ESSENTIALS OF REAL ESTATE FINANCE

DAVID SIROTA

9TH EDITION

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Preface

Welcome to the intriguing and always exciting world of real estate finance. As this ninth edition is being composed, the real estate markets in most areas of our country have settled into relative stability with weaknesses appearing in only a few areas. After a general spurt in activities in the early 1990s, following the devastating recession in the late 1980s, property values have leveled with growth slowing. Apartment vacancies have declined significantly and hotel properties are prospering. However, retail properties are being developed faster than the growth in retail sales and some economists predict an imminent drop in retail property values. Predictions are that the economy will continue its slow but steady growth into the early 2000s.

We will enter the year 2000 with an estimated population of 275 million people and an economic growth factor of less than one percent per year.

Most of our sources for real estate finance have overcome their reluctance to make new loans and have reentered the mortgage loan markets, which enhances the efforts of builders and developers everywhere. The boom days of 1992–1994 have disappeared into a more stabilized market structure, and the prognosis for the next few years is continued stability.

Large institutional owners of real estate will continue to reduce their real estate portfolios, creating new opportunities for pension funds and REITs to enter the equity markets. This will be accompanied by increased equity and debt securitization.

Loan underwriting remains strict, requiring bona fide appraisals from licensed and credentialed appraisers to substantiate property values in excess of $100,000. Down payment requirements and complete documentation of a borrower's ability to pay must continue to meet new levels of scrutiny. Personal liability for defaulted and foreclosed loans is being enforced more thoroughly than ever.

Long-term, fixed-interest-rate loans are still the prevalent form, although lenders would prefer to make short-term, variable-interest-rate loans. However, costs for securing real estate loans have risen substantially. As a result, many principals involved in real estate transactions are designing new and different financing arrangements to meet their needs.

Participation loans, graduated-payment loans, less-than-interest-only (negative amortization) loans, options, leasebacks and other techniques are being used as lenders, builders, sellers and buyers continue to struggle to succeed in the marketplace.

And succeed we will, because the sturdy fabric of capitalism is woven from the strong and resilient threads of private enterprise. To a great extent, private enterprise depends on the ability of many individuals to comprehend and use real estate finance. Each investor need not know everything about all phases of financing real estate, but those who do understand the process are more likely to achieve success in their investments.

During the Great Depression, the U.S. capitalistic system was battered, torn and generally worn threadbare. Safeguards for the government's security were woven carefully into the cloth, and the number and scope of these safeguards have continued to increase over the years.

The safety measures that secured our government also protected the people and their investments. People have depended, in ever-increasing numbers, on banks, thrift institutions and life insurance companies to lend them the dollars with which to buy a piece of America. Some people bought large pieces, and some grouped together to buy even larger ones; but most people bought just the little piece they call home. Although the FSLIC is now defunct, the federal government through the FDIC continues to stand resolutely behind everyone's deposits to the extent of $100,000 per account, guarding our savings.

This ninth edition has been redesigned to serve the needs of our ever-increasingly technological environment. Most of us no longer have the time to reflect on the historic events leading up to the evolution of real estate finance. We need to know the hard and fast rules and techniques of the industry, and we need them explained concisely and plainly with lots of examples as illustrations. Thus, we have eliminated most of the historic materials, together with many charts and graphs. This text has been rewritten to complement our readers' needs.

However, we continue to present the principles of real estate finance in the first half of the text, with the practices and applications included in the second half. Many practical examples have been added, with forms and formulas described in simple terms.

The principles portion of the book opens with the Introduction, which includes the definition of the ownership of property and estates in realty. It also describes the physical, economic and social characteristics of real estate.

Chapter 1 introduces the general aspects of real estate finance. It includes a presentation of our credit system economy, the nature of financing relationships, local and national mortgage markets, the concepts of business and realty cycles, and an update on recent changes in real estate finance.

Chapter 2 examines the major government influences in the finance markets, including the Federal Reserve System, which regulates our money supply, the U.S. Treasury and the Federal Home Loan Bank System. The importance of these agencies in real estate financial activities cannot be overstated.

Chapter 3 covers the special financing needs of farmers and ranchers, as well as the activities of the Department of Housing and Urban Development (HUD) and the various state financing agencies.

Chapter 4 defines the activities of the participants in the nation's secondary mortgage market. They include the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC) and the Government National Mortgage Association (GNMA). It also describes the Real Estate Mortgage Investment Conduit (REMIC), an important tool in the securitization (pooling) of mortgages to back up securities to be sold in the financial markets, both public and private.

In Chapters 5 and 6, the activities of fiduciary, semifiduciary and nonfiduciary sources of funds for real estate finance are described. Included are commercial banks, savings institutions, life insurance companies, pension funds, credit unions, mortgage brokers and bankers, real estate trusts and syndicates, bonds and private lenders.

Chapter 7 presents the principal instruments used in real estate finance, including the note and deed of trust, the note and mortgage and the contract for deed (land contract). This chapter also includes the special provisions that may be included in any of these instruments to better serve participants' needs.

Chapters 8, 9 and 10 begin the practices portion of the book. They examine conventional, FHA-insured and VA-guaranteed real estate loans. They include the latest changes in qualifying requirements.

Chapter 11 takes the loan process from application to closing and describes the various details involved in qualifying the borrower, property and title. Included are the techniques of prorations, preparing the closing statement and examples of actual loan problems.

Chapter 12 investigates contemporary applications of real estate finance, including variations in both interest rates and payments, alternative payment plans and creative financing formats.

Chapter 13 details the ways in which borrowers can default on loans and the consequences of foreclosures.

Chapter 14 examines the applications of alternative financing techniques to minimize the impact of income taxes.

Each chapter begins with a list of key terms and ends with a review quiz. Answers to the quiz are at the back of the book. The Appendix explains the mathematics of real estate finance and the Glossary provides key term definitions.

Every effort has been expended to develop this book in a logical, sequential format, with accurate, easily understandable language. The author welcomes all comments and questions about its contents and will answer them immediately. Address inquiries to D. Sirota, 564 Corpino de Pecho, Green Valley, AZ 85614, or call (520) 625-6417, e-mail dsirota@azstarnet.com.

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To Ann Kennehan, my original indefatigable editor, counselor, corrector and severest critic, my eternal admiration, affection and respect.

To my loving wife, Roslyn, this book is dedicated with everlasting love.

ABOUT THE AUTHOR

Dr. David Sirota has combined 40 years of field experience as a real estate agent, broker, appraiser and consultant, plus an academic background culminating in a Ph.D. from the University of Arizona in Area Development, in the writing of *Essentials of Real Estate Finance*. He says, "To be extraordinarily successful, it's not enough to know how the system works, but why it does. Then you can be in a position to utilize it for your own highest benefits."

Dr. Sirota taught real estate subjects at the University of Arizona in Tucson, the University of Nebraska in Omaha, Eastern Michigan University in Ypsilanti, National University in San Diego and California State University in Fullerton. He held the Real Estate Chair at Nebraska and was a Visiting Professor at the University of Hawaii. He was involved as a consultant in the development of a congregate care center in Green Valley, Arizona, and acts in a consultant capacity for individuals and developers. He is a founding and continuing member of the Real Estate Educators Association, securing one of its first DREI designations. Dr. Sirota is the author of *Essentials of Real Estate Investment* and coauthor of *California Real Estate Finance*.

Introduction

KEY TERMS

- allodial system
- bill of sale
- bundle of rights
- chattel
- condemnation
- condominium
- contract for deed
- deed
- deed of trust
- eminent domain
- equitable interest
- escheat
- fee simple
- freehold estate
- hereditaments
- inheritability
- leasehold estate
- mortgage
- personal property
- police powers
- property
- real property
- security agreement
- time-sharing
- trade fixtures

In the beginning God created the heaven and the earth.

Genesis

And so it has been and ever must be that the earth remain fixed in place and provide the necessities for all manner of life.

Humanity's evolution is a history of war written in blood. It is a history based on survival, predicated on possession and control of this productive earth. It foretells a future based on the earth's ability to continue to support an ever-increasing human race. As the demand for land becomes greater, so does its value increase.

The earth and its natural resources form the basis for a large part of the wealth from which nations grow. Citizens share this wealth according to their ability to participate in the ownership of the earth. Fortunately, our system of government allows its citizens to share in the land's wealth to a great extent. Hence, real estate and property ownership have become important areas of investment in this country.

Under the U.S. system of private property ownership, owners' rights in property are guaranteed by law. Here, as in other nations that honor private property ownership, we may legally enjoy the peaceful possession and quiet pleasure of our property. We may farm, mine, subdivide or build on, under or above the land; we may trade, lease, finance or give it away. Above all, we can *own* property in the most complete sense possible. *We can control it into perpetuity,* because our private property ownership system also guarantees *inheritability.* Not only can we enjoy the fruits of our labor in the form of real property during our lifetimes, but we also can designate to whom our estates will pass when we die.

Inheritability is a strong motivation to work hard. Although most of us work to live, inheritability spurs many of us to work harder and produce more than we can consume. This extra production results in savings, which in turn become the means by which others also can own a portion of our country's wealth—a portion of the earth. To a great degree, the existence of savings makes borrowing possible. The earth bought with these borrowed funds, together with the borrower's labor, provides not only the means for repayment, but also a return on the investment. And it is the earth that stands as the silent guarantor for a loan because ownership of that portion of the earth will pass to the lender if the borrower defaults.

The earth, by literally providing a foundation for wealth, becomes the natural collateral. To own a portion of the earth is to own something of eternal value.

OWNERSHIP OF PROPERTY

The evolution of private property ownership is a long, complicated history of political, social and economic experiments in the quest to discover the ideal arrangement. The design of our ownership is the result of historic events that led to the principles of democracy and capitalism, giving us a system that respects and protects the individual's right to own property.

Our system of property ownership is called the **allodial system.** It descended from the historic Roman Real Property Law of Absolute Ownership, through the English feudal system, and was brought to our shores by the early English settlers.

Real Property

Property is anything that can be controlled and owned. Land and buildings are considered property because they can be owned by individuals. Clothing, furniture, automobiles, refrigerators and like items are also considered property.

Is water property? Water falling from the sky in the form of rain is not property, nor is the water in the middle of the ocean. These waters may not be "owned" by anybody. However, the water in a well is the property of its owner, as is distilled water in a container. The water in the navigable lakes and rivers of this country, as well as the land and water located up to 200 miles off our coasts, is the property of the government.

Is air property? The air above the land is not property until it is enclosed within a structure; the air in an oxygen tank is property. Rights to air over property can be sold subject to zoning and building height restrictions.

Is an idea property? Not until it is converted into a patented invention or into a copyrighted manuscript is an idea considered property.

Thus, property is not so much something that can be *owned* as it is something that can be *controlled*. We can own a portion of the earth because we can control it, and we can control it because our system of government has laws that protect these rights.

Real estate is described as the land and all natural and manmade **hereditaments** found permanently attached thereto. Hereditaments are things capable of being inherited. Land, streams, trees, minerals, buildings, fences and other features permanently in place on the land are interpreted as real estate. Thus, real estate is an inheritable estate.

Real property marries the legal concept of ownership and control with the physical description of real estate. Now real property can be further defined as that **bundle of rights** in property—including possession, control, enjoyment, exclusion, disposition and others—that enhance the inheritable ownership of the land and everything permanently affixed to it. Real property ownership is transferred by a **deed** and encumbered by the use of either a **deed of trust,** a note and **mortgage** or a **contract for deed** when it is pledged as collateral for a loan.

Personal Property

Personal property, also called **chattel,** is generally considered to be anything that is not real property. This presumes that it is movable, *not* permanently attached to the earth. Automobiles, furniture, clothing and other portable objects are obviously personal property. A classic example of the various attributes of property is the tree that is *real* while growing, *personal* in the form of lumber and *real* again when used to build a house. Personal property ownership is transferred with a **bill of sale** and is encumbered with a **security agreement** when it is used as collateral for a loan.

Commercial Fixtures

The exception to the permanently attached rule is the category of property classified as commercial or **trade fixtures.** Personal property used by commercial tenants in pursuit of their occupations retains its personal property quality, no matter how permanently it is affixed to the real estate. Heating units, coolers, walk-in refrigerator boxes, floor coverings, interior partitions, shelves, counters, cabinets, dentists' chairs and all other items that are installed by business and professional tenants retain their personal property classification and must be removed from leased premises before the expiration of the lease. In the event of a dispute, the following tests are applied in determining whether a property is a fixture:

- Intention of the parties
- Manner of annexation
- Nature of use or adaptation
- Agreements between the parties
- Relationship of the parties to the property

ESTATES IN REALTY

Freehold Estates

An estate for an indeterminable length of time is called a **freehold estate.** An *estate in fee simple,* also called a fee simple absolute or just **fee simple,** designates the highest bundle of rights a person may enjoy in real property in our allodial system. In the language of real estate, a person is said to own a "fee" in a property as the legal owner. This ownership is defined by the deed held. It is this fee that an owner will pledge as collateral to back up the promise to repay a real estate loan.

A fee ownership may be divided into a variety of legal forms. One person may own the fee in the land, while another may own the mineral rights under the land. Fee ownership can also be divided into time elements such as interval ownership or **time-sharing.** Under time-sharing, a fee owner can use property for a specified time period, such as for one or two weeks a year, as in a vacation time-share. Fee ownership can also pertain to a space within a cube, in addition to an undivided ownership of certain designated common areas, as in a high-rise **condominium** project.

Companies and corporations may hold title to real estate in their designated names. However, individuals may own a fee in real estate in one of the following designations:

- *Tenants by the Entirety,* exclusively between husbands and wives. Includes *automatic survivorship,* where the surviving spouse inherits the deceased's portion without probate.
- *Tenants in Common,* which includes any number of partners who may own specified undivided interests in a property. Each proportionate owner needs a will to designate successor heirs.
- *Community Property,* exclusively between husbands and wives who own an equal, undivided interest in a property. Exists only in eight states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington. Needs a will to designate successor heirs.
- *Joint Tenants with Rights of Survivorship,* includes any number of partners who own equal, undivided shares in a property. However, when one partner dies, this portion is automatically divided equally among the surviving partners. Thus, this ownership format is generally limited to family members.
- *Sole and Separate,* implies ownership by married persons in their separate right, as with a property inherited by one spouse. Needs a will to designate successor heirs.
- *Severalty Ownership,* implies ownership by a single person. Needs a will to designate successor heirs.

Leasehold Estates

An estate that is for a determinable length of time is called a **leasehold estate.** A leasehold estate is established when a landlord gives up possession of real estate to a tenant. The tenant acquires an **equitable interest** in the property according to the terms and conditions of the lease. The landlord retains the legal fee, but the tenant has physical control of the leased property. According to special conditions, the tenant may be able to pledge the equitable leasehold interest to secure financing for making improvements to the leased property.

The freehold and leasehold estates are of primary interest in the field of real estate finance. A person's degree of ownership and control of real property will determine the amount and terms of the financing that will be available—financing that will come primarily from the savings of others.

REAL ESTATE CHARACTERISTICS

Real estate has certain properties that enhance its ability to qualify as collateral for financing purposes. These characteristics are generally grouped into three categories: physical, economic and social.

Physical Characteristics

Real estate is considered to be fixed in place. Some shifting can take place under certain conditions such as *avulsion,* when the land is torn from its place by the force of rushing waters, in the distorted wrenching of the earth in a sudden earthquake or when people deliberately change the earth's topography, as during open pit mining. Nevertheless, the boundaries of the land remain clearly definable. This quality of *fixity* creates the security that lenders require in order to know that their collateral will be there in the morning if a defaulting borrower should disappear in the middle of the night.

Using this same reasoning, land is considered to be *indestructible.* Although the quality of land changes as it is used, it prevails eternally and can be rejuvenated. This quality of durability has made land a popular form of investment.

Furthermore, each parcel of land is *unique.* Legally, each parcel is individually definable according to specific boundaries and ownership. Because property is readily definable, the legal enforcement of contractual promises pertaining to a certain property is made easier. This provides the protection required by lenders.

Economic Characteristics

Land is *scarce,* but not in the aggregate sense. There is virtually an unlimited supply of land that could be expanded through more intensive use. In the microsense, however, there is a *relative scarcity.* People congregate in small areas of the world, usually in cities, where they find the employment and cultural activities that community living develops. The press of demands on the relatively fixed supplies of land in these small areas creates a *value.* This value is the economic result of buyers bidding against each other for the limited supply of land.

Also, the *fixity of the investment* placed upon the land complements its unique position. Aside from minor improvements, most construction has a quality of longevity intrinsic in its design. Bricks and mortar, streets and sewers, all have a long life expectancy that, when coupled with the concept of scarcity, underwrites the lenders' abilities to make loans.

In addition, land has a *locational characteristic* that affects its value in relation to other, similar parcels in the same area. This situs definition enables lenders to identify its worth more accurately—an important input into the quantity and quality of loans to be made.

Social Characteristics

Real property has an increasingly important third general characteristic, one that is currently being enlarged on by social consciousness. This characteristic adds a stimulating, but often frustrating, dimension to the definition of real estate. It is the *social characteristic,* defined as the rights of the public in the private property of the individual.

A private property owner's rights are defined by statute and common law. An owner's highest bundle of rights is limited by the government's **police powers,** which regulate the use of property to protect the public welfare. **Eminent domain,** which gives the government sovereign powers of **condemnation** over private property for the community's benefit, also limits an owner's rights. In addition, private property rights are limited by the government's taxing powers. The concept of **escheat** is the reversion of a property without an identifiable owner to the government. Subdivision and deed restrictions are imposed to control property uses.

Currently, these social limitations of private property rights are being expanded to include controls of property uses as they affect our environment. Of major concern is the pollution of air, earth and water as it affects our current well-being and the well-being of generations yet unborn. The imposition of social controls can seriously affect some property values and even inhibit community development in certain areas of the country. The costs of these controls are reflected, to a great extent, in increased real estate prices.

SUMMARY

The earth, and our legal rights to own, possess and use it, form the basis for all nations' wealth. Individuals can participate in this wealth in proportion to their abilities to own a part of the earth as a result of the laws of their nations. Our allodial system of private property ownership enables us to own and control a part of the earth, to enjoy its benefits in our lifetimes and to designate to whom our estates will pass upon our deaths.

In many instances our individual ability to own the land and improvements is made possible by the savings created through surplus productivity. Through our individual efforts, we produce more than we consume. This extra production is deposited in the form of money into banks, savings institutions, life insurance companies and pension funds. From these financial institutions flow the loans required for continued growth and expansion.

Real estate has the physical, economic and social characteristics that form the qualities of safety and value upon which lenders rely in order to make loans. The earnings from these financial endeavors, in turn, create the basis for additional loans and continued growth.

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