



# What A Borrower Should Know Before Obtaining A Mortgage

ABA Real Property,  
Probate & Trust Law Section  
Pro Bono Committee  
Predatory Lending  
Subcommittee

## WHAT A BORROWER SHOULD KNOW BEFORE OBTAINING A MORTGAGE

Whether it is a first-time homebuyer or a veteran homeowner who is refinancing an existing mortgage, obtaining a mortgage loan can be a daunting process. As an informed counselor, you have a critical role in guiding your clients through the mortgage process. Before the flurry of paperwork begins, the borrower must determine if:

- he/she can afford a mortgage and what amount of principal and interest is within his/her budget.
- the proposed mortgage is overpriced and if better rates are available.

When deciding whether to refinance an existing mortgage, your client must determine if there is sufficient financial incentive to do so (i.e., will the borrower save enough money from the refinance to make it worthwhile). Finally, the borrower must know the signs of mortgage fraud that are perpetrated by unscrupulous lenders.

### Mortgage Affordability – The Personal Balance Sheet

While determining the affordability of a proposed loan is a straightforward process, it does require a detailed examination of the client's finances – a process that can cause borrowers a lot of anxiety. There are two ways to complete effectively this analysis: 1) the client completes the analysis (or at least gathers the raw data) on his or her own or with the assistance of a disinterested party; or 2) the client provides information to a mortgage counselor. The first option is unlikely to happen because, if the client sufficiently understood the mortgage process or had sufficient disinterested assistance to do the affordability analysis, then the client would not be seeking assistance from you.

### Gaining Trust

Without first getting the client to trust you enough to honestly disclose his or her financial situation, you will not be able to effectively assess the client's finances, so gaining trust is a vital step in the process. Gaining the trust of a client can be a challenge, particularly in the early stages of the relationship. Toward this goal, you should tell the client about your specialized training in dealing with home financing, that information is held in strictest confidence, and that you are working at no cost out of a sense of commitment to fair play and honest dealings. Frequently, trust is established when the counselor is the speaker at a seminar, establishing the counselor as a subject matter expert. You can also establish trust by becoming associated with established community organizations such as Volunteer Income Tax Assistance or the Area Agency on Aging. Do not rely on trust established by a friend's referral, as this is a favorite entry point for predatory lenders.

This booklet is designed for use by mortgage counseling professionals who wish to offer informed guidance to consumers seeking to obtain home financing, who are considering refinancing, or who might be targets of fraud and/or deception by unscrupulous lenders. It contains comprehensive information as well as valuable supplementary resource materials to aid you in counseling consumers seeking information regarding the borrowing process.

If you have any questions about this booklet, please contact Professor Gregory M. Duhl of the University of Tulsa College of Law at (918) 631-2477 or at [gregory-duhl@utulsa.edu](mailto:gregory-duhl@utulsa.edu).

**ABA Real Property, Probate & Trust Law Section**  
**Pro Bono Committee**  
**Predatory Lending Subcommittee**  
**American Bar Association © 2006**

Moreover, it is important to remember that although the foregoing discussion applies equally in some instances to first mortgages as well as to refinancing and second mortgages, there are factors unique to each situation that should be considered in the affordability analysis. We address some of these factors briefly before presenting the general affordability analysis.

### **Issues Unique to Purchase Money Mortgages**

People buying a home for the first time are particularly susceptible to unscrupulous lenders. In their eagerness to own a home for the first time, consumers may accept less than optimal loan terms from lenders who take advantage of the consumers' relative lack of knowledge of mortgage financing. For instance, many lenders will offer "teaser" or introductory rates in order to convince the first-time homebuyer that he or she is getting a good deal. With these types of loans, known as adjustable rate loans, the interest rates of the loans are relatively low at the start, and then rise over time. Before a buyer enters into one of these types of loans, it is important for him or her to understand when the rate increases take place as well as the amount of the increase in payments.

Another potential danger for consumers, particularly first-time homebuyers, is the proliferation of the so-called "interest only" loan. One of the true benefits of owning a home, as compared to renting, is that the home's value, as with other investments, tends to appreciate over time, while at the same time the consumer is paying down the principal amount owed on the loan, which increases the equity in the home. With the traditional home loan, the consumer's initial payments consist mostly of payments on the interest owed on the loan, but over time the amount of principal paid down increases. With an "interest only" loan, however, at the beginning of the loan period, the borrower pays only interest on the loan, and the payments on principal are paid at the end of the loan period.

An often-touted benefit of an "interest only" loan is that a consumer is offered a relatively low monthly payment, so these loans initially appear attractive to some homebuyers. For instance, the initial monthly payments on an "interest only" loan for a \$500,000 home could be as low as around \$1600, as compared to around \$2900 for a 30-year, fixed rate mortgage. The downside, however, is that the "interest only" loans often result in the consumer paying only interest over the life of the loan, with no principal paid. When the consumer subsequently sells the home, the payments have only been on the interest on the loan, so the only equity will be the amount that the home has appreciated since the purchase. Therefore, with an "interest only" loan, home ownership becomes a lot like renting, except for the tax deduction on the interest paid, as the consumer effectively builds up little or no equity in the home that the consumer supposedly "owns." Moreover, if the housing market tanks and the home's value actually decreases, then the borrower could end up taking a loss when the borrower sells the home for less than the borrower paid for it. For this reason, "interest only" loans are

generally not advised, and as a counselor, you should warn clients of the risks associated with taking out this type of loan.

### **Issues Unique to Refinancing and Second Mortgages**

Refinancing occurs when a first or subsequent mortgage has already been taken out and the borrower wishes to negotiate for a loan with new terms. One potential danger for consumers related to refinancing is a phenomenon known as "loan flipping," which occurs when consumers are convinced by unscrupulous lenders that refinancing will save them money over time, when in fact the cost of the refinance exceeds the benefit derived from receiving a lower interest rate on the new loan. Unscrupulous lenders make large profits on fees and yield spread premiums associated with refinancing, and will often aggressively promote refinancing, particularly when interest rates have decreased. As a counselor, you need to alert the client that the promise of a lower interest rate after a refinance will not always translate into an overall savings. Indeed, clients need to be aware that the more frequently they refinance their mortgages, the more likely it is that they are not saving money over the life of the loan. For instance, if a buyer has entered into an adjustable rate mortgage and believes that he or she will remain in his or her home past the date when the rate is subject to increase, it may be advisable to refinance the loan to benefit from a fixed mortgage rate. If, however, the buyer intends to sell the home before the rate is subject to adjustment, it may not be advisable to refinance in order to take advantage of a fixed rate. Some consumers, however, may prefer the peace of mind that comes from knowing that they have the option of remaining in the home at a fixed rate. For them, it may be worth it to pay the closing costs associated with refinancing from an adjustable to a fixed rate mortgage, even if they are not sure whether they will still be in the home when the adjustable rates are due to kick in. Discuss all of these options with your client. We provide a more detailed discussion of refinancing below.

Lending institutions have also begun to market aggressively home equity loans and other types of second mortgages, in which consumers use their homes as collateral to secure the debt. Home equity loans have become very popular within the past decade, but consumers need to understand fully the potential pitfalls involved with taking out a home equity loan, with the most obvious being that the consumer faces losing his or her home if the loan is not paid off. Furthermore, because home equity is, for most Americans, their most significant investment and the most popular means for building wealth, borrowing against the equity in one's home to pay for consumer items that are not investments, such as furniture, vacations, cars, etc., may be a particularly bad idea.

In sum, although the affordability analysis applies generally to first-time mortgages, refinancing, and second or subsequent mortgages, you need to be aware of the unique issues that may arise in the context of these different situations. We will now turn to the general principles of the affordability analysis.

## THE AFFORDABILITY ANALYSIS

To conduct an accurate affordability analysis, you must review three components of the client's financial status:

- 1) income
- 2) expenses
- 3) planned use of loan proceeds.

### Income

You must determine all income sources for your client. It is important for the client to identify all income sources to determine how he or she will not only make monthly mortgage payments, but also pay for unforeseen expenses such as property repairs. Income sources may include obvious sources such as employment, pension, IRA distributions, or annuities, as well as periodic sources of income from stock dividends or coupon redemption. The client should also consider whether the source of income is from a governmental aid program in which the income is protected from creditors. For instance, suppose a client wants to pay down credit cards by taking out a home mortgage and using the proceeds from the mortgage to pay down the credit card debt. He or she intends to repay the mortgage with income from governmental aid programs. In this case, the client loses the benefit of the credit protections offered by receiving the income from governmental aid sources because now the client will use up the governmental aid to protect the house, when before, the client might have decided to file for bankruptcy to discharge the credit card debt rather than use the governmental aid to pay the debt.

Hidden income is another aspect of income analysis. Does the client qualify for food stamps and/or Medicaid? Does the client receive Meals on Wheels? Does the client receive services through a church program such as a senior lunch program? Programs like these provide hidden or in-kind income. This is an important component of the income analysis. Will liquidating equity through the proposed loan disqualify the client from such programs, and in turn, increase expenses? How will the client handle potential reductions in program benefits? The value of the program benefits needs to be factored into the income data.

### Periodic Expenses

Tallying monthly expenses is the second component of the affordability analysis. This is not always an easy process. To begin, review the client's checkbook and credit card statements for the past four months. If the client keeps a cash ledger, reviewing it would be helpful too. If not, request that the client reconstruct cash expenditures. The review should go back at least four months to achieve an accurate running average.

Review expenditures in detail with the client and determine cash flow before and after the loan. It is important that the client consider all expenses associated with owning the home, including loan payments, taxes, insurance, and general living expenses.

While there are obvious expenses, such as utilities and groceries, there are less obvious considerations such as medications, medical supplies, charitable giving, and family gifts. Moreover, the analysis should take into account affordability from the client's perspective, not from the perspective of what you think is appropriate. For instance, some clients consider supporting their church and birthday gifts for grandchildren as important as food. If your client places such importance on non-essentials that those expenditures will be made even if they force the client into default on the proposed loan, then the items are not non-essentials to the client. You can, however, invite the client to consider the implications of treating those items as essentials.

Other expenses to be considered are those that may be integral in your client's life, such as shoveling the driveway, mowing the yard, putting up storm windows, cleaning the gutters, and taxi/delivery service. In other words, these are activities that your client must pay someone else to do. Further, these may be expenses for which the client pays in cash and does not even consider an expense. You may have to work diligently to gather accurate information about these types of expenses.

### Occasional Expenses

Occasional expenses include such items as annual auto or life insurance premiums, or annual homeowners' association dues. Because these expenditures do not come at predictable intervals, they can easily be overlooked when constructing a balance sheet. Many clients find such annual expenses to be unpleasant surprises because of a lack of advanced planning. When the expense "suddenly" appears, the client may be forced to pay other expenses or bills late, or default on mortgage payments. When late fees are added for these expenses/bills/payments, the "surprise" expense may be overwhelming.

Predicting the unpredictable is another aspect of capturing occasional expenses. Contingency planning is something many clients do not want to discuss because they are already financially pressed and the prospect of costly contingent events may be overwhelming. However, a few simple questions can help bring the issue into focus. Examples of such questions include "Can you pay the deductible if you're in an automobile accident?" and "What if you have to call a plumber and the bill is \$300?"

### The Loan Proceeds

How will net proceeds be distributed? It is important for the client to understand the distribution breakdown of net funds. If the expenses associated with the loan exceed 10% of the principal amount of the loan, your client probably is not getting appropriate value and the mortgage may not be worthwhile. In such cases, the settlement statement deserves intense scrutiny. Indeed, 10% of the loan amount is a very

high level for loan costs. A more appropriate level for loan costs (exclusive of any fees related to getting a lower-than-market interest rate or fees to compensate for a higher risk loan) on a refinance would be a little over 1% of the loan amount. Likewise, you should determine how the client intends to use the proceeds. For instance, is the client going to use the proceeds to buy frivolous items, pay off credit cards, buy a house, or reinvest in a current house? Although a client is free to use the money as he or she wishes, it is your responsibility to advise whether the use of the proceeds makes financial sense.

### Integrating the Analysis

Once all data has been gathered, you can calculate the debt service ratio (DSR) for the specific mortgage, together with all existing mortgages that will remain outstanding, and all associated mortgage loan expenses. To calculate the DSR, take monthly debt related to the loan and divide it by income. In this case, debt consists of the mortgage-related expenses, such as monthly loan payments, mortgage insurance, and costs related to the mortgage. The debt may also include any loan payments for existing mortgages on the same property. Example: A client has a gross income of \$3,000 a month and wants a mortgage with monthly payments of \$500 and payments of \$50 per month for mortgage insurance. This client would have a DSR of 18.3% and could “safely” make the loan payments. Now decrease the same client’s income to \$1,500 a month and the DSR increases to 36.7% because of the increased risk of the client’s inability to make the loan payments as a result of a lack of “excess” income.

This calculation reveals a DSR in one of three general categories: 1) below 25%, 2) between 25% and 50%, and 3) greater than 50%, for consumers with an employment future (versus elderly clients). The DSR separating the lowest and middle ranges has been gradually increasing over the past decade so that higher risk loans are increasing in the lowest category. For elderly clients without an employment future, the ranges should be below 20%, between 20% and 40%, and greater than 40%.

The first category represents a loan that the typical consumer can afford. The second category represents a high-risk loan which the typical consumer can manage only with great diligence and which may go into default in the event of a relatively small financial crisis. You can provide examples of relatively small crises such as an illness, a car accident, or home repairs, to illustrate this point. The third category represents a situation in which the client is in continuous danger of losing his or her home. Clients should be strongly advised against entering into a mortgage that will result in a DSR in this third range.

Emphasize that the slightest default may trigger higher interest rates, late charges, and inflated collections expenses, resulting in a loss of additional equity in the client’s home. If equity drops, the client’s options for refinancing diminish dramatically. Even worse, if the unsecured equity drops too low, the client may be unable to salvage the home at a foreclosure sale, and the proceeds may be insufficient for a down

payment on a replacement home. Stress to the client that, absent extraordinary circumstances or emergency needs for funds that cannot otherwise be obtained, a mortgage should be considered only if the DSR is in the first, and in certain circumstances the second, category.

### Mortgage Affordability DSR Calculation Chart (assuming current renter)

Income (per month)			
Part-Time Employment		\$2,500	
Pension		\$1,500	
<b>Total Income</b>		<b>\$4,000</b>	
Expenses (per month)		Before Loan	After Loan
Grocery Bill		\$250	\$250
Utilities		\$150	\$300
Credit Card Payments		\$250	\$250
Car Payment		\$350	\$350
Rent		\$500	\$0
Yard Mowing		\$0	\$50
Mortgage Payment		\$0	\$900
Property Taxes (\$1,800/12 months)		\$0	\$150
<b>Total Expenses</b>		<b>\$1,500</b>	<b>\$2,250</b>
Debt Service Ratio (DSR)			
<b>Monthly debt related to loan divided by income</b>	<b>\$900 + \$150/\$4,000</b>	<b>26.25%</b>	

### HOW TO DETERMINE IF A MORTGAGE IS OVERPRICED

**A** loan is overpriced when a person who would normally qualify for a prime loan instead receives a sub-prime loan at a higher interest rate, or otherwise is charged an interest rate that is higher than the market rate for the borrower based upon the borrower’s credit score and certain other factors discussed in this section. There are four basic steps to determine if a particular loan is overpriced: 1) determining the client’s credit score, 2) cross-referencing the client’s credit score with current interest rates, fees, and costs, 3) determining the loan terms from the proposed lender, and 4) comparing the proposed loan terms with the rate the borrowing candidate should be eligible to receive.

#### Step 1 - Determine the Client’s Credit Score.

The first step is to determine the borrowing candidate’s credit score. A credit score is the primary tool that lenders use to assess the risk of making a loan to a par-

ticular applicant. Credit scores fall in the range of 350 to 850 (the higher the score, the better the client's credit rating). Scores can vary depending on which credit reporting agency is calculating the score. The credit score is based on the information collected by one of the three national credit reporting agencies, Equifax, Experian, and TransUnion. Each of the major credit reporting agencies uses the FICO score as a basis for the calculation of its score. Individuals with higher credit scores are typically offered loans with better terms and interest rates because it is more likely that the borrower will pay back the loan in accordance with the lending agreement. Conversely, people with lower credit scores will likely be offered loans with higher interest rates and terms that are more favorable to the lender. Individuals with exceptionally low credit scores might be denied a loan altogether.

Clients can obtain their credit reports from a variety of sources. By requesting credit scores from the lender with whom the client is working to obtain the mortgage loan, the client often saves the additional expense of purchasing a credit score from a third party. Yet, there are drawbacks to the client asking for the lender's credit score. First, the credit scores received from the lender may or may not be trustworthy. Because the credit score is a large part of the process of determining the pricing of the loan, relying solely on the lender's assessment of the client's credit score might not adequately protect the client's interests if the lender has not used the client's correct credit score. Remember, small differences in the credit score can mean small differences in the interest rate, which could mean a difference of thousands of dollars over the life of the loan. This fact makes the small fee associated with obtaining a credit score from a third party worth the client's money.

Also, the lending institution may or may not comply with your request. Currently, only the state of California requires lending institutions to supply the client with copies of the information received from the credit reporting agencies, including the client's credit scores. In all other states, this information can be requested, but lenders are not obliged to provide it. The states of California, Colorado, and Vermont allow clients to seek the information given to the lender by making a written request to the credit reporting agencies, in lieu of the lender itself, when borrowing.

Credit scores can also be obtained online from a number of different sources. The following is a list of the most recognized sources and their websites:

<b>Name of Agency</b>	<b>Name of Scoring Method</b>	<b>Internet Address</b>
Fair, Issac and Co.	FICO	<a href="http://www.myfico.com">www.myfico.com</a>
Equifax	BEACON/ FICO	<a href="http://www.equifax.com">www.equifax.com</a>
Experian	Experian/ FICO	<a href="http://www.experian.com">www.experian.com</a>
TransUnion	EMPIRICA/FICO	<a href="http://www.transunion.com">www.transunion.com</a>

Each credit reporting agency offers the opportunity to select a single credit score and report from one agency, or a credit score and report from each of the three major credit reporting agencies (Equifax, Experian, and TransUnion). This second option is offered primarily because credit scores may differ between credit reporting bureaus as each bureau has different information about the client's credit history that they do not share with one another. Although it is not necessary to obtain all three scores, it may be beneficial for a number of other reasons. Different credit reporting agencies may use different scoring scales and lenders may use their own standardized scoring scale, and if there is a report with a much lower number (due to a mistake or otherwise), obtaining an average of all three can even out the impact of a lower score by one. Of course, a borrower should obtain a copy of his or her credit report to ensure that it does not contain any disadvantageous information that is false or no longer accurate, and to have the report updated to reflect the accurate information. The cost of receiving these scores is approximately \$15 for a single score and \$40 for all three scores, depending on the source chosen. One credit report, but not a credit score, may be obtained from each of the three major credit reporting agencies once a year without charge through the website [www.annualcreditreport.com](http://www.annualcreditreport.com). Because credit scores change over time, clients should make sure that their credit reports/credit scores are as up-to-date as possible.

## **Step 2 - Cross-Reference the Client's Credit Score with Current Interest Rates in the Client's Home Area.**

By performing this cross reference, you are determining the best possible interest rate available for the client, while simultaneously taking into consideration the risk of lending to the particular client. You can use the loan calculator available at [www.myfico.com](http://www.myfico.com); click on "*Calculators*" at the bottom of the page, then click on the "*FICO Score Loan Savings Calculator*" in the middle of the page.

Because you are only concerned with the interest rate in the client's area, enter the client's home state and the type of loan the client is seeking in order to find the appropriate annual percentage rate, or APR. The APR takes into account the interest on the loan as well as other charges the borrower will be required to pay, such as finance charges. The total interest paid over the life of the loan is displayed by completing the four required fields. By using this feature, you can also see how a small difference in the credit score and offered APR can mean thousands of dollars in savings over the course of the loan (see example 1 at the conclusion of this booklet). The mortgage calculator located on the [www.myfico.com](http://www.myfico.com) web site calculates monthly payments, and provides an amortization table and report based on the values entered into the system (see example 2 at the conclusion of this booklet). Once you have determined the average APR for which the client qualifies, it is time to move to the next step in the process.

### Step 3 – Determine the Terms of the Loan from the Proposed Lender.

The Truth in Lending Act (TILA) and its implementing regulation, known as “Regulation Z,” are the primary tools in determining whether a creditor has made adequate disclosures in the lending process. Regulation Z requires a lender in residential mortgage transactions to define the terms of the loan, through a TILA compliance form, before consummating the transaction or within three days of receiving the client’s written application, whichever is earlier. Additionally, the lender is required to conspicuously disclose the APR and total finance charge in the TILA form in closed-end transactions, such as a mortgage. The APR figure on the TILA form should be located in the first box in the upper left-hand corner of the form.

It is also important to review with your client any closing costs associated with the loan transaction. Specifically, you should examine any charges for credit life insurance, recording charges, appraisal fees, express delivery charges, wire fees, and title insurance fees. Check for any duplicative charges, especially in the context of attorneys’ fees and document preparation fees. To help determine if the closing costs of the proposed loan are in line or excessive, compare the costs of the loan with the average national charge for closing costs. You should compare the closing costs, reflected in the Good Faith Estimate of Closing Costs, against the average closing costs in the area, which can be determined by looking at [www.bankrate.com](http://www.bankrate.com). Alternatively, you can simply shop around the proposed loan to at least three lenders/mortgage brokers and obtain from them the TILA Statement reflecting the APR and the Good Faith Estimate of Closing Costs before the borrower makes a formal loan application.

### Step 4 – Compare the Proposed Loan Terms with the Rate the Loan Applicant Should Be Eligible to Receive. When Possible, Obtain the APR and Good Faith Estimate Prior to Borrower’s Payment of Any Non-Reimbursable Expenses.

Take the APR from the proposed loan and compare it to the APR the client should expect to receive with his or her respective credit score. If the APR for the proposed loan is lower or equal to the APR the client should expect to receive, the loan is probably an accurately priced loan. However, if the APR for the proposed loan is higher than the APR the client should expect to receive, the loan may be overpriced and the prospective client should seek alternative lending options. Keep in mind that the broker may have increased the APR on the loan due to considerations other than the client’s credit score, such as the client’s debt-to-income ratio or the client’s source of income, and this may account for a higher APR.

Although a comparison of the APR expected by the client and the APR proposed in the loan provides a relatively accurate assessment of whether a particular loan is overpriced, another consideration that should be taken into account in this analysis is whether the loan contains a “yield spread premium.” A yield spread premium is one that the lending institution pays to the mortgage broker based on the broker’s ability

to get the client to accept a loan at a higher APR, similar to a commission. The presence of a yield spread premium is indicated on the Good Faith Estimate of Closing Costs form, which may, and should be, obtained from the lender.

## REFINANCING A MORTGAGE

There are three questions the client must ask when planning to refinance:

1. What is the purpose of refinancing? For instance, does the client want to cash-out? Or does the client want to obtain a lower interest rate, a lower monthly payment, or a shorter term on the loan?
2. How long does the client plan on living in the home or keeping the loan?
3. Will the client recoup costs related to refinancing during the period of the loan, thus making it a financially wise decision to refinance?

### Purpose of Refinancing

A refinance is only cost-effective if consistent with the client’s purpose for getting the loan. For example, if a client wants to cash-out and is subsequently told by the lending institution that he or she does not have as much equity in the home as first thought, the client may be forced to accept a lower cash-out amount – or even no cash-out at all. Unfortunately, most lenders will attempt to persuade the client to refinance his or her home despite this fact.

When getting a cash-out, many people also fail to consider whether the loan requires Private Mortgage Insurance (PMI). Most financial institutions require PMI on any loan that is over 80% of the value of the home. PMI increases the payment and cost of the loan. In fact, PMI can increase monthly payments by \$25 to \$100. For example, if a client makes a down payment of between 15% and 20% on a \$150,000 mortgage, PMI of approximately \$40 a month will be assessed. Again, this cost must be considered when determining if the loan is cost-effective.

If the client’s goal is to lower the monthly mortgage payment and the lender is only able to deliver a minimum payment decrease, the client must determine if the cost of the new loan is worth the small payment reduction. As a mortgage professional, you can advise the client as to whether a lower payment is actually helping the client in the long term. For instance, in the case of “interest only” or negative amortization loans, the client may wish to stay with his or her current loan or choose a different loan product because over the entire life of a new loan, the client may be paying a substantially higher amount of interest or may have a large lump-sum principal payment at the end of the loan period, which could lead to default if the property’s value declines or if the borrower needs to refinance and interest rates have risen. Because many people do not

look at the amortization table or are not made aware of it at closing, it is also important to counsel your clients on the different payments that are being made in the monthly mortgage payment. For instance, payments in the first years of a traditional mortgage consist primarily of interest, with some principal, plus taxes and insurance.

Explain that if the client can afford making the monthly payments on a loan with a shorter amortization period, such as a fifteen-year period versus a thirty-year period, the borrower will ultimately pay a lower amount of interest during the time he or she makes payments on the loan. When discussing your clients' mortgage options, we recommend that you review:

- The far-reaching positive impact of making one extra principal payment annually.
- The amount of equity currently available in the client's home. Equity is the current market value of a home minus the remaining balance on the mortgage. The borrower should be cautioned that if he or she borrows the maximum amount a lender will loan with the house as security, and, if in the future he or she needs to borrow additional money and the property's value has not risen or has declined, he or she will not be able to use the home as security for a new loan because the borrower will have no additional equity in his or her home to pledge. In addition, if the value of the property has declined and the borrower had previously borrowed the maximum he or she could based on the value of the property, it will now be difficult for the borrower to refinance even the existing debt (i.e., not borrowing an additional sum) to take advantage of a drop in interest rates. Finally, if the borrower is in default under the loan and wishes to pay off the debt through a refinance as a means to prevent a foreclosure, he or she will have difficulty obtaining the refinance if there is no equity in the home due to past refinancing of loans. He or she will lose the property at the foreclosure sale, and there will not be any bid in excess of the secured debt on the property to go to the borrower to help him or her in securing new housing.

- Many lenders advertise 125% home equity loans, which not only take away all of the borrower's equity in the home, but which also force the client to be responsible for 25% more debt because home loans are "recourse" debts in which the lender is able to pursue the borrower for any deficiency between the amount bid at a foreclosure sale (usually the loan amount, but a lesser figure if the loan amount is greater than the fair market value of the property) and the amount due the lender by recovering against the borrower's other assets or by garnishing the borrower's wages. These loans are not advisable for most home buyers.

Clients may refinance at a lower interest rate; a popular strategy during the rate decreases at the beginning of the decade. Many people actually lost money because they refinanced so frequently that they could not recover the costs of the numerous loans they refinanced. These clients did not keep their loans long enough to recoup the costs, and each time they refinanced, the cost increased even more than it appeared on paper because they had to pay the closing costs they had not yet finished paying on the older loans.

Most people in need of counseling do not refinance for a shorter term on the new loan, but this should be considered. Shorter terms often mean lower interest rates and substantially less interest paid over the life of the loan. If the borrower can afford the higher monthly payments, this can be a beneficial strategy to save money, even if there are closing costs associated with obtaining the refinancing at the lower rate, so long as the borrower does not plan to sell the house within the repayment period.

### How Long Does the Client Plan To Reside in the Home?

Many clients make the mistake of refinancing and then moving/selling their homes within the cost recovery period. While this may not seem like a mistake at first glance, when this happens, the client may not recoup the costs of the loan and thus may not actually save any money by refinancing. It is important to ascertain how long the client is planning to live in/own the house. If the client does not plan to live in the house for longer than is necessary to recoup the closing costs, there is no overall cost savings involved in refinancing the mortgage.

### Does the Loan Make Financial Sense?

The final question gets down to the number crunching. Once you know how long the client plans to be in the home, and what his or her true purpose is, you can assist in determining which loan, if any, makes the best financial sense. It is best to use an Excel spreadsheet (see example on page 14) or the breakeven calculator found at:

[www.myfico.com/CreditEducation/Calculators/MortgageRefinance.aspx](http://www.myfico.com/CreditEducation/Calculators/MortgageRefinance.aspx)

(see example 3 at the conclusion of this booklet) to determine the cost of the loan, and when the costs have been recouped and the savings begin.

The Excel spreadsheet is an effective tool that can be used to show overall savings after the cost considerations. Spreadsheet Calculator can be downloaded from Microsoft at:

<http://office.microsoft.com/enus/templates/TC010566211033.aspx?CategoryID=CT062100581033>.

Enter the Good Faith Estimate Costs provided by the lender in the appropriate section. The client should also enter the number of months he or she actually plans on having the loan (this may or may not equal the term of the loan, depending on the individual situation). Both the spreadsheet and calculator take into consideration the tax deduction on both loans and figure that into the savings amount. To calculate the tax deduction, you need to know the marginal tax rate found in the IRS tax rate schedules (2006 rates are provided at the conclusion of this booklet). The *marginal tax rate* is the amount of tax paid on each additional dollar of income and is often used to calculate tax savings.

The spreadsheet and calculator make the savings, or lack thereof, easy to explain and easy to understand even to those who may shy away from complex interest computations. The [www.myfico.com](http://www.myfico.com) calculator also provides graphs and charts that visually explain the breakeven point to recover closing costs.

## MORTGAGE REFINANCING

Personal		
Marginal tax rate		15.00%
Resale plan (months)		60
Mortgage Terms		
Original mortgage amount		\$150,000
Current mortgage rate		5.750%
Original term (years)		30
Months paid		12
New mortgage rate		4.950%
New term (years)		30
Points		1.50
Refinancing Fees		
Application		\$400
Title		\$350
Legal		
Other		\$200
Points		2,221
Total Fees		\$3,171
Analysis	Current	Proposed
Mortgage Amount	\$148,070	\$148,070
Mortgage Payment	\$875.36	\$790.36
Months to recover financing costs		37
Mortgage balance at resale	\$136,573	\$135,874
Principal repaid to resale	\$11,498	\$12,196
Total payments to resale	\$52,522	\$47,421
Total interest to resale	\$41,042	\$35,225
Tax deduction on interest	\$6,154	\$5,284
Net interest cost to resale	\$34,870	\$29,942
Interest savings (costs)		\$4,929
Refinancing Fees (closing costs)		(\$3,100)
<b>Total savings (costs)</b>		<b>\$1,758</b>

## FRAUD

It is an unfortunate fact that with the recent boom in the residential real estate market more consumers have become victims of unscrupulous lenders. This section outlines the various ways that clients can be defrauded.

While there are numerous definitions of fraud, a couple of definitions are applicable for our purposes:

**Definition 1:** An intentional perversion of the truth for the purpose of inducing another to part with some valuable thing belonging to him or her (money) or to surrender a legal right (give a mortgage).

**Definition 2:** A false representation of a matter of fact, whether by words or conduct; a concealment of that which should have been disclosed, which deceives and is intended to deceive another.

In a loan transaction, a fraud can be perpetrated by both written and verbal communications. However, the most common form of fraud occurs when the client has been “told” the terms of the loan but the written contract does not contain those same terms. To guard against this type of fraud, it is important that you determine the client’s understanding of the loan terms as well as the actual contract terms contained in the client’s loan documents, and make sure that what was promised to the borrower is reflected in the loan package the borrower has been asked to sign at the closing of the loan. You should also establish whether the client could be vulnerable because of language, literacy, or other barriers. For instance:

- Can the consumer speak, read and/or understand English?
- Can the consumer read and write? If so, what is the consumer’s reading comprehension level?
- Is the consumer elderly or unsophisticated regarding borrowing?
- Does the consumer live alone and not have a family member or a friend who assists him or her in making purchases?
- Does the consumer have health problems that could prevent him or her from understanding the nature of the business transaction (i.e., can the consumer hear within a normal range or does the consumer have difficulty with his or her eyesight)?
- Is the consumer taking medications that interfere with his or her ability to understand or remember details?

Sadly, unscrupulous lenders often prey on individuals who are elderly, live alone, have health problems, and/or may have a diminished ability to comprehend the long-term effects of the proposed debt. These predatory lenders may also use the consumer’s religion or other beliefs to manipulate the consumer into trusting them.

The following are guidelines for spotting potential fraud:

### Step 1

Learn how the consumer chose a particular lender. Determine who initiated the original contact between the parties and how the consumer became associated with the particular lender (i.e., how did the consumer get the lender's name). A contact initiated by the lender or a referral from an existing creditor of the consumer, especially where the consumer is delinquent on his or her unsecured payments, should raise a red flag. The following are common fraud scenarios:

**Scenario 1** - Unsecured creditors may provide the consumer with the name of a lender that is working with the creditor. It is not uncommon for unscrupulous lenders to make uninvited contact by phone, door-to-door solicitations, or through referrals by existing creditors. These types of lenders may use a process called redlining, where particular neighborhoods are identified for solicitation because homeowners have little or no debt against their properties, are unsophisticated about borrowing, and there has been substantial appreciation in the real estate values.

**Scenario 2** - Solicitations made by someone for home repairs by unlicensed or unethical contractors. The repair may be necessary or not. The solicitor arranges the repair and the loan proceeds to pay for the repair. The proceeds are paid by the lender to the contractor when work begins. Often the workmanship of these repairs is done in a shoddy manner, if the repairs are completed at all. In the end, the consumer may have to pay a legitimate contractor to complete these repairs. In the meantime, the consumer is still responsible for the mortgaged funds.

Oftentimes, consumers are pressured by unscrupulous lenders and even encouraged to provide false information on applications to allow them to qualify for a loan with payments that are beyond their means. They may be asked to sign blank documents that will be completed by the lender at a later time or made to feel that voluntary credit or life insurance must be purchased and financed with the loan. Fees for recordation of satisfactions of the mortgages being paid off should appear on the statement if the loan is a refinance. Contact the paid-off financial institutions within three calendar days to verify receipt of the pay-offs. Use the laws of your state to pursue any failures to record satisfactions. Beware of loans that close Friday evening on a long weekend. That can be a strategy to avoid any three-day rescission period.

### Step 2

Review the exact terms of the loan with the client. The consumer should have his or her loan documents from the lender. If the lender has refused to provide the consumer with these documents, the legitimacy of the lender must be questioned. For your convenience, a questionnaire designed to assist you and the consumer in the review of the general terms of the loan follows this section.

### Step 3

Following the review of loan terms with the client, provide an assessment of the loan package. Inform the consumer about any specific shortcomings or strengths of his or her pending loan application. This information can prove critical in allowing the consumer to make intelligent choices regarding the loan. Encourage the client to compare the terms and rates offered with other local lenders, and those rates appearing in the newspapers for similar loans. Review all mortgage documents with the consumer to ensure that they comply with all of the TILA (Truth in Lending Act) requirements.

### Fraud Checklist

<i>What do you believe about your loan?</i>	<i>What do the loan documents say?</i>
A. Amount of loan?	A. Amount of loan?
B. Interest Rate? 1. Fixed, Variable or combination of both?	B. Interest Rate? 1. Fixed, Variable or combination of both?
C. Length of loan?	C. Length of loan?
D. Monthly payment? 1. Amortized, Negatively Amortized, Interest Only or Combination?	D. Monthly payment? 1. Amortized, Negatively Amortized, Interest Only or Combination?
E. Amount of mortgage broker fee?	E. Amount of mortgage broker fee?
F. Prepayment penalty?	F. Prepayment penalty?
G. Other costs? (See Good Faith Estimate)	G. Other costs? (See Good Faith Estimate)
H. Use of Funds? 1. Pay debt out of escrow? 2. If so, what debts?	H. Use of Funds? 1. Pay debt out of escrow? 2. If so, what debts?
I. Impounds? 1. Taxes? 2. Insurance?	I. Impounds? 1. Taxes? 2. Insurance?

## 2006 TAX RATE SCHEDULES

*Note: These tax rate schedules are provided so that you can compute your estimated tax for 2006. To compute your actual income tax, please see the instructions for 2006 Form 1040, 1040A, or 1040EZ as appropriate.*

### Schedule X - Single

If taxable income is over --	But not over --	The tax is:
\$0	\$7,550	10% of the amount over \$0
\$7,550	\$30,650	\$755 plus 15% of the amount over 7,550
\$30,650	\$74,200	\$4,220 plus 25% of the amount over 30,650
\$74,200	\$154,800	\$15,107.50 plus 28% of the amount over 71,950
\$154,800	\$336,550	\$37,675.50 plus 33% of the amount over 154,800
\$336,550	no limit	\$97,653.50 plus 35% of the amount over 336,550

### Schedule Y-1 - Married Filing Jointly or Qualifying Widow(er)

If taxable income is over --	But not over --	The tax is:
\$0	\$15,100	10% of the amount over \$0
\$15,100	\$61,300	\$1,510 plus 15% of the amount over 15,100
\$61,300	\$123,700	\$8,440 plus 25% of the amount over 61,300
\$123,700	\$188,450	\$24,040.00 plus 28% of the amount over 123,700
\$188,450	\$336,550	\$42,170.00 plus 33% of the amount over 188,450
\$336,550	no limit	\$91,043.00 plus 35% of the amount over 336,550

### Schedule Y-2 - Married Filing Separately

If taxable income is over --	But not over --	The tax is:
\$0	\$7,550	10% of the amount over \$0
\$7,550	\$30,650	\$755 plus 15% of the amount over 7,550
\$30,650	\$61,850	\$4,220 plus 25% of the amount over 30,650
\$61,850	\$94,225	\$12,020.00 plus 28% of the amount over 61,850
\$94,225	\$168,275	\$21,085.00 plus 33% of the amount over 94,225
\$168,275	no limit	\$45,521.50 plus 35% of the amount over 163,225

### Schedule Z - Head of Household

If taxable income is over --	But not over --	The tax is:
\$0	\$10,750	10% of the amount over \$0
\$10,750	\$41,050	\$1,075 plus 15% of the amount over 10,750
\$41,050	\$106,000	\$5,620.00 plus 25% of the amount over 41,050
\$106,000	\$171,650	\$21,857.50 plus 28% of the amount over 106,000
\$171,650	\$336,550	\$40,239.50 plus 33% of the amount over 171,650
\$336,550	no limit	\$94,656.50 plus 35% of the amount over 336,550

To determine the marginal tax rate, consult the IRS charts for any given year.

## Example 1

**Loan Savings Calculator**

Interest Rates as of 11/17/2006

A 30-year loan in which the interest rate does not change during the entire term of the loan.

**step ONE**  
Select the type of loan  
30-Year Fixed

**step TWO**  
Select the state you live in  
Illinois

**step THREE**  
Enter the loan principal amount  
\$ 150000 **calculate**

FICO Score	APR	Monthly Payment	Total Interest Paid
720-850	6.068 %	\$906	\$176,122
700-719	6.193 %	\$918	\$180,488
675-699	6.729 %	\$971	\$199,490
620-674	7.876 %	\$1,088	\$241,575
560-619	10.040 %	\$1,321	\$325,486
500-559	10.150 %	\$1,333	\$329,885

**step FOUR**  
Select your current FICO Score range  
675-699

If your score changes to 720-850, you could save an extra \$23,368  
If your score changes to 700-719, you could save an extra \$19,002  
If your score changes to 620-674, you could pay an extra \$42,085  
If your score changes to 560-619, you could pay an extra \$125,996  
If your score changes to 500-559, you could pay an extra \$130,396

The rates shown are averages based on thousands of financial lenders, conducted daily by Informa Research Services, Inc. The 30-year fixed home mortgage APRs are estimated based on the following assumptions: FICO scores between 620 and 850 (500 and 619) assume a Loan Amount of \$150,000, 1.0 (0.0) points, a Single Family - Owner Occupied Property type and an 80% (60-80%) Loan-to-Value Ratio.

## Example 2

myFICO - Mortgage Loan

Calculators > Mortgage Loan

### Mortgage Loan

Use this calculator to generate an amortization schedule for your current mortgage. Quickly see how much interest you will pay, and your principal balances. You can even determine the impact of any principal prepayments! Press the "View Report" button for a full yearly or monthly amortization schedule.

**Fixed Mortgage Loan Calculator**

Principal balances  Total payments

**Loan Information:**  
 Mortgage amount: \$150,000  
 Term: 30 years  
 Interest rate: 5.750%  
 Monthly payment: \$875.36  
 Total payments: \$315,128.75  
 Total interest: \$165,128.75

**Prepayments:**  
 Type: None  
 Amount: \$0  
 Start with payment: 1  
 Savings: \$0.00

Report amortization schedule by year  Report amortization schedule by Month

Normal payments

## Example 3

myFICO - Mortgage Refinance Breakeven

### Mortgage Refinance Breakeven

**Original loan amount:**  
 Original loan amount: \$150,000  
 Appraised value: \$200,000  
 Years remaining: 29

**New Loan Balance, Rate and Closing Costs**  
 Check here  to calculate balance  
 Loan balance: \$148,070  
 Term in years: 30  
 Other closing costs: \$950

**How long to breakeven with \$3,171 in closing costs?**  
 Original interest rate: 5.750%  
 Term in years: 30  
 Income tax rate: 15.00%  
 Appraised value: \$200,000  
 Interest rate: 4.950%  
 Loan origination rate: 0.00%  
 Points paid: 1.500  
 = \$2,221.06

**Chart selection:**  
 Breakeven points  
 Monthly payment breakdown  
 New payment by year  
 Old payment by year  
 Prepaid payment by year  
 Savings by year  
**Other options:**  
 Show schedule by year  
 Show schedule by month

**Months to Breakeven**

Monthly payment savings 38 months  
 PMI & interest savings 33 months  
 Total savings after taxes 39 months  
 Total savings vs. prepayment 47 months

The preceding information can help you advise your clients as to the best course of action regarding the selection of mortgage products. Although the client makes the final decision about the mortgage he or she selects, you can provide invaluable information that your clients can use to make thoughtful, educated decisions.

If you have any questions about this booklet, please contact Professor Gregory M. Duhl of the University of Tulsa College of Law at (918) 631-2477 or at gregory-duhl@tulsa.edu.

ABA Real Property, Probate & Trust Law Section  
 Pro Bono Committee  
 Predatory Lending Subcommittee  
 American Bar Association © 2006