the interest rate may shift up or down over the term of the mortgage, depending upon the fluctuations of the index to which the rate is tied. It may be tied to the prime rate offered by banks, the consumer price index or some other indicator. There is usually a contractual limit as to how much the rate may increase within a certain time period and over the life of the loan. Payments are adjusted annually. ARMs can result in negative amortization during periods of rising interest rates.

C. Graduated Payment Mortgage (GPM)

One featuring low payments early in the mortgage term, increasing to a contracted amount in later years. This may benefit younger persons whose income has not yet reached a level necessary for an amortized loan, but whose future looks promising. Graduated payment mortgages often result in negative amortization during the early years of the loan.

D. Package Mortgage

A loan that finances the purchase of a home along with the personal property (stove, refrigerator, etc.) essential to the livability of the property. The real estate mortgage describes the equipment and recites the intention of the parties that such articles shall be deemed fixtures.

E. Demand Mortgage

One that may be called for payment at any time at the discretion of the lender. This type of financing is usually not a good practice for either the lender or borrower. Demand mortgages are rare.

F. Limited Reduction Mortgage

A loan offering only a limited amount of principal reduction prior to the expiration date of the loan. The principal balance remaining at the expiration date is sometimes known as a **balloon** payment.

G. Term or Straight Mortgage

A loan that matures at a certain future date, with no amortization of principal. Interest payments on term loans are typically periodic, i.e. monthly, quarterly, semi-annually, etc.

H. Straight Amortization Mortgage

This plan provides for the payment of a fixed amount of principal at specified intervals with interest payable on the remaining balance of the loan. Each subsequent mortgage payment is lower because interest is calculated on the reduced loan balance each month.

I. "Wrap-Around" Mortgage

Similar to an installment land contract, in that a cash down payment and a promissory note for the balance "wraps" completely around the balance of the seller's equity and existing mortgage. The seller then uses a portion of the payment received on the larger wrap-around note to pay the smaller existing note in accordance with its terms.

The seller has the advantage of collecting interest on the equity loaned plus marginal interest over the rate of the first lien and the buyer obtains better overall financing at usually better terms than they could find during periods of high interest rates. A "wrap-around" should be structured to relieve the buyer of personal liability in the event of foreclosure of the original note.

For title purposes, a "wrap-around" is treated as a second mortgage. The title insurance policy will merely have two exceptions, one for the first loan and a second exception for the "wrap-around" loan.

A great deal of care must be used in drafting a "wrap-around" mortgage. It should give the buyer the right to directly pay the holder of the original note if the seller defaults. Legal assistance should always be sought in drafting a wrap-around mortgage. Installment land contracts are sometimes referred to as "wrap-around" mortgages.

J. Construction Loan Mortgage

Also known as a building loan, in which the lender does not immediately disburse the full amount to the borrower. The loan is intended to aid the borrower in financing the erection of a building, and the commitment permits the builder to begin construction. Funds are advanced to the borrower in installments as construction progresses. The maturity date on the loan is usually a definite period after completion allowing adequate time to sell the property. Professional builders usually secure commitments from lenders by purchasing the commitments to lend a certain amount of money at a certain interest rate.

Builders with substantial financial assets are often able to secure commitments for the construction of many dwelling units. These commitments also typically afford the builder adequate time to sell to residential purchasers. A builder may find it necessary to secure a take-out loan from one lender to pay off a short-term construction loan. Some builders of commercial property will secure a tenant on a long-term lease to encourage the lender to grant a construction loan.

K. Blanket Mortgage

A loan secured by more than one parcel of real estate. Subdivision developers often use this type of mortgage to obtain an entire tract of land, executing a mortgage as a lien on the tract. They then subdivide the tract, build on each lot, and sell each lot to individual purchasers. A blanket mortgage normally features a partial release clause so that individual lots are released from the mortgage as they are sold, and the sales price is paid in part or in whole to the mortgagee.

L. Open End Mortgage

A loan containing a clause permitting additional advances of money under the original mortgage instrument for repairs, improvement, or some other worthy reason, without a change in the original instrument. Home equity loans are most often open-end loans.

M. Divided Amortization Mortgage

A loan in which the amortization schedule is split into a shorter maturity on one part of the loan and a longer maturity on the remainder. Alternatively, only interest may be charged for several years and a complete amortization schedule developed from that point on.

N. Participation/Shared Appreciation Mortgage

A loan in which the lender participates in the income and/or resale profits generated by the property. Depending on the terms, the lender may either have only a contractual interest or actually hold partial title to the property. Such financing gives added security to a lender, who in turn may offer more attractive terms or may loan to borrowers who otherwise would not qualify. Originally used in large commercial transactions, residential loans are sometimes participatory, particularly if members of the buyer's family advance part of the purchase price.

O. Bridge Mortgage

A short-term loan intended to "bridge" between two permanent loans. A bridge may be either commercial, such as when used to repay a construction loan before permanent financing is in place; or residential such as when a borrower closes on a new home prior to the sale of a previous property.

P. Balloon Mortgage

A loan with a fully amortized payment schedule but with an earlier due date for payment in full. For example, equal monthly payments based on a 30-year amortization schedule with the entire unpaid balance due in full after five years. Colorado law may permit extending certain balloon notes if payments are not in default.

VII. Supplemental Methods of Financing

The following methods of financing help promote widespread ownership in real estate. However, this section is merely to acquaint the licensee with the existence of such methods and to make the most elementary explanation. The licensee must research and study extensively to be competent in the field of finance.

A. Second Mortgage

Subordinate to a first mortgage. Sometimes used when the down payment is not enough to make up the difference between the first mortgage and the sales price. For example, if a buyer has $15,000 cash available for down payment and is only able to borrow $150,000 toward a $180,000 house, the $15,000 shortage could be made up by a second mortgage, either by the seller "carrying back" a purchase money second mortgage or by a third party. Owner carry backs are a major source of second mortgage financing.

B. Installment Land Contracts

This instrument is covered extensively in Chapter 15 as a security device. It is most commonly seen when a buyer wishes to go into possession but has little money to invest. The seller permits this under a contract to provide a deed at a later date. The seller is doing the financing that may supplement an earlier and lesser encumbrance the seller is obligated to pay. This instrument is full of pitfalls and may cause injury to both buyer and seller. The broker should be thoroughly familiar with the effects of the installment land contract before brokering a transaction using it and both parties must be advised to seek legal counsel.

C. Collateral Loans

These loans are secured by collateral or parallel assets other than the property. Collateral security can be either real or more often personal property. An offsetting deposit in the lending institution can also serve as collateral security. When a purchaser has reduced the loan to an amount approved by the lender, the collateral security often will be released.

D. Sale and Lease-Back

This is a simultaneous process by which an investor first purchases or finances construction of real estate used by a well-established business corporation—usually a retailer or a manufacturer. The investor then leases the property back to the seller on terms usually favorable to the seller. From these two steps we obtain the name "sale and lease-back."

There are tax advantages to both parties in a sale-leaseback. The original seller-tenant frees up investment capital. The seller may treat rent paid as a tax-deductible expense. It is also possible to sell only the land and retain the improvements and thereby get the benefits of deductible real estate depreciation.

The buyer/investor turned landlord also has advantages. The purchaser usually buys the improvements as well as the land and gets tax shelter from depreciation. In addition to having a stable tenant, the lease is usually "net-net" which means that the tenant-occupant bears the costs associated with maintaining the property.

E. Syndication or Joint Venture

When the purchase of real estate is made primarily for investment purposes, financing is often conducted by a group of investors. One person may not have sufficient capital for the purchase of the desired equity; therefore, two or more persons may join in the purchase and take title in common (trusteeships are often used). Pooling money in this fashion makes it possible for a person of limited financial means to share in the profits of a real estate investment.

The most popular type of syndication is the limited partnership. This is a partnership made up of general and limited partner(s). Limited partners have invested money in the partnership but have no voice in its management. Limited partners share in the profits of the partnership proportionately to their respective investments. Limited partners are not responsible for the debts of the partnership beyond the amount of their investment. Title to the real property is taken in the name of the partnership and the articles of agreement of the limited partnership are recorded. If the limited partnership agreement is not recorded, the liability of the limited partners would not be limited to their investment and creditors could attack them as well as the general partners. A limited partnership agreement is a difficult vehicle to draft, and should be drafted by an attorney skilled in this field. Limited partnerships are also subject to state and federal securities laws.

F. Buy Down

A form of loan subsidy in which a builder/developer of residential property who wants be relieved of the construction loan, offers to pay an up-front sum to the lender. This payment has the same effect as discount points, increases the lender’s yield and typically reduces the interest rate or buyer’s payment amount for a specified period of time, or in some cases for the duration of the loan. Buy downs are not restricted to builders and sellers may finance buy downs as an inducement to buyers.

G. Lease-Option

This is a lease, with a future option of the lessee to buy the property on terms (and forfeitures) established at the signing of the lease. A lease-option is more an interim agreement to allow buyer and seller to lock in the terms of a future sale than a supplemental method of financing. It allows time for a buyer to marshal additional resources, such as funds for a down payment, while providing a seller with some assurance of a sale or at least compensation if the sale fails. A lease-option agreement should be carefully drafted and not tacked on as an added provision to either a lease or sales contract. The agreement should clearly spell out application and disposition of the option money, rents and security deposits as well as detailing future terms of sale.

VIII. Truth-In-Lending

Title 1 of the National Consumer Credit Protection Act, commonly known as the Truth-in-Lending Act, became effective on July 1, 1969 and is regulated by the Federal Trade Commission. The act authorized the Board of Governors of the Federal Reserve System to prescribe regulations and consequently Regulation Z was revised effective April 1, 1981. Compliance with the revised Regulation Z was made mandatory October 1, 1982.

The Act and Regulation Z are not printed in this manual because of length and difficulty of interpretation. Therefore, this section will only briefly describe their coverage and how they concern real estate practice.

Essentially, TIL requires disclosure of certain information to a borrower, the most important of which are the finance charge and the annual percentage rate. In a final rule published September 19, 1996 and effective October 21, 1996, fees charged by mortgage brokers and paid directly by the borrower must be included as part of the finance charge unless they would be excluded when charged by the creditor. Also, the rule established new tolerances for errors in the amount of the finance charge. TIL applies only to consumer credit extended to a natural person. It does not cover credit extended to corporations, partnerships, associations, government agencies, etc. The act does not apply to business loans or commercial loans such as construction loans to builders, but it will apply when a construction loan is converted to a consumer loan made to the purchaser of the house. Loans to finance non-owner occupied (for more than one year) rental properties are considered business loans and are excluded. Loans for rental property containing three or more units are excluded even if the owner occupies one unit.

A. Truth-In-Lending Creditors

All persons (and organizations) that are "creditors" under Truth-in-Lending must comply with the act. Licensees who regularly extend credit by carrying commissions or by lending money in real estate transactions may be creditors as defined by TIL and therefore be subject to the TIL disclosure and other requirements.

Regulation Z defines a creditor as anyone who extends consumer credit more than five times in either the preceding or current calendar year in transactions secured by a dwelling, or 25 times in a year in other transactions. Creditor status is also met by extending consumer credit subject to a financing charge or payable under a written agreement in more than four installments (not including down payment).

The disclosure requirements with which all creditors must comply pertain not only to new extensions of credit, but also to assumptions and refinancing.

Assumptions of existing residential mortgage loans are usually subject to Regulation Z. If the purchaser agrees to pay an existing obligation and the creditors accept it in a written agreement to the effect that the purchaser is the primary obligor, the creditor must make new disclosures based on the remaining obligation. Disclosure must be made prior to assumption. Refinancing is also covered if the existing obligation was subject to Regulation Z and is satisfied and replaced by a new obligation undertaken by the same consumer.

B. TIL Disclosure

The primary purpose of Regulation Z is to disclose to the consumer how much it costs to borrow money and to disclose the terms and conditions. The "creditor" must provide the borrower with a disclosure statement before the credit transaction is consummated—meaning before the consumer becomes contractually obligated on a credit transaction, not on a purchase obligation alone.

In the usual real estate transaction, disclosure may be made any time prior to final settlement when the deed is delivered and the credit instruments executed, although earlier disclosure is encouraged. When a creditor-seller carries back a purchase money mortgage

under a liquidated damages buy/sell contract, for example, disclosure must be made prior to the purchaser's signing the note and trust deed, i.e., prior to becoming obligated on the credit transaction. In the case of an installment land contract, disclosure would be prior to execution of the ILC rather than prior to the signing of a preliminary contract. In any case, disclosure should be made a reasonable length of time before the signing of the credit instruments.

There are two primary disclosures intended by Regulation Z.

1. The **finance charge** is the cost of consumer credit as a dollar amount. It includes any charge payable by the consumer and imposed by the creditor incident to or as a condition of the extension of credit.

   In a residential real estate transaction, the finance charge **includes**:

   a. Interest, service charges, carrying charges.
   b. Loan fees, assumption fees, finder's fees and similar charges.
   c. Insurance premium, if required by the creditor.
   d. Points, if paid by purchaser.

   In a residential real estate transaction, the finance charge **excludes**:

   a. Points paid by seller.
   b. Fees for title examination, abstract of title, title insurance, survey, etc.
   c. Payments into escrow or trustee accounts.
   d. Insurance premiums if not required by the creditor and this fact is disclosed and if the consumer signs or initials a statement requesting the insurance.
   e. Payments prescribed by law and made to public officials, e.g., filing fees, etc., even if these are disclosed on the settlement sheet.

2. **Annual percentage rate** (APR) as used in Regulation Z is not "interest" as it is usually understood. Interest is included in computing the annual percentage rate along with the other finance charges. APR is the relationship of the total finance charge to the total amount to be financed, computed to the nearest 1/8 of 1 percent. (A tolerance of up to 1/4 of 1 percent is allowed for irregular payment transactions.) Thus, the APR informs the borrower of the total cost imposed by the lender for making the loan. The licensee may have to explain this differentiation to the client. Any federal reserve bank will provide, for a nominal fee, tables, which may be used to determine the APR. Since the APR varies with the term of the loan and frequency of payments, computation is made much easier by use of the tables.

   The **Finance Charge**, **Annual Percentage Rate** and creditor's identity must be disclosed in a more conspicuous manner than all other disclosures.

   The disclosure statement itself must disclose the following information as applicable:

   1. Identity of the "creditor."
   2. Amount financed.
   3. Itemization of amount financed. (This itemization can be accomplished by delivering the purchaser's settlement sheet to the purchaser, although Reg. Z provides a model form for such.)
   4. The finance charge and when it begins to accrue.

5. Annual percentage rate.
6. If the annual percentage rate increases after consummation, an explanation and an example of the payment terms that would result from an increase.
7. Payment schedule showing the number, amounts and timing of payments.
8. "Total of payments" using that term and a descriptive explanation as "the amount you will have paid when you have made all the scheduled payments."
9. Any demand feature. If payable on demand, the disclosures will be based on a maturity date of one year. If payable on demand at alternate date, the disclosures must be based on that date.
10. "Total sale price," using that term. This figure includes the down payment, the finance charge and any other amount financed by the creditor. This is required only when the seller is the lender and is not required of third party lenders.
11. Prepayment privilege or if a penalty is imposed for prepayment.
12. Any dollar or percentage charge resulting from a late payment.
13. The fact that the creditor will have a security interest in the property purchased.
14. A reference to the trust deed for information about default or acceleration of rights of the creditor.
15. Whether or not a subsequent purchaser may assume the indebtedness.

C. Truth In Lending (TIL) - Right of Rescission

Residential mortgages are exempt from rescission requirements if created to finance the acquisition or initial construction of the consumer's principal dwelling. There is a three-day rescission right granted to the consumer if the mortgage was created for purposes other than acquisition, such as a second mortgage. Rescission rights are also granted to purchasers of time-share interests, condominium and loft conversions, and most types of raw land subdivisions under the Subdivision Developer's Act printed in Chapter 4 of this manual.

D. Truth In Lending (TIL) - Advertising

TIL does not prohibit advertising credit terms but it does specify how they may be advertised. All licensees must comply with TIL advertising rules, regardless of whether or not they are "creditors."

In general, you may advertise the "cash price" and the specific term "APR" (not the interest rate).

If an advertisement contains a finance or interest rate, it must be stated as an "Annual Percentage Rate." If the annual percentage rate may be increased after consummation, the advertisement must state that fact. A simple annual rate or periodic rate that is applied to the unpaid balance may be stated in conjunction with, but not more conspicuously than the Annual Percentage Rate.

The following four items trigger TIL disclosure, if stated or inferred in an ad ("80% financing available" infers a 20% down payment):

1. The amount or percentage of any down payment.

2. The number of payments or period of repayment.
3. The amount of any payment.
4. The amount of finance charge.

Any of the above four items automatically trigger full and clear disclosure in the same ad of:

1. The amount or percentage of the down payment.
2. The terms of repayment.
3. The "Annual Percentage Rate", using that term, and, whether the rate may be increased after consummation.

TIL does not prohibit advertising in general terms, e.g., "excellent loan for assumption," "reasonable monthly payments," "FHA-VA financing available."

E. Truth in Lending (TIL) - Enforcement and Penalties

The Federal Trade Commission is responsible for the administration and enforcement of TIL insofar as most licensees are concerned. The Office of Thrift Supervision enforces TIL as it applies to Savings and Loan Associations. Commercial banks and other creditors will have their respective federal agency to administer and enforce TIL as it concerns them.

Any "creditor" who willfully and knowingly gives false or inaccurate information or fails to provide information they are required to disclose is subject to criminal liability punishable by up to a $5000 fine or one year in jail, or both.

If there is a failure to disclose to a borrower any information required under TIL, one may become civilly liable to the borrower for as much as twice the finance charge but in no case less than $100 or more than $1000, and one may also be liable for court costs and reasonable attorney fees.

A "creditor" may avoid liability by correcting an error within 60 days of its discovery, providing that suit has not been brought and the creditor has not received written notice of the error. The creditor may successfully defend a civil action if they can show by a preponderance of the evidence that the error was not intentional but resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid any such error. No civil penalty may be imposed unless the action is brought within one year from the date of the violation.

IX. Uniform Consumer Credit Code

A. Title 5 Articles 1-9, C.R.S.

The provisions of the Colorado Uniform Consumer Credit Code (U.C.C.C.) relating to disclosure and the right of rescission are similar to Regulation Z (Truth-in-Lending). However, Colorado has not received an exemption from the Board of Governors of the Federal Reserve System; and therefore must also comply with Regulation Z.

Colorado's U.C.C.C. applies Regulation Z disclosures to Colorado. The Colorado Attorney General's Office of Uniform Credit Code administers and enforces this act.

The U.C.C.C. applies the "more than 5" rule of Regulation Z, defined in the previous section on Truth-in-Lending. This is the rule that anyone who extends consumer credit secured by real property more than five (5) times in the preceding or current calendar year is a creditor, and must make the required disclosures to the borrower.

One of the major distinctions between Regulation Z and the U.C.C.C. is that the U.C.C.C. establishes finance charge rate limitations for consumer credit sales, consumer loans, and supervised loans.

The following finance charge rate limitations are currently in effect.

1. **Seller Financing (carry back).** If the seller is not a "creditor," the U.C.C.C. does not apply. A creditor-seller may charge up to 45%. (This is true whether the installment land contract or purchase money mortgage is a first or junior lien.)
2. **Seller Financing (carry back and discounting).** If the sale of the note or assignment of an installment land contract has been pre-arranged to a creditor, the finance charge may not exceed 21% whether or not the seller is a creditor, unless the loan is a first mortgage for acquisition, construction or refinance of a residence, including a mobile home.
3. **Owner/Creditor Financing.** If the seller is considered a "creditor" (more than 5 transactions), the finance charge rate is 21% regardless of the amount financed, unless the loan is purchase a residence secured by a first mortgage, in which case the maximum rate is 45%. (C.R.S. 18-15-104.)
4. **Supervised Lenders.** Mortgage lenders not regulated by an agency of state or federal government. The finance charge rate limitation is 21% unless the loan is a first mortgage for the acquisition, new construction or refinance of a residence (includes mobile home), in which case the finance charge rate limitation is 45%.
5. **Broker commissions.** No limit, but if a commission is to be paid from the proceeds of a U.C.C.C loan, the amount must be included in calculating the APR and is limited to 21%.

Other provisions of the U.C.C.C. of interest to licensees are:

1. Provisions in notes providing for judgment by confessions are prohibited. Any such agreement between lender and borrower is void.
2. If a contract or any part thereof is found to be unconscionable by a court, the court may refuse to enforce such an agreement. The debtor may defend even against an innocent assignee of the agreement.
3. A note secured by a second, or lower priority lien, providing for a balloon payment, gives the borrower the right to refinance at the creditor-lender's then prevailing interest rate, if the borrower still qualifies under the lender's normal credit standards, and if the lender is still in the business of making loans. This right to refinance assumes that the person extending credit or lending money is regularly engaged in so doing within the framework of the code. This right would not apply to an "interest only" note with the principal amount to be paid at an agreed time, so long as no negative amortization is involved in the transaction as scheduled. A "non-creditor" seller typical one-time owner carry back, does not have to allow refinancing when a balloon payment is due. (5-2-405 C.R.S.)

X. Syndications and Securities

Sales of interests in real estate may be considered to be securities under both federal and state law. Both laws contain "laundry list" definitions of what constitutes a security, but in general, a security will be deemed to be involved when a person invests money in a common enterprise with the expectation of profit based on the essential managerial efforts of the promoter or a third party. General partnership interests, limited partnership interests, promissory notes and condominium interests have all been construed to be securities under a variety of circumstances. The definition is not limited to stocks and bonds.

The U.S. Securities and Exchange Commission (SEC) administers federal securities laws. The Colorado Securities Commissioner and the Securities Division administer the Colorado Securities Act. Federal and state securities regulations are administered concurrently, meaning that persons engaged in securities activities must be in compliance with both federal and state laws.

Securities regulatory systems are comprised of three basic elements:

1. Securities must be either registered or exempt from the requirement;
2. Persons engaged in the business of selling securities must be registered with the SEC and licensed by the Securities Commissioner, or exempt from the requirement; and,
3. Regardless of whether the securities are registered, exempt or sold illegally, and regardless of whether the person selling them is licensed, exempt or excluded from the requirement, or selling in violation of the licensing requirement, it is unlawful to offer, sell or purchase a security by fraudulent means.

Under securities law, failure to make full and fair disclosure of all material facts in connection with the offer, sale or purchase of a security is fraudulent. The rule in the securities field is "seller beware." Violations of securities laws can lead to administrative and civil injunctive action as well as criminal prosecution. Private civil actions for damages are also possible.

A. Colorado Requirements

The Colorado Securities Act is closely coordinated with SEC requirements. Offerings registered with the SEC may register by filing with the Securities Commissioner. Colorado also has full registration by qualification (including the SCOR program) for issuers who want to sell publicly who are not registering with the SEC. Offerings made in reliance on SEC Regulation D are also exempt in Colorado, but a Colorado filing is required. SEC Rule 504 offerings may be sold publicly in Colorado, but only if registered with the Securities Commissioner or if limited to accredited investors only.

Insurers who employ individuals to sell their securities for them must make certain that those individuals obtain sales representative licenses from the Securities Commissioner. Officers, directors and similar persons who sell the issuer's own securities may be excluded from requirement, but they may not receive direct sales compensation.

XI. Sales of Secured Notes

The question arises as to whether real estate licensees must register with the Colorado Division of Securities when engaging in certain real estate related activities. When a seller

carries back a promissory note and trust deed on the sale of their property, the broker might arrange for the sale of the note on behalf of the seller. Under the Colorado Securities Act these notes are defined as securities and real estate licensees must either be licensed or otherwise exempt under the Security Act to engage in such sales.

A. Exemptions

In 1990, the Securities Act was amended, creating certain exemptions from the securities broker and dealer registration requirements for real estate licensees whose securities activities are limited to transactions in mortgage or trust deed backed notes originating in real estate transactions in which they were involved as real estate licensees. Under these exemptions, the examination, minimum net capital, and complex registration requirements are waived.

B. Federal Requirements

Real estate securities must be registered with the SEC unless exempt. Two common exemptions involve intra-state offerings and private offerings. SEC Regulation D, Rules 501-506 are the most frequently utilized and discussed SEC exemption sections. Even if the security is exempt, the broker or dealer may have to register with the SEC. There is an intra-state and an issuer exemption. Any SEC registered broker or dealer must be a member of the National Association of Securities Dealers (NASD).

C. Other States

If the offering is to be sold in states other than Colorado, those states will likely have their own requirements regarding the sale. If the sales are being made pursuant to Regulation D, many states have adopted a "Uniform Limited Offering Exemption" to coordinate with the federal exemptions. Other states still apply merit review standards and require that the deal be "fair, just and equitable" to the investor. A syndication must carefully research the laws and regulations of every state where the offering is to be sold.

D. Condominiums as Securities

Under certain circumstances, the sale of condominium units may be considered the sale of a security. Generally, securities commissions have implemented their jurisdiction and required registration in condominium offerings when these factors are both present:

1. The developer, or an entity the developer may control, is to be the exclusive sale or rental agent; and,
2. A rental pool is a requirement or condition of the sale or offering. (A rental pool is when all money collected by the management is "pooled" and disbursed to all owners according to their proportionate interests instead of income from only rented properties going to the respective unit owners.)

Even if there is no requirement for a purchaser to make his or her condominium unit available for rent, a condominium may be considered a security if the tax deductible benefits of depreciation are used as an inducement to purchase.

Provisions for management services, if not operated for profit, do not make the offering subject to registration. Neither does charging fees for the use of a golf course, swimming pool, or other common elements, if not done for profit.

The sale of securities is an extremely complex area of the law and has been made more so by the SEC's adoption of Regulation D and the State of Colorado's statute. For that reason, a real estate broker should not become involved in syndicating without the guidance of competent and specialized legal counsel.