California Real Estate Finance

Robert J. Bond / Alfred Gavello / Carden Young

Sixth Edition

CALIFORNIA REAL ESTATE FINANCE

SIXTH EDITION

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The world's a stage: To all who play a role, this book is dedicated, so that they may learn to appreciate the vital role of finance in our dynamic real estate economy ... and to my dear wife and best friend, Nanci, who was so supportive throughout this project.

Robert J. Bond

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PREFACE

This sixth edition updates all material presented in the previous edition. New topics include a whole new chapter targeted for low- and moderate-income buyers, beefed-up treatment of institutional and non-institutional lenders, refining of the Two-Step Mortgage, enlargement of customary buyer and seller closing costs, amplified AMIs and other loan variations, hard money loans, latest forms, new buyer qualification requirements, end-of-chapter questions conforming to affected textual changes, an expanded glossary, and addition of graphics to improve grasp of topics, such as the oft-misunderstood Equal Credit Opportunity Act. For those in areas of low and moderate incomes, the last chapter dealing with that subject will prove most beneficial. In short, this edition is one of the most current and practical textbooks on real estate financing principles and practices in California.

For many readers, the most exciting part of the book may be the section on the use and application of the financial calculator to solve real estate math problems. Some respondents stated that they found this the most valuable and challenging part of the 5th edition, and that they plan to use the financial calculator outside of real estate as well.

Throughout the book you will find 12% interest rates to illustrate problems and cases. It may not be a realistic number when rates are at single-digit levels, but 12% is easy to deal with, since it translates easily into 1% per month, thus making math computations easier. In any event the principles and applications remain the same, regardless of the interest rates in existence.

The chapter on financing income-producing properties is now the Appendix. This is in response to the many teachers who told me they believed that emphasis in a basic Real Estate Finance course should be on the financing of homes, and not income properties. For those interested in the topic it is not lost, only transferred to the back of the book where its condensed version can be readily retrieved for readers' use.

Readers will appreciate the addition of chapter numbers located in the upper right-hand side of each odd-numbered page, for easier identification and referencing.

Because the financing field is full of words and terms that are not used in one's everyday speech—indeed many agree that real estate is itself a foreign language—readers are encouraged to turn to the Glossary whenever the meaning of a word or term is unknown or forgotten. So, go ahead and check on the expression, "hard money loan," that was introduced above for the first time.

Upon completion of the book, the reader should be able to put into practice the information and concepts that have been presented. Each chapter in the book is self-contained, allowing instructors to adapt the book to various course formats. Instructors and students alike will appreciate the multiple-choice questions for testing, learning, and reviewing purposes.

The text parallels the Instructor Guide and Student Study Guide published by the Community College Real Estate Education Center, Modesto Community College. For inquiries regarding these guides, contact the center at P.O. Box 4065, Modesto, CA 95352.

It is not possible to acknowledge all the assistance received from students, colleagues, and friends. We hope we've successfully communicated the insights that they have generously given us. Particular thanks go to the many real estate instructors who have participated with us at instructor and coordinator workshops sponsored by the California Community Colleges Real Estate Education Center and the California Real Estate Education Association.

Robert J. Bond

Contents

Chapter 1
Why Real Estate Finance?

Preview

This introductory chapter provides a short overview of real estate finance, as well as the flow of money and credit into the mortgage market.

After completing this chapter, you should be able to:

1. Describe why financing is important in the real estate marketplace.
2. Trace the flow of money and credit into the mortgage market.
3. Discuss the role of the Federal Reserve System.
4. List five characteristics of the California mortgage market.
5. Explain and illustrate two basic types of promissory notes.
6. List the parties involved in deed of trust and mortgage instruments. Which is favored in California and why?
7. Contrast trust deeds with "installment sales contracts." When are the latter used?

1.1 WELCOME TO THE REAL WORLD OF REAL ESTATE FINANCE

Real estate is expensive, and few people ever accumulate enough savings to pay for it with all cash. Most real estate transactions hinge, therefore, on the buyer's ability to obtain financing. Even people who have sufficient funds rarely pay cash for real estate because (as noted in a later chapter) income tax deductions and investment yields favor purchasing real estate with borrowed funds, called "leverage." Thus, whether by necessity or by choice, financing is essential for most real estate transactions.

Historically, the population growth rate in California has exceeded the national average. This has created a strong demand for mortgage money to help finance the housing, agricultural, and business real estate needs of that state. California has a wide variety of real estate lenders, including banks, savings and loan associations, insurance companies, private parties, and pension and trust funds. The state is also dotted with experienced and highly efficient mortgage companies that serve as loan correspondents for many local and out-of-state lenders and investors.

Even with this excellent array of lenders, there are times when real estate financing has been difficult to find and abnormally expensive. When this occurs, the California real estate market drops into a recession. The market does not recover fully until real estate financing once again becomes more available, at lower interest rates.

Roller-Coaster Ride

Real estate in the form of land and improvements comprises a substantial amount of the total net worth of the United States. In addition, the real estate industry is a major employer, providing billions of dollars in income for millions of American workers and investors. When mortgage funds are scarce, real estate activity and employment decline, and a general hardship is felt throughout the economy. The housing market is considered by many economists to be a "leading indicator." That is, ups and downs in the housing market lead the general economy into and out of recessions.

Unfortunately, the housing cycle is irregular and wild, with great booms followed by disastrous busts, as shown in Figure 1-1.

Several "boom times" in real estate included the early 1960s, 1971–1972, 1975–1979, 1982, and 1985–1989. However, between these periods were some bad years—1966, 1969, 1973–1974, 1980–1981, and again from 1990 to 1996 in many parts of the state.

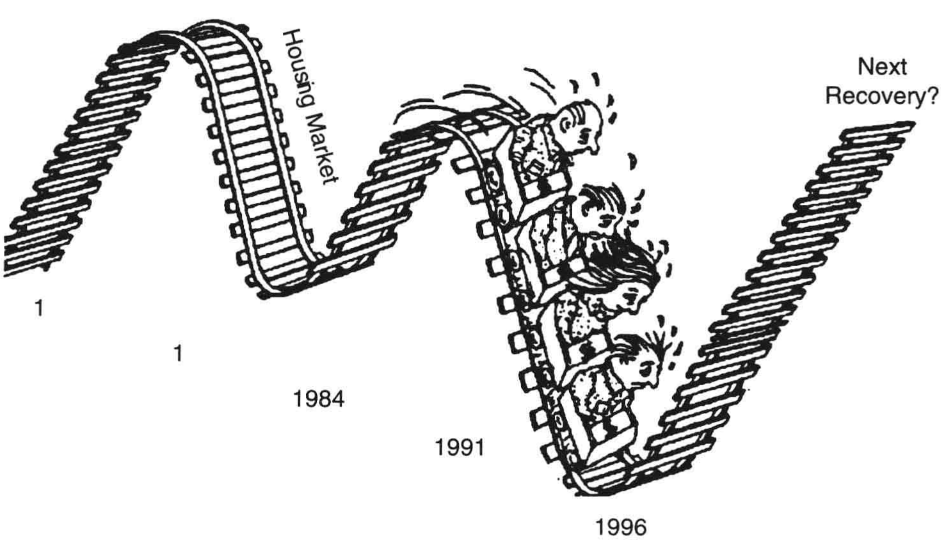


Figure 1-1 The roller-coaster ride of the housing market.

What causes a bust in the real estate market? High interest rates, government deficits, and inflation psychology can cause what is known as *disintermediation,* or the sudden flow of funds out of thrift institutions and into the general money market. (Disintermediation is discussed later in this chapter.) The point stressed now is that real estate activity is directly tied to the availability and cost of mortgage funds and to the state of the economy.

Therefore, an agent's or an investor's success in real estate partially depends on a thorough understanding and skillful use of real estate finance. The remainder of this book is devoted to an explanation of real estate finance, including the wide range of creative and alternative financing techniques used in buying and selling real estate.

1.2 SHORT OVERVIEW OF THE MORTGAGE MARKET

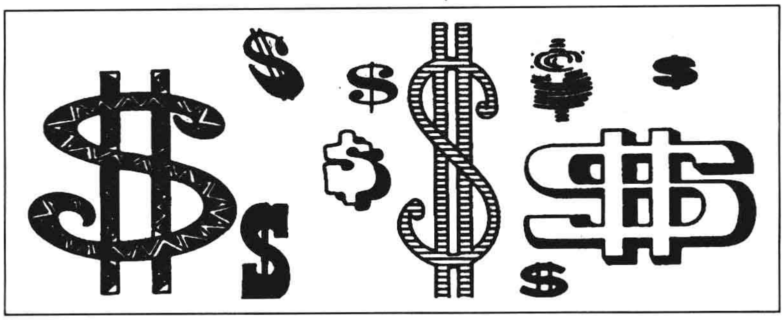
Real estate financing sometimes requires the seller to carry *paper,* or the buyer to find new *hard money loans,* or a combination of both. In all cases the interest rate and terms of real estate loans are dictated by the operations of the money and mortgage market. This section is a short primer on the operations of the mortgage market, stressing the functions of money and the role of the Federal Reserve System.

1.3 THE MEANING OF MONEY

Money has been defined in a variety of ways: a medium of exchange, a standard of value, a storehouse of value. In general, money is anything that people will accept in exchange for goods and services. Its value lies primarily in our confidence that other people will accept the money in exchange for their goods and services. Contrary to popular belief, money does not have to be a precious metal. Anything that is universally accepted by society can be used as money. Figure 1-2 outlines the many forms of money.

How Is Money Created?

Our money supply is usually thought to consist only of coins and paper currency, issued by the U.S. Treasury. But money comprises more than the "cash" that people have in their wallets and purses. Indeed, the bulk of what is called the money supply is in the form of checking accounts—that is, money that individuals and businesses have deposited into checking accounts, *plus* the money "created" by the banking system under what is called *fractional reserve banking*. This will be explained and illustrated shortly.



Money is commonly considered to be:

1. Coins.
2. Paper currency.
3. Checking accounts, technically called demand deposits.
4. Negotiable orders of withdrawal accounts, or NOW for short.
5. Money market accounts issued by financial institutions.

Near money consists of assets that can be quickly converted to cash, such as:

1. Savings accounts, technically called time deposits.
2. U.S. government bonds.
3. Cash value of life insurance.
4. Preferred and common stocks on organized exchanges.
5. Money market mutual funds.

The following items operate like money but are forms of *credit*:

1. Personal credit cards ("electronic IOUs").
2. Bank-allowed overdrafts (ODs).
3. Credit reserves.
4. Home equity lines of credit.
5. So-called "debit" cards ("electronic checks").

Money and credit are frequently used interchangeably—but they are not the same. *Money* means currency and checking accounts, while *credit* consists of loan funds or savings that a saver or lender makes available to a borrower. Both money and credit can be used to purchase real property; that is why both terms are frequently used in the real estate business.

Figure 1-2 Money is....

How Is Money Accumulated?

Money accumulates in many ways. The principal method is through savings, that is, spending less than one earns. Money is *earned* in one of four ways:

1. Wages, fees, and commissions in exchange for labor and services.
2. Interest and dividends in exchange for the use of capital.
3. Profits in exchange for management and entrepreneurship.
4. Rents in exchange for real and personal property usage.

To repeat, savings are accumulated funds not needed at the time that they are earned. Savings represent surplus money put aside for future use. There are many ways to save money, and where those savings will ultimately accumulate is dependent upon needs, degrees of risk, and personal preferences of the individuals. Although it is not necessary to explain the various methods of saving, it is important to recognize that the *ultimate source of funds for borrowing is savings.* In other words, one person's savings becomes another person's source for borrowing. If everyone spent all their income, there wouldn't be any funds for borrowing! The greater the rate of savings inflows, the greater the reservoir for borrowing.

1.4 THE FLOW OF MONEY AND CREDIT INTO THE MORTGAGE MARKET

If the source of all loans, including mortgage loans, is ultimately savings, how do savings via money and credit flow into the mortgage market? Stated differently, how does capital for real estate financing accumulate? This occurs through a process called the *circular flow of the economy.* Don't be troubled by this section, which appears to be heavy stuff! We've tried to simplify, but if you're not comfortable with even basic economics, just read lightly and go on to the next section dealing with the Federal Reserve, which gets into the nitty-gritty of how money is created to finance real estate transactions.

As noted in Figure 1-3, the production of goods and services requires that money be paid for the use of labor, raw materials, management, and capital. This money is called personal income, and all or some of it may be taxed, spent on goods and services, or saved. That which is saved is usually deposited in financial intermediaries, which, in turn, pump funds back into production. Figure 1-3 is a simplified model of how savings accumulate to become the reservoir for future loans. Carefully trace this circular flow until you understand that individuals "own" land,

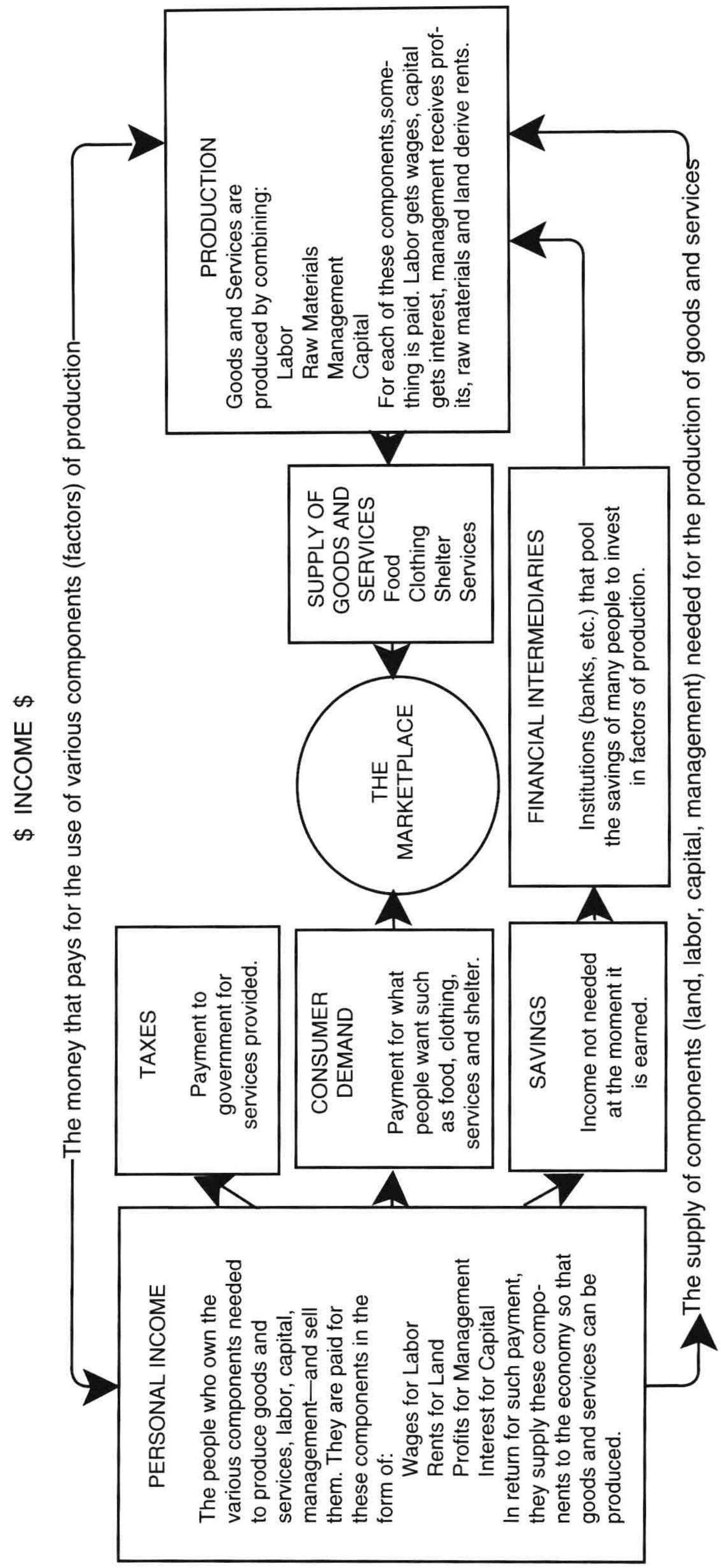


Figure 1-3 The circular flow of the economy.