

LOANS & LENDERS A GUIDE FOR
BUYERS & BORROWERS

Second Edition

Patrick Schwerdtfeger

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Printed in the United States of America.



Acknowledgements

Many thanks to my friends and colleagues for contributing to this publication. In particular, I wish to acknowledge Andrew McCririck, Bryan Beyer at Windsor Capital, John Padlo at John Padlo Designs and Bill Katakis at National City Mortgage.

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Information & Documentation Checklist

Introduction

The US Department of Housing and Urban Development (HUD) estimates the rate of home ownership in the United States to be 68.6% (Q4 2003), the highest in history. According to the National Association of Realtors®, average home prices increased 5.6% annually during the past 10 years. The Mortgage Bankers Association (MBA) measured total mortgage originations in 2003 (including purchase and refinance transactions) at 3.8 trillion dollars, a record.

These impressive 2003 statistics were fueled by the lowest interest rates in over 45 years. Loan wholesalers and mortgage brokers have flocked to the industry in recent years, capitalizing on the booming market. Over 300 different lenders offer loan products in California today and thousands of mortgage brokers are soliciting the business with mass mailings and aggressive telemarketing campaigns.

Although increased competition generally benefits consumers, the present situation has created a frustrating predicament for borrowers. Countless solicitations each promise incredible benefits and borrowers no longer know who or what to believe.

“Lower your monthly payment by hundreds of dollars!”

“Enjoy an unbelievable start rate of just 1.25%!”

“No Cost Loans! Refinance without paying a penny!”

Amidst these claims, the old adage still applies: *if it looks too good to be true, it probably is*. At the very least, there’s usually a catch.

This handbook strives to empower consumers with detailed information about today’s competitive lending environment. It evaluates the various purveyors of real estate loans, explores the complicated world of credit scoring, explains loan qualification, discusses loan selection and reviews some of the disclosures. A glossary of relevant terms is also provided.

Purveyors of Real Estate Loans

There are three possible ways of getting a real estate loan: you can go to a **retail lender** and apply in a branch; you can work with an independent **mortgage broker**; or you can work with a **mortgage banker**.

Retail Lenders

The first option involves retail lenders such as Wells Fargo, Washington Mutual, Bank of America, Chase and a variety of credit unions. Each has loan officers working in their branches. These are generally unlicensed bank employees who cross-sell mortgages with other banking products like checking accounts and credit cards.

Retail lenders are limited to the loan products and underwriting criteria offered by their particular bank. The product selection usually includes staples like 30-year fixed mortgages and 5/1 ARMs but lacks the new and innovative products offered by other loan wholesalers. In addition, they are generally limited to fixed pricing models, leaving little room for exceptional circumstances or negotiation.

Mortgage Brokers

Mortgage brokers are licensed by the California Department of Real Estate (DRE) and work as middlemen between loan wholesalers and borrowers. They make money by marking up wholesale products either through a rebate, processing charges or origination fees. The real estate boom has attracted thousands of new mortgage brokers to the industry. Most are low volume producers with limited expertise.

The theoretical advantage of using mortgage brokers is that they have access to a far wider selection of loan products. While this is true, most overlook the opportunity and become familiar with only three or four loan wholesalers. Admittedly, it would be impossible to develop a functional familiarity with the products of 300+ lenders but their independence as brokers implies an industry-wide perspective. Not always true.

The obvious disadvantage is that mortgage brokers have an incentive to work with lenders who pay them better. Loan wholesalers pay mortgage brokers through a rebate structure. Brokers earn larger rebates by raising the interest rate for their borrowers and generally favor those lenders who pay the most generous rebates.

Mortgage Bankers

Mortgage bankers are a combination of direct lenders and mortgage brokers. While they represent a single lender, they facilitate the loan process independent of the bank's other product offerings and do not work in a traditional branch. Mortgage bankers develop expert knowledge of their loan products while retaining the right to broker deals to outside wholesalers if no internal product exists for the borrower's circumstances.

Mortgage bankers generally process higher volumes at lower margins than mortgage brokers. They work closely with their underwriters and establish close relationships with those who approve or deny their loan submissions. This proximity results in greater flexibility, influence and control. Borrowers benefit from commonsense underwriting and have ready access to the status of their application.

Mortgage bankers represent the best of both worlds. I began in this industry as a mortgage broker but quickly switched over to better position myself for an increasingly savvy borrower. The underwriting control, product expertise and origination flexibility make mortgage banking the clear choice for borrowers in today's competitive lending environment.

Components of Your Credit Score

Credit scoring is a statistical method lenders use to quickly and objectively assess the credit risk of a loan applicant. Specifically, credit scoring uses historical information to assign a probability of the borrower being 90 days late on a credit obligation.

A credit score is based on the data available in the borrower's credit report. It is **not** a measure of a borrower's income, assets, down payment or demographic factors like gender, race, nationality or marital status. In fact, the use of such demographic factors within the loan application process is illegal. On the other hand, *non*-demographic factors such as income and assets are standard requirements for loan underwriting and approval.

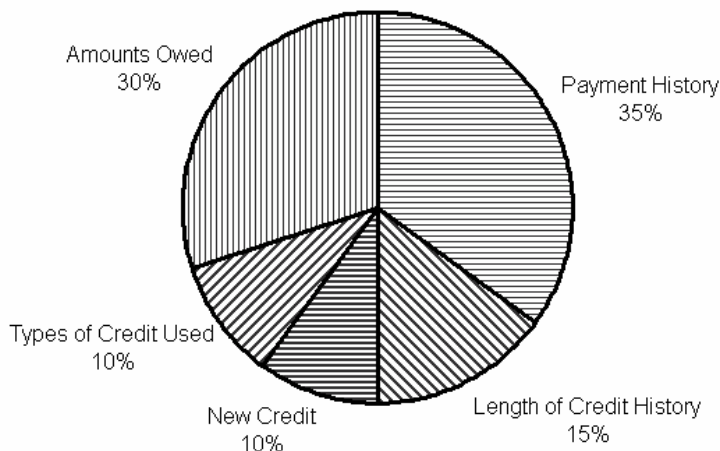
Credit scores are available through three national credit data repositories: Equifax, Trans Union and Experian. The FICO score (created by Fair Isaac & Company) is the most widely used score today. Although it established the standard for modern credit scoring, each repository has developed a unique label for its proprietary score. FICO (or similar) scores are considered in over 75% of US mortgage originations.

Equifax, Trans Union and Experian are credit information databases. Information is provided to them by the same people who request credit scores: real estate lenders, automobile lenders, credit card companies, retail creditors and others. While each repository contains very similar information, there may be some small differences between them. As a result, your credit score may be slightly different from each.

For the purposes of mortgage approval, lenders use the 'low middle' score between the borrowers. If there is only one borrower, the middle score becomes the 'decision score', not the highest or lowest. If there are multiple borrowers, the lowest middle score is used. Depending on the lender, the holder of the low middle score is also considered the primary borrower, regardless of who makes more money.

Although each repository has slightly different limits, credit scores generally range from 350 (very high risk) to 850 (very low risk). They use complex mathematical algorithms to model the credit patterns of millions of consumers and forecast credit performance. The credit data used is grouped into five primary categories, each carrying a unique importance within the final score.

FICO Score Components



These percentages are based on the contribution of these categories for the general population. For those who only recently created a credit history (and other exceptional groups), the relative importance of these categories may vary. Each category is discussed further below.

Payment History (35%)

Paying your bills on time is the most important factor for a good credit score, even if the debt you owe is small. Minimum payments are infinitely better than no payment at all. If a number of bills arrive at once and you don't have enough money to pay them all, you are much better off making minimum payments on each account rather than paying some while leaving others until next month's cycle.

The Payment History category considers the following:

1. the types of accounts (revolving or installment)
2. adverse public records (bankruptcies, judgments)
3. delinquencies or collections activity (past due items)
4. severity of delinquency (how long past due)
5. dollar amount past due on delinquent accounts
6. recentness of past due items or adverse public records
7. total number of past due items on file
8. number of accounts paid as agreed

Derogatory data in this category has less influence on the credit score as time passes. A missed payment in 2002 has a smaller effect than one missed just six months ago. Over time, you will make significant improvements to your credit score by paying credit obligations on time and using credit wisely.

Amounts Owed (30%)

This category of your credit score considers the total amount of credit issued to you and the percentage of 'available credit' currently owed. It also considers the total amounts owed and the cumulative minimum payments necessary to keep all accounts current. It's never a good idea to max-out your credit cards or take on more credit than you can handle.

The Amounts Owed category considers the following:

1. amount owing on accounts
2. the types of accounts with balances owing
3. number of accounts with balances
4. proportion of revolving credit lines used
5. proportion of installment loans still owing

Many people believe it's a good idea to close unused credit accounts. Not necessarily true. In fact, your score benefits if these accounts are kept active with periodic usage. Significant credit available demonstrates confidence from other creditors. Low or no balances on these accounts reduces the proportion of revolving credit lines used, increasing your score. Of course, there is a finite limit to this strategy and opening new accounts is not recommended.

Length of Credit History (15%)

This category relates to the previous point. New credit accounts tend to reduce your score while long-established accounts raise it. Creditors like to see long credit relationships with regular on-time payments. If additional credit is needed, you are better off requesting a credit limit increase from an existing card than opening a new one. Keep new cards to a minimum.

The Length of Credit History category considers the following:

1. the time since accounts were opened
2. the types of accounts
3. the time since the last account activity

Types of Credit Used (10%)

There are only two types of credit: installment and revolving. Installment credit has a fixed number of payments and a fixed payment amount. Examples include home mortgages, car loans or leases and student loans. Revolving credit is used up to a predetermined limit and paid down at any time. Examples include home equity lines of credit, credit cards and retail credit accounts.

Loan qualification may require some credit obligations be paid off. Such requirements are generally directed towards installment credit. Lenders understand that reduced credit card balances can quickly be run back up while reduced installment balances are more likely to provide lasting benefits to a borrower's cash position.

The Types of Credit Used category considers the following:

1. the number of accounts in each category
2. any recent information on these accounts

New Credit & Inquiries (10%)

The law requires a record of all inquiries into a person's credit file and such inquiries cannot be removed. A higher number of inquiries will generally lower your credit score. However, the FICO score gives special consideration to certain inquiries.

Inquiries from consumers requesting their own credit file are not considered in the calculation. Likewise, multiple inquiries (within 14 days of each other) related to a mortgage or auto purchase are counted as one. This special consideration intends to discount multiple inquiries relating to a single application for credit (i.e. a home or car loan).

People often get nervous when they receive credit card solicitations in the mail. FICO scores treat these solicitations as 'spot inquiries' with no negative impact on your score. Those inquiries resulting from a new application for credit are treated as 'hard inquiries' and are factored in. Excessive recent inquiries have a negative impact on your FICO score.

The New Credit category considers the following:

1. number of recently opened accounts by type
2. number of recent credit inquiries
3. time since recent account openings
4. time since recent credit inquiries

Disputed Information

Credit scores consider everything in your credit file. If your file contains inaccurate information, it is sometimes difficult to remove it from all three credit repositories. However, it's easy to file a dispute against the item, possibly mitigating its effect on your overall score. Consumers may contact the credit repositories at the following numbers or online.

1. Equifax 800-685-1111 www.Equifax.com
2. Trans Union 800-916-8800 www.TransUnion.com
3. Experian 888-397-3742 www.Experian.com

Efforts to remove a disputed item should be done in writing and should include (1) a cover letter explaining the situation, (2) a written statement from the creditor referencing the account number and acknowledging the error and (3) a copy of your credit report displaying the disputed item. It should be sent to all three credit repositories.

Removing or changing one specific derogatory item does not guarantee an increase in the score. Because the scoring calculations involve such complex algorithms, it is impossible to estimate the impact ahead of time.

Facts and Figures

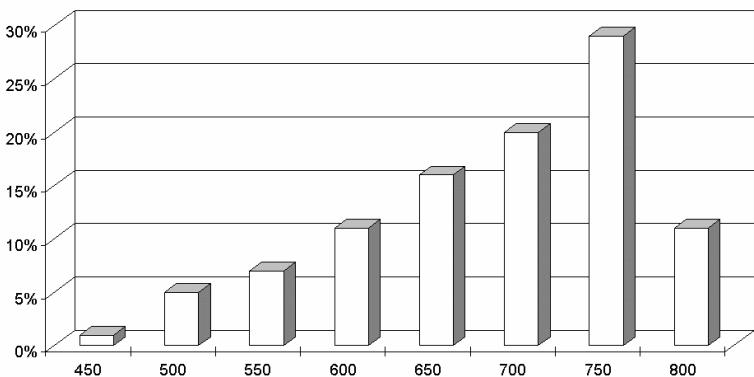
Your credit report must contain at least one account that has been open for six months or more and at least one active account in the past six months for a credit score to be calculated. One credit account can achieve both criteria. If you do not meet the minimum criteria to obtain a score, you may need to establish a credit history prior to applying for a mortgage.

Every score is accompanied by a maximum of four reason codes. Reason codes identify the most significant reasons you didn't score higher and often help lenders justify credit denials. These codes are not part of the credit profile and are not covered by the Fair Credit Reporting Act. Although these codes have less validity for those with high scores (700 or higher), they provide valuable direction for those with lower ones.

There are 43 possible reason codes and the 10 most frequently used are listed below.

1. serious delinquency
2. serious delinquency and public record or collection filed
3. derogatory public record or collection filed
4. time since delinquency is too recent or not known
5. level of delinquency on accounts
6. number of accounts with delinquency
7. amount owed on accounts
8. proportion of balances to revolving credit limits is too high
9. length of time accounts have been established
10. too many accounts with balances

FICO Scores for Americans



The graph above shows how the population breaks down on FICO scores. With 60% of the population over 700, the average American has a respectable credit score. Most A+ loan products require a credit score of 720 or higher.

For more information on credit scoring, visit www.myFICO.com.

Qualifying for a Loan

Before a home purchase is considered, you need an idea of what you can afford. Unless you have sufficient funds to buy a house for cash, this depends on the amount of money a lender agrees to lend you. A good rule of thumb is to multiply your gross annual household income by three. Of course, lenders take a more sophisticated approach to assess a borrower's financial status. Although many factors are considered, the following six carry particular significance.

1. gross monthly income
2. monthly expenses
3. low middle credit score
4. down payment amount
5. choice of loan program
6. prevailing interest rates

The first four factors converge into two financial measures; the debt-to-income ratio and the housing expense ratio. These ratios are then matched with the last two factors to determine the maximum loan amount the lender will approve.

Debt-to-Income (DTI) Ratio

Traditional lending guidelines limit loan commitments at the point where total monthly debt obligations (including mortgage, car payment, student loans, credit cards, etc.) equals 36 percent of gross monthly income. In today's competitive lending environment, most lenders are more lenient. If your credit score is under 680, most lenders allow up to 40% DTI. If your score is over 680, you can usually go to 45%.

Other lenders specialize in less-than-perfect (or 'sub-prime') credit scores and/or complicated scenarios. Such lenders allow DTI ratios of 50% or even 55% but charge higher interest rates to compensate them for the increased risk. The following table uses a conservative 40% DTI ratio to provide some common examples.

Annual Salary	Monthly Salary	Monthly Maximum
\$ 48,000	\$ 4,000	\$ 1,600
\$ 60,000	\$ 5,000	\$ 2,000
\$ 72,000	\$ 6,000	\$ 2,400

Underwriting criteria vary by lender.

The above examples show maximum monthly limits to pay for *all* monthly debt obligations, of which housing expense is only one component. Each applicant will have unique non-housing expenses that must be subtracted to determine a maximum monthly *housing* payment.

Housing Expense Ratio

Housing expense is a subset of total debts discussed above and only includes the mortgage payment, property taxes and homeowner's insurance. Traditional guidelines limit loan commitments at the point where housing expenses fall between 28 to 33 percent of gross monthly income, depending on the borrower's down payment contribution.

Since the DTI ratio (discussed above) includes *all* debt obligations and each borrower has unique non-housing expenses, it offers a truer representation of the borrower's cash position and is heavily favored by underwriters. In fact, some lenders don't even consider the housing expense ratio. Nevertheless, it's worth reviewing and the following table uses the traditional housing expense limits mentioned above.

Monthly Salary	Lower Limit	Higher Limit
\$ 4,000	\$ 1,120	\$ 1,320
\$ 5,000	\$ 1,400	\$ 1,650
\$ 6,000	\$ 1,680	\$ 1,980

Underwriting criteria vary by lender.

The above examples show payment limits exclusively for housing expenses including principal, interest, property taxes and homeowner's insurance. Other obligations such as student loans, car payments or credit cards fall outside of these limits.

Down Payment Amount

Lenders that consider the housing expense ratio (discussed above) are more lenient for borrowers who contribute a substantial down payment. For example, a person with a 20% down payment may qualify with a 33% housing expense ratio while someone with a 5% down payment may be held to the stricter 28% ratio.

Assume a monthly salary of \$5,000 and a property value of \$250,000.		
Downpay. Amount	Downpay. Percent	Maximum Payment
\$ 12,500	5 %	\$ 1,400
\$ 25,000	10 %	\$ 1,500
\$ 50,000	20 %	\$ 1,650

Underwriting criteria vary by lender.

The above examples demonstrate different limits permitted for a borrower depending on his or her down payment contribution.

Please note these two financial ratios result in different payment limits. Although the amounts of non-housing debt obligations (such as credit cards, car payments and student loans) help reconcile this variance, the

two ratios rarely provide identical payment thresholds. Every lender evaluates the ratios according to their own underwriting criteria and may select the lowest payment limit for their qualification calculations.

Chosen Loan Program

The DTI and housing expense ratios give lenders enough information to select a maximum monthly payment. A given payment amount, however, may be sufficient to maintain quite different loan amounts. Qualification will depend on the loan program chosen, prevailing interest rates, property taxes and homeowner's insurance.

Assume a maximum payment of \$1600 per month, including property taxes of \$200 and insurance of \$100.		
Loan Program	Interest Rate	Max. Loan Amount
30 yr. Fixed	7 %	\$ 195,400
7/1 ARM	6 %	\$ 216,829
3/1 ARM	5 %	\$ 242,166

Underwriting criteria vary by lender.

The table above provides qualified loan amounts for three different loan programs, given a single monthly mortgage payment. Since each loan program provides a different interest rate, borrowers fit into larger loans by selecting more aggressive loan programs with lower interest rates and lower monthly payments.

These calculations form the basis of loan qualification and should not be confused with loan approval. Qualification is determined with a few simple questions (as demonstrated above) while approval requires underwriting as well as an appraisal of the property and a title search.

Prospective homebuyers may wish to get pre-qualified or pre-approved before making an offer on a property. Pre-qualification involves the above analysis with an unknown property and an estimated interest rate. Pre-approval requires actual underwriting and may improve your negotiating position, much like a cash buyer. The only missing components in a pre-approval are the appraisal and title search.

Liquid Assets, Reserves and Gift Funds

The cash position of an applicant is of vital importance to the lender. How large is the down-payment? Where is the money coming from? How much will be left over after the down payment has been made? The answers to these questions contribute to the risk assessment of a particular borrower.

Please keep in mind as we review the following definitions and guidelines that underwriting criteria vary by lender. While some employ the rules described here, others use more stringent standards. Yet others use

looser guidelines, focusing instead on credit scores. The purpose of this discussion is to introduce the reader to the various measures used by underwriters, *not* to provide specific thresholds for loan approval.

Liquid assets are those funds that can be drawn upon to make a down payment, including cash as well as money in checking, savings and brokerage accounts. Lenders verify liquid assets to ensure no part of the down payment is borrowed from another source. Funds must exist within these accounts for at least two months to qualify. Lenders require sufficient liquid assets to cover the down payment with enough left over for their reserve requirements.

Reserves are those funds that can be drawn upon if necessary to support the borrower's lifestyle. Circumstances might include the unexpected loss of employment or medical emergencies. Reserves include liquid assets as well as IRAs and 401Ks, although these retirement funds are generally reduced by 30% to reflect the tax consequences of withdrawal. Lenders commonly require at least two months reserves of the proposed housing expense (principal, interest, taxes and insurance) for approval.

First-time homebuyers often receive gift funds to help with their down payment. Most lenders allow gift funds if the borrower is contributing personal funds as well; usually a minimum of 5%. An explanation letter is often required and the source of gift funds may require verification. Each lender handles gift funds differently and homebuyers are encouraged to contact their mortgage banker for details.

Stated Income vs. Full Documentation

Standard loan submissions imply full documentation, with the borrower providing pay stubs, W-2s and bank statements to verify income and assets. For some, this documentation is unavailable or misleading. Sales professionals and self-employed people are examples. 'Stated income' loan products cater directly to this market segment.

Stated income loans allow the applicant to *state* their income without providing verification. Underwriters for such loans place more emphasis on credit scores and may require tighter debt ratios and larger reserves (both discussed in previous sections) for approval. Although stated income loans have become extremely competitive, they are still priced higher than standard 'full doc' loans.

Lenders have gone even further in recent years by offering products that require absolutely *no* income or asset verification. Underwriters for such loans place a heavy emphasis on the applicant's credit score. Tight debt ratios and large cash reserves are required. Although pricing for such loans is noticeably higher than 'full doc' loans, they provide valuable flexibility for certain borrowers.

Property Classifications

Real estate loans are treated differently depending on the property used as security. Borrowers receive the best rates for loans secured by their primary residence, reflecting lower risk. Residential investment properties (i.e. rental units), vacant land and commercial developments are subject to more stringent underwriting guidelines and higher rates.

Rental units and commercial properties both imply rental income. This income is used within the DTI ratio (discussed in a previous section) but is offset by the debt obligations on the corresponding property. In addition, rental income is usually reduced by 25% to reflect periodic vacancies. Rental agreements are required to verify occupancy.

Properties are also differentiated by their characteristics. Single family residences are treated differently than duplexes or townhouses. Condos fall into a unique category and are subject to detailed guidelines for the percentage of units occupied by owners and the usage rights of common areas such as the lobby or the garage. Loans for condos are priced higher than other residential loans and high-rise condos (4+ stories) are priced higher than low-rise equivalents.

Understanding Different Loan Programs

Selecting one loan program over another can have a major financial impact on your lifestyle. Prevailing interest rates, fixed rate duration and principal reduction each have a direct effect on the monthly payment. For first-time homebuyers, there are additional considerations when comparing a new mortgage obligation to an existing rent payment.

Tax Advantages of Home Ownership

There are two primary tax implications for homeowners in the United States. First, home mortgage interest and property taxes are both tax deductible. Second, these large new tax deductions bump homeowners above the standard deduction permitted in the tax code, allowing them to itemize other deductions on their tax returns.

These two realities may create substantial tax savings and dramatically reduce the 'after-tax' monthly payment required to buy a home. In other words, a monthly rent of \$1200 may have the same financial impact as a \$1500 mortgage payment – not considering the principal reduction or value appreciation available through property ownership.

Assume a person whose marginal tax rate is 30% has a monthly mortgage payment of \$1600 of which \$300 is principle, \$1000 is interest, \$200 is property taxes and \$100 is homeowner's insurance. Since the interest and property taxes are both tax deductible, the 'after-tax' payment is only \$1240. Furthermore, the principal reduction of \$300 is essentially a forced savings program, reducing the rent-equivalent payment even further to just \$940.

The above analysis does not consider any appreciation in property values. Although appreciation is not guaranteed in the future, recent years have shown impressive gains. These gains make the ownership decision even more profitable.

When evaluating what you can afford, you should focus on the after-tax equivalent rather than an intimidating gross dollar amount. When buying a home, you can claim higher deductions with your employer, increasing your take-home pay and reducing the financial impact of a large mortgage payment. Consult a registered CPA to determine how many deductions would accurately reflect your new tax situation.

The Interest Rate Structure

Today's lending environment has more selection than ever before. An increasing number of lenders are offering borrowers innovative and flexible options including adjustable rate mortgages (ARMs), interest only payments and graduated payment programs. These creative programs frequently provide lower initial interest rates, requiring lower monthly payments as a result.

To understand the interest rate structure, you need to understand the lender's objectives. Lenders intend to earn interest on their investments (loans) equal to or greater than the prevailing market rate. Since the market rate changes daily, lenders assume some risk when they offer a fixed rate to a borrower. The amount of risk they incur depends on the length of time the rate remains fixed.

A fixed 30-year loan requires lenders to assume the risk of market fluctuations for 30 years. Rates may go up during this time but the lender must keep the rate fixed and absorb any resultant losses. Therefore, the interest rate on a 30-year fixed loan must incorporate some premium to offset this added risk and will always be higher rate than a product with a shorter fixed period like a 5/1 or 3/1 ARM (fixed for five years and three years respectively).

Interest rates drop as the fixed period decreases. 7/1 ARMs have higher rates than 5/1 ARMs and 5/1 ARMs have higher rates than 3/1 ARMs. A 6-month ARM carries a fixed interest rate for only 6 months and generally has the lowest initial rate as a result. This base rate approximates the prevailing market rate for retail lenders. Anything above it amounts to a risk premium for the lender – a premium paid by the borrower for the stability of a fixed rate and a fixed payment.

The selection of a loan program depends largely on the length of time you intend to keep the subject property. For example, if you plan to sell in seven years, there is no benefit in a 30-year fixed rate. In fact, such a program requires higher payments during the ownership period with less principal reduction. On the other hand, a 7/1 ARM fixes the rate for the same seven year period and allows for lower payments.

Another consideration is the possibility of future refinancing. Future interest rates cannot be predicted. However, believing rates will rise or fall affects the selection of a loan program today. If you believe rates will drop in five years, a 5/1 ARM might provide sufficient payment stability until a refinance is possible. Likewise, a contention that rates will rise for the foreseeable future may make a longer fixed period more attractive.

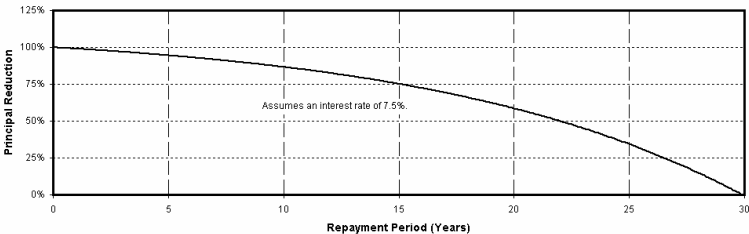
After the fixed period expires on an adjustable rate mortgage (ARM), the interest rate becomes variable along with the monthly payment. If rates rise, the monthly payment will also rise. If rates fall, the payment will drop as well. The variable interest rate adjusts every six or 12 months and is calculated as an index (such as the treasury index or the LIBOR) plus a predetermined margin.

Fixed rate mortgages are unaffected by fluctuating rates or inflation and most homeowners 'grow into' their mortgage payment over time, even if it seemed unmanageable at first. Your employment salary may increase; cost of living adjustments, promotions, investment income, etc. The monthly payment may appear overwhelming at first but circumstances often change, making the payment more manageable as time goes by.

Principal Reduction

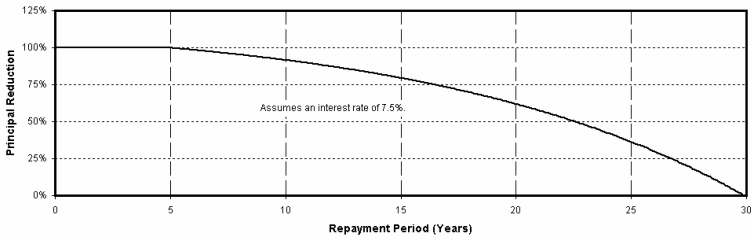
The above discussion explores the impact of shorter fixed-rate periods on interest rates but there are other principal reduction alternatives as well including interest only and graduated payment options. Historically, most mortgages amortized fully during the repayment period. The graph below displays a standard amortization for a 30 year fixed loan.

Fully Amortized 30 Year Fixed



Today, many lenders are offering borrowers temporary interest only options for the repayment of their loans, reducing their initial payment by eliminating any principal reduction. Borrowers should fully understand this relationship before selecting an interest only program. Although such options are often presented as perpetual, they generally expire after five or 10 years. After that time, the principal repayment begins, amortized equally over the remaining life of the loan. The graph below displays principal reduction with a five-year interest only option.

5 Year Interest Only Option

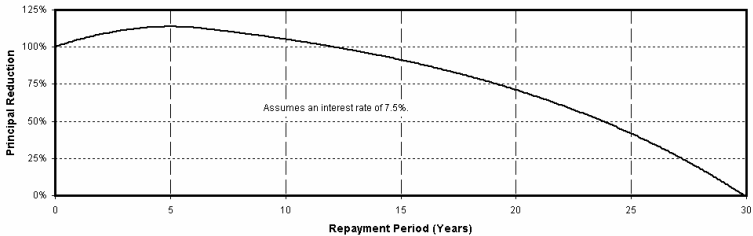


Another increasingly popular program allows even *lower* payments by requiring an amount that does not even cover the accrued interest on the loan. Such programs add the unpaid interest to the principal balance, increasing the loan amount over time. Such programs are called graduated payment (or negative amortization) loans.

Within the context of an appreciating real estate market, graduated payment loans can sometimes be justified but they introduce significant risks for borrowers and can result in negative equity within a stagnant or depreciating real estate market. Careful consideration is encouraged before selecting such a program.

The graph below displays principal reduction with a graduated payment loan. Notice the increasing principal balance during the early years of the repayment schedule, caused by accumulated unpaid interest.

6 Year Graduated Payment Option



Similar to interest only options, graduated payment programs are generally limited to five, six or seven years, after which principal repayment must begin. Monthly payments increase annually during the initial years and then level off with a fully amortized payment. Such programs also cap the extent to which the principal balance can grow, usually 125% of the original loan.

In all three graphs above, the principal reduction (when fully amortized) accelerates as the repayment term progresses. This happens because the early principal reduction lowers the balance from which interest is calculated. As a result, each successive monthly payment contains a

slightly smaller interest component, leaving more for principal reduction and accelerating repayment. This progression is accentuated with higher interest rates as demonstrated below.

Fully Amortizing 30-Year Loan		
Loan Interest Rate	% of First Payment to Interest	Time to Pay ½ the Original Loan Balance
5 %	78 %	20 yrs, 1 mth
7.5 %	89 %	22 yrs, 0 mths
10 %	95 %	23 yrs, 6 mths

Extra and/or Larger Payments

The full loan term is shortened dramatically by making extra (or larger) payments. The table above shows a fully amortized 30-year loan at 7.5% allocating only 11% (100% - 89%) of the first payment towards principal reduction. If the monthly payment is exactly \$1,000, only \$110 goes towards principal reduction. Therefore, the addition of just \$100 almost doubles the principal reduction for the first month.

The principal component of each payment increases over time so the amount necessary to double the principal component increases as well. It may not be financially practical to meet this goal forever, but an effort to pay extra will make a significant impact on the principal reduction of your loan. The greatest impact is achieved at the beginning of the repayment period. Generally, the impact will not affect your monthly payment, but will shorten the total loan term instead.

Fully Amortizing 30-Year Loan @ 7.5%	
Amount Paid Each Month	Time Removed from Repayment Period
Payment + 5%	55 Months
Payment + 10%	92 Months
Payment + 15%	119 Months
Payment + 20%	141 Months

Prepayments and Penalties

The payment of principal before it is due is known as a prepayment. Borrowers generally prepay for one of three reasons. First, they sold the property and are using the proceeds to retire the mortgage. Second, they are refinancing the property and using new loans to retire old ones. Third, as discussed in the previous section, they are accelerating the principal repayment of their loan.

Some loans include extra charges for early repayment of debt, known as prepayment penalties. These penalties attempt to discourage borrowers from excessive refinancing but often allow extra or larger payments for accelerated repayment of principal. Although specific provisions vary,

many prepayment penalties allow the borrower to pay as much as 20% of the original loan balance in any given year *before* it is considered a prepayment. In other words, a prepayment penalty will not necessarily prevent you from accelerating repayment.

Prepayment penalties benefit lenders by encouraging stability among borrowers. Used properly, they can also benefit you. Lenders are often willing to take a lower interest rate in exchange for a prepayment penalty. Particularly if the penalty allows extra or larger payments (as discussed above), there is little risk in this strategy. Ask your mortgage banker for more details.

Beyond the various topics discussed above, there are broader loan categories warranting discussion. Three of these are reviewed below.

Conforming Loans

Conforming loans are secured by government-sponsored entities such as Fannie Mae and Freddie Mac. Typically, these loans have lower interest rates reflecting lower risk. They can be first or second mortgages and are available for purchase and refinance transactions, provided the underlying property has only one to four units (1-4 family homes).

The single-family first mortgage loan limit is currently \$333,700 (2004) except in Alaska, Hawaii, Guam and the US Virgin Islands where the limit is \$500,550 (50% higher). This limit is reviewed annually and adjusted to reflect changes in the national average price for single-family homes.

Non-Conforming (Jumbo) Loans

Loans larger than limits set by Fannie Mae and Freddie Mac are called jumbo loans. These loans generally carry a higher interest rate and have additional underwriting requirements because they lack the security of conforming loans. Jumbo financing requirements can sometimes be achieved with a conforming first mortgage accompanied by a second for the excess, minimizing the overall rate for the borrower.

The interest rate difference between conforming and jumbo loans is less significant in today's competitive lending environment than it was years ago. It is also less significant for ARM products than it is for 30-year fixed loans. While any interest rate advantage is worth exploring, borrowers of jumbo loans are receiving extremely competitive rates in today's market.

Home Equity Lines of Credit (HELOCs)

Home equity lines are a form of revolving credit, similar to credit cards but secured by home equity. While lines are a valuable tool for managing personal finances, there are important advantages and disadvantages to consider. The three primary advantages are (1) they generally carry interest rates far lower than credit cards, (2) they provide access to large amounts of cash and (3) the interest is tax deductible (consult your CPA for limitations).

These advantages offer significant financial benefits but come with additional risks. Credit cards are secured only by your good credit. An inability to pay results in collections activity and reduces your credit score but does not jeopardize your home. On the other hand, home equity lines are secured by the equity in your property. An inability to pay your monthly payment may result in foreclosure – you can lose your home.

Large credit limits available through home equity lines create a false sense of affluence and encourage excessive spending beyond a manageable debt load, particularly if an initial interest only repayment option is provided. The benefits of these lines are only achieved if accompanied by mature purchase decisions and genuine financial responsibility.

Home equity lines are also used as alternatives to regular second mortgages. In this capacity, the full credit is drawn immediately, providing additional financing to pay for the property. As the principal is repaid, the credit limit remains unchanged leaving revolving ‘credit available’ for the borrowers should they need it in the future.

Signing the Loan Documents

Signing loan documents is an intimidating experience. There seem to be more forms every year all presenting complicated legal verbiage while requiring signatures from the borrowers. Here are a few hints to simplify the process and help you make sense of the many agreements and contracts.

In the entire stack of paper, there are three or four forms that carry most of the weight. The first is the Estimated Closing Statement provided by the title company. This form is discussed in the following section about the Real Estate Settlement Procedures Act. The second is the actual note and the third is the Truth-In-Lending discloser, also discussed in a later section.

The note is the document detailing the loan amount, lender, interest rate and repayment terms. It specifies the date of your first payment, the amount (principal & interest) and prepayment provisions. For adjustable rate mortgages, it also specifies the date when the interest rate may change and the way it is calculated thereafter (an index plus some margin). The note is the most important document in the package.

In California real estate transactions, a Deed of Trust accompanies every note. While the note makes little mention of the collateral, the deed deals exclusively with that aspect of the transaction. It identifies the property being used as security for the loan and the obligations of the owner to pay the note as agreed, maintain the property, carry sufficient hazard insurance and pay all property taxes and special assessments.

Another valuable document is the Right To Cancel form. It is required for all refinance transactions and second mortgages but not for 'purchase money' first mortgages. Under federal law, you have the right to cancel without cost within three business days from the latest of (1) the date of the transaction, (2) receiving the Truth-In-Lending disclosures or (3) receiving the Right To Cancel form. When signing your loan documents, you are entitled to receive two signed originals of this form.

Real Estate Settlement Procedures Act (RESPA)

RESPA protects consumers from abuses during the residential real estate purchase and loan process. It requires lenders to disclose all settlement costs, practices, and relationships after applying for a loan and again at settlement. RESPA also limits the escrow funds lenders may require for real estate taxes and insurance, and prohibits certain referral fees.

RESPA is the law regulating the Estimated Closing Statement and the Good Faith Estimate. Read these forms carefully before signing. The Estimated Closing Statement is generally at the top of the stack. It itemizes all costs associated with the loan transaction, regardless of who is paying for them (if your mortgage banker is paying for these costs, the credit will reference NRCCs or Non-Recurring Closing Costs). Make sure you understand these itemized fees before you sign the form. Contact your mortgage banker for additional clarification if necessary.

Truth-In-Lending & Regulation Z

The federal Truth-In-Lending Act (TILA) is designed to protect consumers by requiring clear disclosure of key terms and costs involved in credit transactions intended for personal, family or household purposes, exceeding \$25,000 and secured by real property. It enables consumers to compare costs between different lenders and understand the total cost of credit as compared to cash. The law also has a variety of other requirements and limitations designed to ensure maximum disclosure.

When you sign your loan documents, TILA will account for at least one form and often two or three. The primary Truth-In-Lending disclosure provides a valuable summary of your loan arrangement. Across the top, it displays a series of boxes providing your annual percentage rate (APR), the total finance charge, the amount financed and the total of all payments.

The APR often confuses borrowers because it rarely matches the rate specified on the note and is frequently higher. The reason for this variance is that the APR includes other costs of the transaction paid for outside of the loan including discount points, mortgage insurance, various fees and some finance charges. It calculates what the rate *would* be if everything was included.

For adjustable rate mortgages, lenders must assume future interest rates are identical to today when estimating future payments. Since the initial

fixed rate is temporary, the majority of payments are calculated using an adjustable (and slightly lower) rate. This assumed lower rate pulls the APR down. As a result, the APR specified on the TILA disclosure for adjustable rate mortgages is lower than the specified rate on the note.

In either case (fixed or adjustable rate mortgages), the APR is an excellent measure for comparing different lenders. All lenders must follow the same rules when calculating figures for the TILA disclosure. If you are comparing identical loan programs from competing lenders, the APR will tell you which lender is offering the best deal.

The TILA disclosure also provides the total amount financed, an amount somewhat less than the loan amount specified on the note. The variance results from the subtraction of 'prepaid finance charges', charges incurred in connection with the loan that must be paid upon closing. Details of this adjustment are often provided in a second form called the "Itemization of Amount Financed".

The two most important components of the TILA disclosure are the APR and the amount financed but the form also provides a variety of summary information including some hazard insurance specifications, late payments fees, a reference to the securing property, the existence of a prepayment penalty and the ability for someone buying your house to assume the loan with the same terms.

No-Cost Loans & Closing Costs

There is no such thing as a no-cost loan. The term is heavily marketed but is generally misused and misunderstood. Every loan has costs associated with its origination. Someone pulls your credit report and prepares your application. An appraisal is done on the property. The lender underwrites the loan. Title insurance is issued. The escrow company processes the transaction and a notary public is paid to facilitate the signing. These activities all cost money.

There are three different ways closing costs get paid. The originator can pay for them by boosting the interest rate, then receiving a rebate from the lender sufficient to cover the costs; the borrower can pay for them by bringing cash to the closing; or the costs can be financed by adding them to the new loan amount. Either way, these costs exist and are paid by you, the borrower.

Although the majority of people select the first option (where the originator pays for everything), most are unaware the rate inevitably bears these costs. The advantage is that borrowers incur no out-of-pocket expenses, allowing them to consider *only* the interest rate for future refinance transactions. On the other hand, the rate will never be as low as one where closing costs are paid with cash or financed.

Similar to the loan program, the decision of how to pay for closing costs depends on the length of time you intend to carry the loan. If you are getting a 30-year fixed loan with the intention of keeping it to maturity, you will definitely save money by paying closing costs and even paying points to 'buy down the rate'. If you intend to carry the loan for two years or less, it may be easier to ask the originator to pick up the tab.

Points (one point equals 1% of the loan amount) are upfront fees reducing your interest rate. One-point loans have lower interest rates than no-point loans. In essence, paying points is a trade-off between paying money now and paying money later. While the calculation depends on prevailing interest rates, points generally have a payback period between 18 months and three years.

Points (and some other NRCCs) are tax deductible. For home purchases, these costs are deductible in the transaction's tax year. For refinances, they are allocated over the life of the loan in proportion to the interest paid each year. If you refinance again before realizing the full deduction, the remaining portion is taken in the tax year the initial loan is retired.

More information on these deductions and other related tax issues are found at the Internal Revenue Service's website: www.irs.gov.

Publication 936	Home Mortgage Interest Deduction
Publication 523	Selling Your Home
Publication 527	Residential Rental Property
Publication 530	Tax Information for First-Time Homeowners

Steps Taken After the Signing

Borrowers receive a full set of loan documents at the signing. Although these documents are awkward and take up a lot of space, they should be kept in a safe location as long as the loan is active and at least six years thereafter. You have three years to discover errors in your tax returns and re-file with the IRS. The IRS also has three years to audit your returns if it suspects good faith errors.

Most people believe the signing of documents is the last step before closing. Not so. At the time of signing, the lender has not yet officially approved your loan. They have only made a commitment to fund under certain conditions. Lenders will not finalize approval until everything is in place including borrower signatures. As a result, a few things should receive your attention during the signing.

Every loan is initiated with a Uniform Residential Loan Application (form 1003). A copy of this form will accompany your loan documents, usually at the bottom of the stack. Read it carefully. It details your personal and financial information. Any errors should be corrected and initialed by each borrower. Unnoticed inaccuracies may complicate final approval and closing.

A number of figures on the Estimated Closing Statement provided by the title company remain estimates at the time of signing. Unknown figures are over-estimated wherever possible. Prepaid interest is a good example. As a result, the borrower will generally receive a small refund beyond that specified on the Estimated Closing Statement.

Once the documents are signed, some of them are returned to the title company and others are returned to the lender. The title company finalizes closing costs on the final closing date and the lender finalizes loan approval and funding. Escrow is closed once funds are disbursed and relevant documents are then recorded with the county. The recording of documents is the last step in the loan process.

Glossary

3/1, 5/1, 7/1 and 10/1 ARMs – adjustable rate mortgages in which rate is fixed for three year, five year, seven year and 10-year periods respectively, but may adjust annually thereafter.

Adjustable rate mortgage (ARM) – a mortgage in which the interest rate is adjusted periodically based on a predetermined index.

Amortization – loan payment by equal periodic payment calculated to pay off the debt at the end of a fixed period, including accrued interest on the outstanding balance.

APR – Annual Percentage Rate, a measurement of the full cost of a loan including interest and loan fees expressed as a yearly percentage rate, providing consumers with a good basis for comparing closing costs between different lenders.

Assumption – the agreement between buyer and seller where the buyer takes over the payments on an existing mortgage from the seller.

Balloon Mortgage – a loan that is amortized for a longer period than the term of the loan with the remaining outstanding principal due in one lump sum at the end of the term.

Biweekly Payment Mortgage – a plan to reduce the debt every two weeks (instead of the standard monthly payment schedule), resulting in 26 (or possibly 27) biweekly payments each year (equal to 13 monthly payments) and providing substantial savings in interest.

Closing Costs – expenses over and above the price of the property or the refinance, normally including origination fees, property taxes, title insurance, escrow fees and appraisals.

Conventional loan – a mortgage not insured by FHA or guaranteed by VA.

Credit Report – a report documenting the credit history and current status of a borrower's credit standing.

Credit Risk Score – a credit risk score is a statistical summary of the information contained in a consumer's credit report (eg. FICO score).

Debt-to-Income Ratio – the ratio, expressed as a percentage, of a borrower's total monthly payment obligations divided by his or her gross monthly income.

Deed of trust – in many states such as California, this document is used in place of a mortgage to secure the payment of a note.

Default – failure to meet legal obligations in a contract such as a mortgage.

Down Payment – money paid to make up the difference between the purchase price and the mortgage amount.

Equal Credit Opportunity Act (ECOA) – a federal law that requires lenders and other creditors to make credit equally available without discrimination based on race, color, religion, national origin, age, sex, marital status or receipt of income from public assistance programs.

Equity – the difference between the fair market value and current indebtedness against the property.

Escrow – an account held by a third party into which the lender and the homebuyer pay monies required to close the transaction.

Fannie Mae – Federal National Mortgage Association (FNMA), a tax-paying corporation created by Congress that purchases and sells conventional residential mortgages as well as those insured by FHA or guaranteed by VA.

Federal Housing Administration (FHA) – a division of the Department of Housing and Urban Development (HUD) that insures residential mortgage loans made by private lenders.

Fixed Rate Mortgage – a mortgage whose interest rate remains the same throughout the term of the mortgage for the original borrower.

Foreclosure – a legal process by which the lender or the seller forces the sale of a mortgaged property because the borrower has not met the terms of the mortgage.

Freddie Mac – Federal Home Loan Mortgage (FHLMC), a quasi-governmental agency that purchases conventional mortgages from insured depository institutions and HUD-approved mortgage bankers.

Ginnie Mae – Government National Mortgage Association (GNMA), a quasi-governmental agency providing sources of funds for residential mortgages insured or guaranteed by FHA or VA.

Graduated Payment Mortgage (GPM) – a type of negative amortization mortgage where the payments increase for a specified period of time and then level off (see Negative Amortization).

Hazard Insurance (Homeowner's Insurance) – a form of insurance in which the insurance company protects the insured from specified losses such as fire, windstorm, etc.

HUD-1 Statement – a standardized document providing an itemized and numbered listing of funds payable at closing as well as the buyer and/or seller's net proceeds.

Impound – that portion of a borrower's monthly payments held by the lender or servicer to pay for property taxes, hazard insurance, mortgage insurance and other items as they become due.

Index – a published interest rate against which lenders measure and adjust the interest rate on adjustable rate mortgages (see LIBOR).

Insured Mortgage – a mortgage that is protected by the Federal Housing Administration (FHA) or by private mortgage insurance (PMI).

Jumbo Loan – a loan that is larger than the limits set by the Fannie Mae and Freddie Mac (\$333,700 in 2004).

LIBOR – an abbreviation for the "London Interbank Offered Rate," the interest rate offered by a specific group of London banks for U.S. dollar deposits of a stated maturity, used as an index for setting rates of some adjustable rate mortgages (ARMs).

Loan-to-Value (LTV) Ratio – the relationship between the amount of the mortgage loan and the appraised value of the property expressed as a percentage.

Margin – the amount a lender adds to the index on an adjustable rate mortgage to establish the adjusted interest rate.

Maturity – the date on which the principal balance of a loan becomes due and payable.

Mortgage – a legal document that pledges a property to the lender as security for payment of a debt (California uses Deeds of Trust).

Mortgage Broker – an individual or company licensed by the California Department of Real Estate (DRE) that brings borrowers and lenders together for the purpose of loan origination.

Mortgage Banker – an individual who represents a single lender but retains the right to broker loans out to other loan wholesalers when necessary or appropriate.

Negative Amortization – a mortgage written with a monthly payment that is insufficient to satisfy the accrued interest with the unpaid portion added to the loan balance.

Note – a legal document that requires a borrower to repay a debt obligation at a stated interest rate during a specified period of time.

Origination Fee – the fee charged by a lender to facilitate the loan application process and prepare loan documents, usually computed as a percentage of the face value of the loan.

Payment Cap – a limit on the amount that payments can increase or decrease over the life of an adjustable rate mortgage (ARM).

Payment Change Date – the date when a new monthly payment amount takes effect on an adjustable rate mortgage (ARM).

Periodic Payment Cap – a limit on the amount that payments can increase or decrease during any one adjustment period.

Periodic Rate Cap – a limit on the amount that the interest rate can increase or decrease during any one adjustment period.

Points (Loan Discount Points) – prepaid interest assessed at closing to provide for a lower nominal interest rate, expressed as a percentage of the loan amount.

Pre-approval – the process of determining exactly how much money you will be eligible to borrow before you actually apply for a loan.

Pre-qualification – the process of estimating how much money a lender will lend you based on current market conditions, basic financial information and ratios.

Prepaid Expenses – charges necessary to create an escrow account or adjust an existing one for things such as taxes, hazard insurance, private mortgage insurance and special assessments.

Prepaid Finance Charges – certain charges incurred in connection with the loan that must be paid upon the close of the transaction

Prepayment – a privilege in a mortgage permitting the borrower to make payments in advance of their due date.

Prepayment Penalty – fees charged for an early repayment of debt.

Principal Balance – the outstanding balance of principal on a mortgage not including interest or other charges.

Principal, Interest, Taxes & Insurance (PITI) – the four components of a monthly mortgage payment.

Private Mortgage Insurance (PMI) – special insurance required by lenders when a borrower has less than 20% down payment and is financing the remainder through a single loan.

Rate Cap – a limit on the amount that the interest rate can increase or decrease over the life of an adjustable rate mortgage (ARM).

Rate Lock – a lender's guarantee that the interest rate quoted will be good for a specific number of days from the day of application.

RESPA – Real Estate Settlement Procedures Act, a consumer protection law that requires lenders to give borrowers advance notice and full disclosure of closing costs.

Rescission – the law that gives the borrower three business days to cancel a mortgage contract after it has been signed and certain mandated disclosures have been provided.

Recording Fees – money paid to the lender for recording a home sale with the local authorities, thereby making it part of the public records.

Refinance – obtaining a new mortgage loan on a property already owned to replace existing loans on the property.

Reverse Annuity Mortgage (RAM) – a form of mortgage in which the lender makes periodic payments to the borrower using the borrower's equity in the home as collateral and eventual repayment of the loan.

Servicer – an organization that collects principal and interest payments from borrowers as well as managing their escrow accounts.

Title Insurance – a policy that insures a lender or a homeowner against errors in the title search.

Title Search – an examination of municipal records to determine the legal ownership of real property.

Truth in Lending – Regulation Z, a federal law requiring disclosure of the Annual Percentage Rate (APR) among other things to borrowers shortly after they apply for the loan.

Underwriting – the decision whether to make a loan to a potential borrower based on credit, employment, assets, and other factors as well as the selection of an appropriate rate and term for the loan amount.

VA Loan – a long term, low-or-no down payment loan guaranteed by the Department of Veterans Affairs and restricted to individuals qualified by military service or other entitlements.

Information & Documentation Checklist

Information for Loan Application

- full contact information for borrower and co-borrower
- date of birth, social security number and years in school
- employer contact information and type of business
- position title, years at job and years in profession
- breakdown of all monthly income (including rents if applicable)
- breakdown of all assets and liabilities (including value of assets)
- names and addresses of all banks and/or creditors
- real estate owned including appraised value and lien amounts
- details of judgments, bankruptcies, defaults and foreclosures

Definite Documentation Requirements

- photocopy of state driver's license and social security card
- 24 months residence history (including landlord info if applicable)
- 24 months employment / occupation history (including contact info)
- most recent two month's pay stubs and two year's W-2 forms
- year-to-date P&L and current balance sheet (if self-employed)
- most recent three month's statements for all accounts (saving, checking, retirement)

Possible Documentation Requirements

- most recent two year's federal tax returns
- supporting documentation for any of the following:
 - o lawsuits and/or judgments
 - o bankruptcies, defaults, foreclosures
 - o divorce, alimony and/or child support payments
 - o citizenship and/or immigration status
 - o property owned and/or assets declared
 - o derogatory items discovered on credit report

This is not a complete list. Every loan application is unique and will require different documentation. Requirements also vary by lender.

Dear reader,

How do you find a good doctor? How do you find a good dentist? How do you find a good financial advisor? And how do you find a good mortgage banker? These questions resonate with all of us. In most cases, we find them through referrals from our friends and associates.

Referrals are valuable indeed, but how do you know you can trust them? While many mortgage originators hold their cards close to the vest, we try to build trust by educating our customers, openly and honestly, about the industry and how it works. We process lean and clean transactions to optimize financial efficiencies for our customers.

We hope the information in this handbook leaves you with a better understanding of real estate finance. There are countless nuances to the loan decision and we would love the opportunity to discuss them with you, along with your particular circumstances and financial objectives. Please feel free to contact me with any questions you may have.

Loan approval is not guaranteed and is subject to the verification of specific information that will be requested at the time of application.

Patrick Schwerdtfeger