

# 4 C's of Lending

Version 2.1

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## Collateral

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## Securing Your Loan

When you borrow money to purchase a home, you sign a note which is your agreement to pay the money back. The note spells out how much you borrowed, your interest rate and the terms of repayment. You also sign a mortgage which gives the lender the security of your home if you fail to make your payments.

If the borrower is not able to make their payments, the lender will take back the home. This is known as a foreclosure. In many states you have to be 12 months behind on your payments before the bank gets the property back. The bank will then sell the home and try to get enough money to payoff the balance due on the note, attorney and realtor fees, and costs to put the home back in marketable condition. Lenders want the home to be in average or better condition and want the home to appraise for the sales price or higher, so they have the best chance of getting paid off in the event of a foreclosure

## **Appraisal**

An appraisal is a report that gives a professional opinion of value of the home in the current market. If someone shows you an appraisal from a year ago the value is most likely not the current value, appraisals for lending purposes are usually only valid for 90 days. There are many rules on appraisals and many lenders use an appraisal management company which will randomly assign the appraisal to a licensed appraiser in the area of the home or the lender will choose an appraiser randomly off a list of approved appraisers.

The appraiser is not an inspector but does check to make sure the utilities are on and by physical observation could require an inspection. For example if the shingles are all curled up the appraiser could require an inspection by a licensed contractor to make sure the roof still has a life expectancy of 5 years or more.

The appraiser will look at the following items to compare with similar recent homes that have sold. These are referred to as comparables or comps. The appraiser will look for the best comparable sales in the last 6 months and make adjustments for the following items:

**Location** – The appraiser has to find similar properties in the same area that have recently sold, so they do not compare a ranch with a two story. As the old saying goes location, location, location. Certain areas or certain school districts may make the property more valuable than a home only a few blocks away. The surrounding areas such as a lake, golf course, or next to a busy highway all affect the value.

**Square footage** – In general, the more square footage the higher the value. The appraiser place a higher value on finished square footage. One of items that confuses a lot of borrowers is above grade square footage. The square footage on a first or second floor is much more valuable than the square footage in a basement.

**Room Count** – The more bedrooms and bathrooms a home has, the more valuable it is. To be a legal bedroom it must have a closet and proper egress. If a bathroom only has a stool it is considered a ½ bath if it contains a bathtub or shower it would be considered a full bath.

**Age** – The age of a home also affects the value, the older the home generally the less valuable. If a comparable home is 15 years old and the home being appraised is 5 years old the appraiser will make an adjustment for the age. If upgrades or improvements have been done to the home the appraiser will note the actual age which may be 15 years old and also put an effective age which in the appraiser's opinion may be 5 years old.

**Quality** – The quality of the construction and products used will also factor into the value. The appraiser will make an adjustment if one of the comps is of a lower or higher quality than the subject property.



**Miscellaneous Items** – There are a number of other items that the appraiser will make adjustments for including porches, decks, fireplaces, underground sprinkling, in ground pools, and air conditioning.

The appraiser has to choose a minimum of 3 comparable properties. Many times they will choose more or will even add a similar home that is listed for sale to help support their opinion of value. They then make adjustments based on the sales price of the comparable homes for any items that differ from the subject property and come up with a final opinion of value for the subject property.

For example if a borrower puts 5% down to purchase a home for \$100,000 the loan would be for \$95,000. Value is determined by whichever is lower, the sales price or appraised value. If the home appraises for \$96,000 the lender would require 5% down based on the appraisal and the loan would be for \$91,200. So instead of having a down payment of \$5,000 the borrower would need a down payment of \$8,800. Normally at this point the buyer would go back to the seller and try and renegotiate the price. The buyer may decide not to purchase the home (or they may not qualify if they do not have any additional funds) or of course they could decide to still purchase the home and put down the extra down payment.

There are really only 4 types of mortgages available today; Conventional, FHA, VA and Rural Development and each requires a different type of appraisal.

FHA, VA and Rural Development appraisals are all very similar and have a number of specific property requirements. However, VA has their own list of approved appraisers and the appraiser is assigned by VA. In order to be approved for a government-insured mortgage loan, a house or condo must meet a specific set of requirements. These requirements are outlined in HUD Handbook 4150.2, chapter 3, which is available online.



## **FHA Property Requirements at a Glance**

If a homebuyer wants to use an FHA loan to purchase a certain property, the property must meet the general acceptability criteria outlined in the HUD handbook mentioned above. Listed below are the basic property requirements for FHA loans.

The physical condition of existing building improvements is examined at the time of the appraisal to determine whether repairs, alterations or inspections are necessary - essential to eliminate conditions threatening the continued physical security of the property.

Required repairs will be limited to necessary requirements to:

- Protect the health and safety of the occupants (Safety)
- Protect the security of the property (Security)
- Correct physical deficiencies or conditions affecting structural integrity (Soundness)

A property with defective conditions is unacceptable until the defects or conditions have been remedied and the probability of further damage eliminated. Defective conditions include:

- Defective construction
- Other readily observable conditions that impair the safety, sanitation or structural soundness of the dwelling

Typical conditions that would require further inspection or testing by qualified individuals or entities:

- Infestation – evidence of termites
- Inoperative or inadequate plumbing, heating or electrical systems
- Structural failure in framing members
- Leaking or worn-out roofs
- Cracked masonry or foundation damage
- Drainage problems



Many Realtors or borrowers are still concerned about an FHA appraisal, but in my experience the appraiser is looking for the same items on any type of appraisal that they do. In most areas it would make sense to do a well and septic test if one exists (which a conventional appraisal may not require) and a termite inspection if the property is located in an area where termites exist.

Most borrowers get inspections done on a property prior to the appraisal being done. Many of the items listed above will show up in the home inspections on the property and will already be discussed with the seller. If the property does not meet the FHA requirements or conventional requirements it is not necessarily a deal breaker. Many times the seller will make the needed repairs since they know they will run into the same issues with another buyer.

The items can be repaired prior to closing or in certain areas a weather related escrow account can be established to make repairs such as a roof replacement that can not be completed during winter months.