INCIDENTAL CHARGES TO THE PURCHASERS OF DWELLINGS

(Under FHA and VA Insured or Guaranteed Mortgages)

BULLETIN NO. 53

NEVADA LEGISLATIVE COUNSEL BUREAU

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(Under FHA and VA Insured or Guaranteed Mortgages)

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The table of contents representing the chapters covered in this report is organized chronologically, beginning with the buyer's deposit of earnest money for the purchase of a home, and ending with his final liquidation of equity in the enterprise. The events are traced to this latter point since, under government-backed mortgages, there are complications in the transaction that are not cleared until the buyer has finally released himself from all interest in his purchase. Each one of the chapters covers a general discussion of the particular point in question and includes illustrative provisions of FHA and VA regulations, interpretations, and the current practice in the State of Nevada. This material is followed by suggestions for correcting situations which are demonstrated to be a disadvantage to the purchaser of a dwelling.

Reference to FHA and VA provisions and form numbers reflects the situation as of the spring of 1962. Frequent changes in these government programs, as well as basic forms, may (in some few cases) date this report and it may not be in harmony at the time of publication and distribution.

The Counsel Bureau notes that some problems brought to the attention of FHA and VA during the course of the study, have been largely eliminated or clarified. In these cases, the FHA and VA action has been incorporated in the study, where in fact, the Counsel Bureau had such information in time to make adjustments.

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FOREWORD

The Nevada Legislative Counsel Bureau is a fact-finding organization designed to assist legislators, state officers, and citizens in obtaining the facts concerning the government of the State, proposed legislation, and matters vital to the welfare of the people. The staff will always be non-partisan and non-political; it will not deal in propaganda, take part in any political campaign, nor endorse or oppose any candidate for public office.

The primary purpose of the Counsel Bureau is to assist citizens and officials in obtaining effective state government at a reasonable cost. The plan is to search out facts about government and to render unbiased interpretation of them. Its aim is to cooperate with public officials and to be helpful rather than critical. Your suggestions, comments, and criticisms will greatly aid in accomplishing the object for which we are all working--the promotion of the welfare of the State of Nevada.

PREFACE

SCOPE OF MORTGAGE TYPES COVERED BY THIS REPORT

Although the directive from the Legislature did not identify any particular types of mortgages with which the charges mentioned were associated, nor the type of transactions common to them, it has only been possible with the time element considered to direct the efforts of the Counsel Bureau to a basic and common type of transaction. As will be explained in the basic introduction to this study, the emphasis has been directed toward a report on the government insured and guaranteed types of mortgage transactions for the reasons stated therein.

Also, the type of purchase referred to in this report is what the industry calls a "sales type home." That is, a home which has been constructed for sale to one who intends to occupy the dwelling as a domicile. Usually the home will have been constructed or nearing completion and ready for sale prior to the buyer making a deposit to purchase, similar to the buying of a new car from those available in a dealer's stock. However, the transaction would be quite similar if a buyer picked his plan in advance and had a selection as to materials, colors, and lot location, as well as certain modifications from the "standard model."

The sales type home which we have emphasized in the report would normally be found in a builder's tract area. Likewise, the majority of these sales are also involved with mortgages insured or guaranteed by either FHA or VA.

In summation, the sale we have reference to in this report is that of a new home that will be sold to one who intends to occupy it himself by a builder developing a tract which has associated with it either a FHA or VA insured or guaranteed mortgage loan. This type would be typical of the majority of the new homes being sold in our two metropolitan areas of Nevada (Clark and Washoe counties), and constitutes the backbone of the new home construction industry. The VA direct loan program has not been considered in this report.

The latitude of the directive from the 1961 Session of the Legislature was so broad that a study could have been conducted for several years by a fair sized staff in order to go into "all matters connected with residential construction in Nevada."

We selected what apparently was the interest of the Legislature as identified in the resolution preamble by reference to certain charges, points and discounts, which are most typified by the selected mortgage types which were examined. This is not to imply that such charges, points and discounts are lacking in other forms of transactions, but they are most common to the types studied.

It is suggested, that in the event the Legislature feels other types of mortgages and other types of sales and used-home sales also should be covered, it should authorize a more or less continuing study be made by the Counsel Bureau in order to cover the broad connotations of the original directive.

This study was undertaken and completed by Mr. Arthur J. Palmer, Jr., senior research assistant for the Nevada Legislative Counsel Bureau. Mr. Palmer and the Legislative Counsel Bureau greatfully acknowledge the valuable assistance furnished during the course of the study, and the review given to certain portions of the study after preliminary draft, by various individuals, corporations, and governmental agencies.

Copies of this study may be obtained without cost from the Nevada Legislative Counsel Bureau, Capitol Building, Carson City, Nevada.

J. E. Springmeyer
Legislative Counsel

Assembly Resolution No. 26 -- 1961 Session

File Number 75

Assembly Resolution--Memorializing the legislative counsel bureau to study incidental charges to purchasers of dwellings.

WHEREAS, It is imperative and vital for the continued economic growth of Nevada that there be a steady and continuous program of residential construction; and

WHEREAS, With the advent of new industry there comes the need for more dwellings to house the personnel of such new industry; and

WHEREAS, It is essential that the cost of such dwellings be within the financial ability of working people to purchase, yet permit reasonable profits to contractors; and

WHEREAS, Since World War II, there has been a gradual increase in all phases of dwelling construction, and all incidents of financing such construction; and

WHEREAS, In connection with financing, there has been a growth of incidental charges for title fees, policy fees, insurance and closing costs which in numerous cases appear to be excessive; and

WHEREAS, Some lending agencies or agents therefor demand and require that borrowers give "points," which is a device that requires the borrower to pay an increased interest rate because the borrower in such a transaction is required to pay a fee for obtaining the building loan, which fee is added to the purchase price or building costs; and

WHEREAS, It has been reported that such fees or "points" are required whether an FHA or conventional loan is obtained; and

WHEREAS, Closing costs in many cases appear to be unrealistic an excessive; and

WHEREAS, Any unnecessary charges are a deterrent to residential construction so necessary to Nevada's welfare and economy; now therefore, be it

RESOLVED BY THE ASSEMBLY OF THE STATE OF NEVADA, That the legislative counsel bureau is hereby memorialized to make a complete study of all matters connected with residential construction in Nevada, and an investigation of all charges made for loans, title fees, policy fees, insurance and any other charges and costs; and be it further

RESOLVED, That such study include a comparison of the practices, procedures and laws of other comparable states and report the results of such study and investigation with such recommendations as appear advisable and proper for the correction of any practices that appear improper or unnecessary to the 1963 session of the Nevada legislature.

CHAPTER I

INTRODUCTORY CHAPTER

The purchase of a home by the average individual is perhaps the most costly of all transactions in which a consumer is apt to become involved within his lifetime. Certainly few, if any, purchases that he makes over the years will have a price tag as high as that on his home. If financed by a long-term mortgage, the overall cost, including large interest payments, will in many cases be double the sale price of the house, and the resulting overall cost might stagger the imagination of most purchasers.

Since most consumers are unable or unwilling to pay cash for their homes, they must obtain a loan to make their purchase possible. Also, most contractors and home-builders do not have, or do not wish to employ, their own funds to construct the home to be sold. They also enter the money market for funds, but, of course, on a relatively short-term basis.

The transactions involved with the purchase of a home by the ultimate consumer are highly complex, to say the least. In the event a mortgage is involved (and the builder or the home-buyer has obtained interim financing) then further complicating the situation the FHA or VA enter the picture to insure or guarantee the long-term loan to the purchaser, the entire transaction or series of transactions with charges, credits, fees, discounts, prorations, and impounds takes on an air of mystery. To many purchasers of dwellings this rivals an extensive shopping tour in an oriental bazaar. By comparison, in many cases, he would be safer to traffic in such a foreign atmosphere, if the revelations of this study were to be taken into consideration. Certainly the language and terminology, as well as all the devices and misrepresentations, might be equally frustrating to the uninitiated in either case. To try and thread through the various charges made to him as a consumer might well cause him to realize that he is way beyond his depth and he would be on safer ground dealing with the bazaar merchant. He might feel like leaving the matter of buying houses to those who care little what they pay for anything, or to someone who has devoted considerable study to such transactions.

The Council of State Governments advises us that the National Association of Attorney Generals has been studying the problem of consumer protection in cooperation with the United States Department of Justice and other federal agencies; however, they have not considered the matter of closing costs for residential property. Apparently overlooked at this date is the most significant area of investigation that might be undertaken. Certainly, closing costs, fees, discounts, treatment of impounds and trust funds, prorations, and other financial considerations associated with the sale of a home deserve immediate attention. Consumer protection on this point is highly necessary in view of the size of the transaction, the largest he will probably encounter in his lifetime. It is true that much has been done in the area of automobile purchase in recent years, culminating in the federal Price Disclosure Act, and representing perhaps the second largest purchase by the average consumer. However, we may be penny-wise and pound-foolish to overlook immediate and thorough attention to the vast implications and possibilities for excessive cost to the consumer when purchasing a dwelling. The

State of Maryland, through action taken at its 1961 Session, directed a commission to investigate the home-improvement business and its financing in Maryland. This is certainly a laudable and desirable move. However, is it not roughly parallel to the concern given to cost of repairs on an automobile, leaving out of the picture the cost of acquisition of the basic unit itself, which may involve far more costly elements of financing?

The State of New York worked in the area assigned to this Legislative Counsel Bureau in 1960 and 1961. It is pertinent to take excerpts from their report issued on March 16, 1961, as follows:

> Whether one agrees or disagrees with Thomas Robert Malthus' theory on population growth as propounded by him in 1793, it is evident that the State of New York is now facing a population explosion which constitues a major problem to those concerned with housing the families that are presently seeking home ownership in New York State, and to those concerned with providing facilities for those families that will appear on the housing scene during the coming decades. (underscoring supplied)

The population explosion referred to in New York is identified in the report. Between 1950 and 1960 it amounted to almost two million people. However, the percentage of increase during this decade was only 13.2%. In Nevada we are experiencing a true explosion. Nevada's increase from 1950 to 1960 was 78.2% and second in the nation, being surpassed only by Florida's 78.7%. It is apparent that Nevada should have an interest similar to that exhibited by New York, with even more reason for concern. The New York report continued:

> With such an increase of population, the incidence of home purchasing necessarily increases. Thus, many individuals are making the most important purchase of their lives for it is undoubtedly true that the largest and most important single purchase that the average New York citizen makes in a lifetime is the purchase of his home. For those fortunate enough to own their own family residence, the home is the most valued tangible asset of the family group, from both the economical and psychological viewpoint; for those who must rent shelter, home ownership is the most sought-after goal of the family financial plan. It is not surprising, then, that being a home owner is often equated with being a substantial "first-class" citizen.
>
> Becoming a home owner not only gives the individual a stake in the economy of the State but it also creates and sustains a vast building indistry which, directly and indirectly, substantially contributes to the State's economy. Of equal, if not greater importance, is the fact that for every new home built, one or more apartments are made available for families seeking shelter but unable to purchase their own residences. Thus it could be stated that facilitating home ownership also stimulates activity and availability of rental facilities.
>
> With such emphasis placed upon home ownership, it is only fitting and proper that the New York State Assembly should jealously guard the right of each citizen of New York State to seek membership in this class of "substantial citizens" and to protect the interests of each aspirant to this ever-expanding group. For, while home ownership is a sought-after goal, it is undoubtedly that, for the average citizen, the path toward attainment of that goal crosses strange and mysterious terrain. The home purchaser is confronted with legal documents of imposing formality; he is introduced to a bewildering and foreign jargon. For perhaps the first time in his life he encounters terms like "search and

survey," "closing costs," "escrow accounts," "amortization" and an endless host of others. Frequently he desires to purchase a modest home which apparently is within his means and current cash holdings, only to find that direct and latent or hidden financing charges make such a purchase impossible, or that financing itself cannot be secured. Often the prospective home owner is met with some of these charges for the first time at the closing when he discovers, to his chagrin, that he is unable to pay such charges. The end product of such frustration is frequently a change of mind with the resultant loss to the entire economy of the State on many fronts. Then, too, the prospective home owner is frequently met with the periodic bottleneck that results from tight money markets in which home building is stultified for lack of available credit and in which home "starts" are crushed before they leave the blueprint stage.

It was with this background of complaint and frustration by many new and prospective home owners that the New York State Assembly, in 1960, by Rules Committee Resolution No. 181 authorized and directed the Committee on Mortgage and Real Estate 'to inquire into and examine all relevant facts, data and information pertaining to the granting of mortgage loans to small home owners.' To finance such an undertaking, the Assembly allocated to the Committee the sum of ten thousand dollars ($10,000.00). (underscoring supplied)

It is interesting to note from the introduction to the New York report that they also had to restrict the nature of their investigation and area of reporting due to the highly complex nature of the directive from the New York Assembly. Their introduction continues:

The Committee, under the leadership of Assemblyman Ernesto Curto, in recognition of the broad area covered by the authorization and directive, and in view of the limited financial resources available, determined to limit the scope of its inquiry in this preliminary investigation to two basic fields. The Committee has studies (1) the costs, direct and indirect, paid by the applicant in acquiring a mortgage loan on a one or two family home and (2) the availability of monies in the New York State market for mortgage loans on one and two family homes. (underscoring supplied)

The New York Committee started out by an extensive questioning of institutions making mortgage loans in New York. However, the information obtained was so overwhelming that the Committee could not cope with it. They lacked competent analysts and finally resorted to general knowledge gathered by meetings, conversation with some lenders, and contact with government insuring and guaranteeing agencies. Due to the size of the project, here in Nevada we did not attempt to glean complete data from lending institutions but did conduct lengthy conversations and interviews with lenders, escrow officers, contractors, and government insuring and guaranteeing agencies in Las Vegas and Reno, and the capital area, Carson City. An explanation of the difficulties encountered by New York in making a complete study with the resources available to them and a hampering time shortage, is as follows:

As a preliminary step in its investigation, and to provide a background for future inquiries, the Committee prepared a questionnaire or survey which, in essence, required the lending institution to report on the number, type and terms of all mortgages granted for one and two family homes, both within and without New York State, in the years 1957 through 1959, inclusive; the number of mortgage applications received and the number granted during this period; the average closing costs in each of the three years paid by the small home owner in acquiring a conventional, VA or FHA mortgage loan and a line of questions directed towards the general availability of mortgage funds during the period in question.

The New York report continued by evaluating the results of the questionnaire method, what they were able to obtain from it, and to what future use it might be put:

> Through the medium of this survey, the Committee has secured information relative to nearly every individual mortgage loan granted for one and two family homes by state chartered lending institutions during the three year period and has gained an insight into basic mortgage practices of the individual lending institutions. Unfortunately, because of the abundance of information obtained and because of the lack of time, assistance and funds required to evaluate this information, no final conclusions could be drawn from the information secured through these media. Having secured such a wealth of information, of a particularly technical nature, the Committee feels that it would be necessary to have these surveys examined by competent analysis in order to translate the data into a more comprehensive report. If this were done, and further investigations could be conducted, it would be possible to pinpoint and expose abuses in the mortgage field which precipitated the current investigation. To date, chiefly because of the lack of time and funds, no comprehensive analysis of this nature has been undertaken. The Committee, however, has carefully examined individual surveys and has used the information so obtained to interrogate those specific institutions which appeared at the public hearings. (underscoring supplied)

The Nevada method by-passed any questionnaire approach to the problem with the feeling that there would develop such a vast amount of material that such a thorough study would be time consuming and perhaps not lead to any material variations from approaching the problem through the method of interrogation, finally resorted to by the New York Committee. The Legislative Counsel Bureau employed the following correspondence technique, also used by New York. Their report continues:

> As the next step, the Committee sought to avail itself of any pertinent information already in possession of various governmental agencies. To this end, correspondence was had with the Federal Housing Administration, the Federal Housing and Home Financing Agency, the New York State Banking Department, the New York Insurance Department and the Attorney General's Office. (underscoring supplied)

The most significant areas covered by the Legislative Counsel Bureau, not mentioned in the New York report, were the extensive meetings and questions put to many escrow officers, representatives of mortgage loan companies, and home-owners themselves, relative to how they processed various loans and what experiences had been found to be typical. It was felt that this part of the procedure was highly important since these people are directly connected with closing the transaction and servicing the loans, or have purchased dwellings.

Apparently the pace of the national economy is strongly influenced by fluctuations in three large expenditure areas. These bellwethers of the national economy--government spending, consumer purchases of homes, and automobile sales--have such a marked effect on prosperity, recession, and depression cycles that frequently artificial stimuli must be applied to guarantee their continuing trends. The area of consumer purchases of homes (new homes in particular) which spurs the home building industry, has not been neglected by federal government planners. People are given the "hard sell", even though the easy acquisition of new homes may not be a wise investment at the time.

Perhaps they cannot afford such a large consumer purchase. The following move is indicative of the "planners" attention to this segment of the national economy, which may or may not be a wise move, but does momentarily "push" the acquisition and purchase of homes with an initially very painless procedure for the consumer. Easy acquisition of dwellings, and the resultant long-term cost to the purchaser, is emphasized by the following example taken from a leading national consumer publication.

> Home buying is made easier by a law passed in June 1961 by the U. S. Congress. The provisions permit 35 and, in some cases, 40-year mortgages with a down payment on a $15,000 house of only $450. The effort of the government to put a new house within easy reach of anyone--whether he can afford it or not--has been criticized as a snare and delusion. According to the calculations of one home magazine, at the end of 40 years the homeowner who has bought a $15,000 house on a 40-year mortgage at 5-1/2 percent interest, plus 1/2 percent mortgage insurance, will have paid over $40,000 for his dwelling. As one retail executive points out, merchants traditionally favor installment-type purchase plans in which the product will surely outlive the payment span. Whether a $15,000 home built under today's conditions will outlast 40 years is something of a question. (Reprinted with permission of Consumers' Research, Inc.) (underscoring supplied)

Note: The figure of $40,000 for a $15,000 dwelling arrived at above is a relatively simple calculation since monthly payments to interest and principal, plus any FHA federal mortgage insurance, will run in the $80 per month area or about $1,000 a year. Another $1,000 in direct cost to the purchaser can be added to the overall price tag for his dwelling, if consideration is given to the discount (paid by him indirectly), the origination fee, and numerous other charges associated with his obtaining such a loan in the first place. Furthermore, many of these costs would be immediate and not theoretically accumulated over the years, and would stand as costs even if he sold his property within a period of a few months.

As can be seen by this illustration, we are truly living in a world of "magic" economy. All manner of consumer items from homes to eggbeaters are easy to acquire. The devices that are employed to move these items (the sale of which forms much of the basis of the national economy) are often questionable. Since they are frequently engineered, sanctioned, and fostered by the government (as in the case of homes) it would seem to be the responsibility of the government to see that abuses, misrepresentations, overcharges, and additional devices provided for by the government, would receive close attention and regulation. However, as this study will point out, there is an apparent disregard of government regulations as well as many consumer rights, and lack of consideration of the part the mortgagor plays in the transactions associated with the purchase of homes. In the absence of directives to the contrary further affront is hurled by government approval of devices designed to provide the lending institutions with additional returns on monies loaned to the veteran and home-buyer.

It should quickly be pointed out that this study does not suggest that any control whatever be placed on what a lender should receive by way of interest for the use of his money by the purchaser of a home. However, it is strongly recommended that whatever the sum total of this interest charge may be to the consumer, it should be expressed and clearly identified as a rate of interest and not masked and made a mockery of by devices such as discounts, service charges, origination fees, and other cost factors which in effect result in a higher rate of interest. A strong question should be asked. How can the purchaser of a dwelling exercise any clear judgment and make an intelligent decision in the purchase and financing of his home when the actual rate of interest or cost of borrowing money is not made available to him? Furthermore, the misrepresentations and additional charges which result in higher rates of return (necessary for lenders to obtain) are sanctioned by government agencies. The consumer wanders in a fairyland where white is black and black is white. To perpetuate a high rate of economic activity (which evidently is a political necessity) at the expense of misinforming the consumer, who is the backbone of the country, is to invite eventual economic disaster. In effect, the government is encouraging its people to spend beyond their ability to pay, a disease easily transmitted by way of federal government example.

In this study emphasis has been placed on FHA and VA insured or guaranteed loans in connection with the purchase of "sales type homes" or new dwellings. It is fully realized that great numbers of homes are purchased without such financing and home sales are not necessarily from the original builder-seller or contractor to the first occupant. Obviously there exists a very large market in the re-sale of used homes, which may or may not be associated with VA or FHA insured or guaranteed loans.

The reason for emphasis on sales type homes with government guaranteed or insured loans is associated with the primary concern that government agencies have in the past (and are presently condoning) certain practices which are questionable when the best interests of the consumer are taken into account. In a conventional transaction, with no government agency insurance or guarantee, it is largely a case of let the buyer beware--"caveat emptor." When the government itself becomes a partner to insuring or guaranteeing the loan and inspecting the dwelling, or authorizes certain questionable charges to be made, then the situation is indeed a serious one. Where we have government agencies a party to making obscure the actual interest costs on loans, and condoning devices which circumvent the intent of legislation to the distinct disadvantage of veteran and home buyer, we feel the emphasis is necessary and warranted. On the conventional market, at least there is not the false sense of security that government agencies are aware of the transaction and have examined and controlled the charges to the veteran or home buyer, as well as the physical structure itself.

The Nevada Legislature has full and complete authority to legislate against practices it deems improper in connection with mortgages. Joint resolutions adopted by the Nevada Legislature might result in changes in federal regulations, either through action by the Congress or by decisions of the federal agencies. However, many of the evil practices could be taken care of at the state level, should the Legislature choose to do so. The federal agencies guaranteeing loans give full recognition to state and local requirements which are above and beyond both financial and structural guarantees provided to the consumer by their own regulations.

In our nation, which is the keystone of democracy itself, apparently we have allowed certain forces to blind us in our ruthless quest for "profits" and have provided for the protection of special interest groups to the distinct disadvantage of the electorate. In short, the man on the street suffers, yet he is the one who fights to protect democracy and justly should derive the full benefits from such a society.

When the purchaser of a dwelling has completed his various transactions, and reviews the mass of papers and documents he has signed, he might reflect for a moment and consider the "why" of this deluge. Has it been done primarily in his best interests? Certainly he does not face the specter of eviction from his castle and dwelling place because the transactions associated with the purchase have been subject to so much checking and review by so many parties. No, he is secure and need only be concerned with the monthly "take" which enables him to remain in his own home. But what of the cost of this rather dubious security? Has he fully understood his charges and credits? Does he know for what reasons many of them were made? Just who was being protected by all that seemingly endless procession of necessary documents? Were they primarily for his benefit or were those associated with his transaction also looking for security? Yes, this last point is an important one. There were others primarily interested in their own protection, first, last, and always, and the government agency insuring or guaranteeing the loan had been pressured into making sure the mortgagee was fully protected through legislation and regulation. But were the rights of the mortgagor equally protected?

As generalized statements, it should be realized that the FHA program places strong emphasis upon security to the mortgagee (lender) and only indirectly some security to the home owner. Under the VA program, the veteran's interests come first, with security to the mortgagee somewhat secondary. However, even under VA, there are areas of serious concern when it comes to consumer interests where that agency has allowed itself to be guided by what has been "normal practice" by lenders.

In the event the buyer has access to the escrow officer's file covering his transaction, and could examine in detail the directives, statements, and charges offered to the escrow company by parties associated with the transaction, he might start to suspect that perhaps he should have had his own attorney to represent his interests. FHA provides the lender with a detailed handbook emphasizing mortgagee protection and procedure; none in such detail for the home buyer. Who, after all, was there to look after the buyer? He had the feeling of security, knowing federal agencies were at hand. In truth there was no one specifically looking after his interests, particularly in an FHA transaction, with the exception of some generalized protection offered by the government agency insuring or guaranteeing the loan.

After a review of the various transactions associated with home purchases, we must conclude that it was the mortgage company, contractor, insurance companies, title and/or escrow company, FHA or VA, agents, assessment districts, interim financer, banks and savings and loan companies, sub-contractors, laborers, suppliers, municipal authorities, and others who came first and were protected. Yes, as far as consideration is concerned, it was the man actually purchasing the dwelling who apparently came last, except where his interests were being protected by some of these parties, for example, title examination by issuing agencies.

The buyer should be intelligent enough and employ sufficient caution to know what he is getting into in a home purchase. If he is not, then it is hard to save a fool from his folly. However, when the cards are stacked against him through device and misrepresentation, authorized or engineered by government agencies, then the time is ripe to fully assess the situation, to suggest and recommend changes in rules and regulations that will eliminate, or at least control, the evils.

This point was met and dealt with at the government level when the federal Price Disclosure Act was passed by Congress in regard to the sale of automobiles. The industry itself, realizing the loss of public confidence, came forward and backed the legislation, realizing that it would strengthen their image and the market place would again be cleared of the irregularities to a reasonable extent.

With a consumer purchase of a new home, the environment and atmosphere surrounding the transaction allows a much larger latitude for operation of the unusual, the charge for this and that which may or may not be a logical cost to the buyer. The transaction is several times more complicated than the sale of an automobile. It is entirely possible that the hour is late and that some time ago the situation should have been assessed with a view toward creating some semblance of order out of chaos. If an industry, with its associates and lending institutions, cannot keep their houses in order and deal cleanly with the public, then, and only then, does government control logically enter the picture.

In specific defense of the building industry and lenders in general, it must be pointed out that many of the practices resorted to are only a practical approach to obtain a reasonable return for their investment of time and funds in relationship to government agency requirements which do not recognize the "facts of life." This is recognized in the main as the taproot of the deception problem. However, if it be recognized as such, then these strong institutions should have moved to voice the problem with sufficient volume to have been heard when the misrepresentations were contemplated by either the Congress or regulatory agencies, and they should not have buckled under to traffic with such unrealistic requirements. We can only suggest that perhaps all parties are equally in error in their attitude toward a true and complete representation of the entire transaction of the sale of a home to the consumer.

The main bone of contention is the greatly misrepresented and manipulated rate of return to the lender, made possible by devices condoned by government agencies, which has the direct effect of making the "cost" of money much higher than specifically indicated and insured or guaranteed by FHA or VA. In the masking of this real "charge" for the use of the money by devices, the consumer is caught in a hopeless situation where it is next to impossible for him to "shop" for money and make comparisons of the cost of a variety of loans which may be available to him as well as alternate methods of financing his dwelling purchase.

In closing this introduction, it should be clearly understood that government by state or federal agency should never at any time attempt to control by artificial regulation the return or profits that investors feel they must have to encourage funds to flow into the market of lending for the purchase of dwellings. Such action would create one of two situations: (a) the money will flow to areas of other investment where such controls do not exist; or (b) the money will continue to flow into housing but the return will be maintained as before through a series of devices designed to comply with the letter of the law, but the spirit of the law will be violated by necessary misrepresentation and other cost factors, the profits of which will of necessity flow back to the investor. The price tag for the cost of a loan should be complete; it should be easy to read, with the interest rate expressed as such directly to cover all costs which the lender feels necessary to execute the loan. No discounts, charges, fees, or other mortgagee costs should enter the picture to obscure the true "cost of money" to the veteran or home buyer. If there is obscurity, he has no way of comparing methods of financing his purchase, and a true disservice is rendered to him with sanction of his own government agencies.

As a closing illustration, perhaps there are those who feel it is more important to maintain the political advantage of government agencies insuring or guaranteeing mortgage loans at only 5 1/4% interest (and thus represent themselves as agencies controlling interest rates to mortgagors) than to allow guaranteed interest rates to seek a more normal level for this area. By the law of supply and demand they would be required to guarantee loans at the going rate. However, this is not politically wise as any incumbent administration realizes. The net result of the masking of the true return which eventually must accrue to the lender for him to initiate his loan, is a series of devices designed to obtain the market rate of interest, which directly and shamelessly circumvent the rate established by government agencies. In short, the home buyer thinks he is obtaining his loan for 5 1/4%, and that the government is a great protector of the veteran and home buyer, making certain that the lender is not going to charge the buyer more than the government has allowed for the loan. This has to be winked at by the government agencies who realize that the lender will execute his full price for the loan. Thus, the specter of the discount enters the picture in areas of normal building competition, and the buyer indirectly pays many hundreds of dollars to the lender as well as a variety of other charges made by him, authorized by the government agencies, in addition to the 5 1/4% rate. The outcome of these other direct and indirect charges by the lender is to raise the true cost of the loan well above the quoted rate of interest.

The true rate of interest will be dependent upon how long the loan is kept by the mortgagee, after consideration is given for the initial costs of obtaining the loan. The discount (or "points") has been employed, not as a tool for shading fractional money rates or selling existing "paper," but for a purpose for which it was never designed. It circumvents government regulation against obtaining an initially higher rate of interest, in excess of 2% in many cases.

This practice, as well as the many others pointed out in the study, are due largely to the artificiality created by government regulatory agencies, apparently to preserve their image before the people. This may serve to generate a high level of national economy in place of a more prudent assessment of the consumer's ability to make home purchases. However, it fails to provide him with the knowledge of such costs, if there must be governmental programs designed to promote the purchase of dwellings for the sake of our national economy. The results thus obtained in momentarily strengthening our economy are lost in the long run, and they become a more serious threat to our system of democracy. When this type of easy spending is fostered at the consumer level, the moral fiber of the people of the nation is threatened. By sheer complication and misrepresentation, by masking real costs to the point where no one cares what anything costs in toto (but only what it costs per month), a form of true socialism creeps in upon the very hearthstone. It must be recalled that, by such manufactured confusion man's freedom becomes eroded; it is one of the foundational methods employed by all totalitarian and socialistic systems. It is the sincere hope that our federal government will quickly realize the inherent dangers existing in certain FHA and VA policies, and that it will drive toward a system of governmental insuring and guarantees of home mortgages which will be free of misrepresentation to the veteran or home buyer, regardless of the political consequences of such a straightforward disclosure. The establishment of a regional rate of interest-guarantee on home loans which closely reflects "market," enabling lenders to deal with home buyers without resorting to circumvention, should go a long way toward the elimination of a number of the abuses pointed out in this report. The tendency to recognize a practical rate of interest has been exhibited by the government in its new guaranteed interest rate recently established for the larger home-improvement loans program.

The suggested changes in FHA and VA procedure and regulations, as well as the suggested legislation to be enacted by the Nevada Legislature, are offered in this report as constructive measures designed to not only protect the Nevada home buyer and consumer of builder-seller products, but also designed to offer a full measure of protection to mortgagees and home builders operating in Nevada with a high level of understanding of public morality. In the past, many of these institutions have, and are continuing to deal with the public in a fashion which would hardly suggest the necessity for strict controls to contain the practices demonstrated by this report.

In final conclusion, it should be understood that this report does not claim to have identified each and every type of charge that may have been associated with any FHA or VA insured or guaranteed mortgage case issued in Nevada. However, it is felt that the most flagrant, and those most common and typical to the majority of FHA and VA cases, have been recorded herein.

In the light of the limited resources of the Legislative Counsel Bureau it has not been possible to review every FHA and VA closure over the past year or so, or to examine even a small percentage of them. Samples have been taken and discussions held with those associated with these transactions to identify the practices set forth in the report. A survey team of a considerable number of experts would have had to labor many months to have produced a report which would be complete, conclusive, and would have identified all irregularities. This would have called for a survey of all Nevada FHA and VA cases. It is felt that the material presented will certainly be sufficient for the Legislature to employ as a foundation upon which to determine how serious the situation is and what action it would desire to take to rectify the many practices identified herein. It will also serve to present the Legislature with information with which to determine what areas should be investigated to greater depth and upon which they might direct that a continuing and broader study be requested of the Legislative Counsel Bureau or some other state agency.

PART I

EXECUTION OF A CONTRACT

Ten chapters are set forth in Part I which cover the basic developments and the associated documents which form the composite of transactions which lead up to a complete agreement(s) for the purchase of a dwelling from a typical builder-seller by a veteran or home buyer. Chapter X carries this procedure through any escrow agreement which places the transaction in the hands of an escrow officer associated with a FHA or VA case.

In Part II, chapters will discuss the results in charges, costs, and impounds which the veteran or home buyer must hurdle in acquiring his dwelling. Particular reference will be made to the authority for these charges to be made under the FHA and VA programs and certain abuses which have been disclosed. Recommendations for correction of certain practices are given in both Part I and Part II.

Most of the negotiations covered in Part I will have been completed within the first few days after the veteran or home buyer has made a decision to purchase a dwelling.

CHAPTER II

IN THE BEGINNING -- CONDITIONAL COMMITMENTS, INTERIM FINANCING, TAKE OUT FUNDS

Under usual circumstances, the initiation of action toward the purchase of a dwelling basically will follow the order described in this chapter. For the purpose of this chronology we will examine a simple form of transaction wherein a buyer makes his purchase from among several homes in a tract area being developed by a builder with mortgage loans insured or guaranteed by FHA or VA. Several homes are ready for occupancy and several additional homes are in various stages of near completion. The consumer has made his selection and, for the purpose of this example, let us further assume that the home has been completed and the government insuring agency insuring or guaranteeing the loan has made a final inspection and approval of the physical structure. Admittedly, all cases are not this simple. In many tract areas the consumer-buyer may have made a selection from models standing completed and wish a home constructed for him on a particular lot, basically the same as one of the models but with the option of selection from a variety of colors and materials, and with or without many added features. He may even elect to have alterations in room sizes and additions incorporated into his order, which necessarily makes for more complexed initiation of action on the part of the builder. However, as far as the buyer is concerned, the procedure will have much in common with an already completed dwelling and with the following stated transactions and documents associated with completed homes.

At the time of making his selection, the home buyer should be in a position to make an earnest money deposit of cash or write out a check usually in an amount of about $250. Some sellers will require a considerably larger deposit if they are not trafficing in volume sales, while others may require as little as $1.00 to $50.00. The amount will vary from one area to another and also to some extent may be influenced by competition for sales. At the same time, the buyer may be asked to make an additional small non-returnable payment (usually $5.00) to cover a credit report. Many builders will absorb this payment temporarily until escrow closure, or the return of most of the deposit when sales are not completed. Salesmen do not like to make an issue of the credit report at the time of closing an agreement to purchase.

From the builder's standpoint the salesman will have sized up the prospective home-buyer by casual questioning and conversation which will probably disclose where the head of the family is employed and if the wife is employed also. He will have gained a very general idea of the economic background of the consumers from observation of their car, dress, and general language pattern as well as certain characteristics of any offspring which happen to have been on the shopping tour. These basic elements are important to the builder-seller since he can ill afford to waste his time and efforts on a party which obviously would have a slim chance of gaining approval from a mortgagee. For the purpose of illustration, the salesman for the tract in our case in point will have gained a favorable impression of the prospective buyers and will be pushing for a sale and deposit with contract to purchase.

At this juncture, we should indicate the builder-seller situation in relationship to what he will have already provided for so that a person can purchase his wares with a minimum of difficulty. Various types of builder-organizations operate to produce homes for sale under FHA or VA insured or guaranteed loans. These will vary all the way from the operator who has practically no immediate financial resources and employs maximum credit (extending to land, improvements, sub-contractors, and/or materials) through the builder who pays for part of the land and employs some of his own funds, and builders who may purchase all land in advance, use very little if any interim financing, and have long established "take out" commitments, to the multiple corporation which may have its own funds with one unit acquiring land, another developing and building, and a third operating in the area of direct sales.

Long before construction of any homes, those contemplating the building and sale of the homes usually have lined up a mortgagee who has made a commitment, or a mortgage company holding secondary mortgage commitments, indicating that such mortgagees will make loans on proposed dwellings built in that tract to acceptable buyers qualifying for a FHA or VA insured or guaranteed mortgage. In the event the mortgagee is a mortgage company which contemplates selling the loan into the secondary market, the mortgagee will also have provided for a "line of credit" from other institutions before any development of the tract area and building of homes.

Most builders and contractors do not have, or do not wish to employ, their own funds to provide for the cost of materials, labor, land and improvements which may be necessary to complete a dwelling. On the other hand, savings and loan associations and banks are happy to provide short-term loans at relatively high rates of interest (plus service charges up to 2 1/2%) to such parties desiring to build. Before lenders will provide the funds, they review the individuals concerned and the structures to be built. If they feel the situation will provide them with the maximum security necessary, the construction loan will be made and interim builders' insurance covering the physical structure will be provided at builders' expense. The relatively high rate of interest associated with these construction or interim loans explains why builders cannot allow houses to remain unoccupied or unsold for any considerable length of time without refinancing the whole package. After the final progress payment is made by the interim lender, the builder must pay interest on the total of these payments for every day the house stands until the take-out funds are provided to the purchaser by the long-term lender.

Particularly disturbing is the apparently high cost of interim financing many builders in the Las Vegas area are experiencing. Obviously, these interim costs must eventually be passed on to the consumer. There is an evident dislike of some large operators who have established themselves in the area and are offering some very strong competition. There is reason to suspect that the competition stemmed from the lack of normal interim financing handicapping other builders who may not have shopped far and wide enough to have located financing at reasonable rates. The Las Vegas area takes on the aspect of funds flowing easily and swiftly, however, at an unusually high cost even when compared to the Reno metropolitan area, which is among the highest cost areas in the nation. General observations disclose subordination, brokerage, holdback, processing, stand-by marketing, and other high cost of third and fourth party arrangements, which, along with excessive builder control charges, worked to the disbenefit of the builder-seller and the eventual FHA or VA home owner. Apparently the builders are willing to accept these excessive interim charges and pass them along since there has not developed any severe over-building which would work to eliminate inefficient financing of homes and their non-competitive position in the market place. With a back-up of mortgage funds, and significant over-building, perhaps the situation may take on different aspects.

Ordinarily an insurance company or mortgage company will not traffic in a house plan and loan money for the construction of a home. They are happy, however, to issue a commitment that, in the event a certain home is built in a certain location, and to be built or purchased by a qualified party, they will loan a specified amount of money on a long-term mortgage. If the loan is to be insured or guaranteed by FHA or VA they will issue a conditional commitment and promise to guarantee the loan to any qualified FHA or VA buyer. These commitments are dated and, if not exercised, expire within a period of time.

These "take out" funds established by the commitments are made available by a disbursement check which may be several hundred dollars or more below the face of the note executed between the lender and mortgagor, due to the discount device, a matter covered in a separate chapter. If a check is disbursed in the full amount of the note, then usually a direct charge is made to the builder-seller and collected by the mortgagee through escrow. At this point, the builder-seller is credited with the sale price of the home out of which his interim financing loan, interest on the loan, and any discount to the mortgagee, is paid off. The interim lender leaves the picture and the "take out" lender provides a loan which is frequently in a higher amount since other factors have entered the picture. Final sale includes such items as value of land being sold, improvements, seller's profits, and, under either FHA or VA, usually the sale price will include most or all of the discount. Unfortunately, both FHA and VA evidently do not protect the home-buyer through FHA valuations and VA Certificates of Reasonable Value, <u>which exclude with certainty</u> the discount factor.

If an insurance company or bank has provided the "take out money" and made the long-term loan, they may or may not negotiate to sell the "paper" to a secondary market. Here in the west, a bank may "package" several loans and sell them in the east, picking up a point or fraction of a point on the transaction, and a new lender will enter the picture. An insurance company may hold the loan until maturity, depending on the market and a variety of their own portfolio conditions, which may or may not suggest they divest themselves of the loan before it has been paid off.

At this point, it should be kept in mind that even though a loan or mortgage may have been made for 20, 30, 35 or even 40 years, the average length of time a mortgage will be outstanding falls in the area of 8 to 12 years.

In the event a mortgage company has provided the take-out money, and made the loan after completion of the structure, they will most certainly move as rapidly as possible to "package" a number of loans and move them into the secondary mortgage market. If they are selling to FNMA, this packaging procedure will not be necessary, as explained in the following paragraph. Mortgage companies act as interim lenders and servicing agencies <u>on completed dwellings.</u> Large insurance companies and other lending institutions or funds, usually do not wish to traffic with an individual house and go through all the red-tape and negotiations which lead up to closure on such a small matter as an individual $15,000 mortgage. They will, however, negotiate and issue commitments to mortgage companies who have threaded their way through this maze, and purchase from them in large groups a number of mortgages at one time. The mortgage company will continue to "service" the loan and collect interest, principal and trust funds from the mortgagor, a major part of their so called "loan administration" operation.

The Federal National Mortgage Association (Fannie Mae) is a federal government acceptance agency which is authorized to purchase large quantities of mortgages from mortgage companies and other lending institutions. Their ability to make purchases depends upon funds made available by the Congress and from resale of mortgages. The passage of a mortgage from the mortgage company to the federal acceptance association does not require packaging and warehousing prior to sale. The theory at the federal level is that, by purchase of mortgages, funds will be made available and flow back into the home-mortgage market. In this case, the mortgage companies merely act as interim agencies. They sell their mortgages to the federal association, frequently as an official agent for FNMA.

The recent and rapid expansion of the mortgage company as the base lender in Nevada is of interest to the home-buyer. Just what is a mortgage company and how does it differ from the conventional lending institution?

The primary function of a mortgage company, as far as the home-buyer is concerned, is to provide the "take out money" or the loan which takes the builder-seller out of his interim loan costs and provides the funds to a veteran or home-buyer to make his purchase. However, the mortgage company is not interested in keeping the loan, but in moving it into the secondary or resale market as soon as possible. As indicated previously, the market for resale is provided by large insurance companies, the Federal National Mortgage Association, and to some extent by pension trust funds, the use of which apparently is on the increase. The mortgage companies provide a service to these secondary markets and are more or less interim agents in originating processing and then selling the loan. Secondary markets are not usually set up for, nor are they authorized or do they desire to process and originate loans and handle the details of a FHA or VA insured or guaranteed loan. The banks, savings and loan associations, and other lenders make loans with the initial intent of keeping them in their portfolios. They may sell the loans later, when market conditions change.

The mortgage company may pass a loan into the secondary market to "Fannie Mae" on an individual basis as soon as all papers are in order. Most large mortgage companies are authorized agents of FNMA. If the mortgage company elects to sell to insurance companies, which may be a necessity when FNMA has insufficient funds for purchasing, then the mortgage company must "package" loans and sell them in blocks, since the insurance companies are not geared to accepting one mortgage at a time. Under this latter method, mortgage companies have the added cost of holding or warehousing the loans for a period of time until a "package" can be sold to an insurance company or private fund.

Another basic reason for the existence of mortgage companies is the servicing aspect which the companies offer to the secondary market and the FNMA. When mortgage companies sell in the secondary market they continue to service the loan. That is, they collect the mortgagor's payments of principal and interest, and his trust funds to be held in reserve. The company also offers service by employing these trust funds to pay the mortgagor's taxes, insurance, and FHA premium payments, if any. Mortgage companies like to refer to this as "loan administration."

Prior to the home-buyer making his deposit, the seller also will have made sure that he can have mortgage loans insured or guaranteed by either FHA or VA. This necessity arises from the fact that, without government insurance or guarantee he would have little chance to obtain conventional mortgage money in an amount sufficient to enable most buyers to take on the loan without a sizeable down payment. In other words, usually conventional loans do not cover most of the cost of the home as do government backed mortgages. With government insurance or guarantee of repayment, usually mortgage money is available that will meet the maximum loan authorized by FHA or VA and provide for a very minimal down payment if any. In order to receive maximum loan insurance or guarantee, the builder-seller will need to submit his building plans and tract area arrangements and facilities to either FHA or VA well in advance of actual construction. When he has received approval of tract and building plans from these agencies, and also has lined up his mortgage money, he is ready to begin developing and building in the tract.

Without an understanding of the foregoing, the veteran or home-buyer is confused from the start if he gives any thought at all to the deluge of papers that will follow. He must be aware of all the preparations made in advance of his deposit which have made it possible to provide him with both mortgage money, without his having to shop around for it on his own, and automatically have him come in under a full government backed mortgage on the home he is buying.

At this point again it should be emphasized that the physical structure in our example has passed all necessary inspections by the mortgagee and guarantor and, to obtain a firm individual FHA or VA commitment, all that awaits is the approval of the buyer by both the mortgagee and FHA or VA. The government agency guaranteeing the loan will already have issued to the builder-seller a commitment (FHA Form No. 2007) Commitment for Insurance, or (VA Form No. 26-1843) Certificate of Reasonable Value, indicating the FHA or VA valuation on the property for mortgage insurance or guaranty purposes. In cases where the home-buyer negotiates for a home yet to be built in the tract area to his particular specifications, the builder-seller will, of course, not be in possession of a FHA Valuation figure or VA Certificate of Reasonable Value to show the buyer at time of execution of the deposit receipt or agreement to purchase. In this case, however, FHA regulations provide that the seller agrees to deliver to the purchaser, promptly after receipt from FHA, the FHA statement of appraised valuation. Under VA, the amount of the Certificate of Reasonable Value will be entered on the loan application which the veteran will execute subsequent to his agreement to purchase and after the Certificate of Reasonable Value has been obtained by the builder-seller, a procedure which is less desirable to the consumer.

In some states, a subdivision report is a necessity at the time of arranging a sale of a new home in a tract area, a copy of which must be given to the home-buyer at the time of his deposit and agreement to purchase. This is a general statement, best approved by a state planning agency, containing factual information about the subdivision and the various utility and other facilities available, including school locations, transit lines, and other data which may be required by various states. Undoubtedly, this is of great advantage to the veteran or home-buyer for the purpose of evaluating the desirable and undesirable features of the tract location in general, and provides him with information to challenge statements made by the salesman in regard to the tract. In the absence of such a requirement in Nevada, this aspect will not be covered at this time but will be included under suggestions in the following chapter.

At this point we have established the necessity for the existence of several basic associated documents for the initiation of action toward the purchase of a sales type tract home under FHA or VA which is ready for occupancy, as follows:

(a) Purchaser's copy of the FHA Statement of Appraised Value to be secured from the builder-seller prior to making a deposit or signing any contract to purchase. This is (FHA Form No. 2562) similar to the upper portion of the FHA Form No. 2007, and identified as "Purchaser's Copy" at the bottom of the form, which also includes important "Notes to Purchaser." Under VA, the home cannot be sold for more than the Certificate of Reasonable Value, and the obtaining of the Certificate of Reasonable Value prior to making a deposit is not quite so critical, but should be provided for and will be suggested in this report.

(b) A deposit of earnest money, usually an amount of around $250, to execute the contract being entered into.

(c) The collection of a credit report charge in an amount of approximately $5.00 to permit a financial background report to be issued on the proposed mortgagor (buyer). This amount may be collected at a later date through escrow or absorbed by the builder-seller.

(d) A contract, agreement to purchase, or deposit receipt, executed by the buyer and seller, setting forth basic information regarding the sales transaction.

Additional papers, which the home-buyer may receive at the time of executing the contract or agreement to purchase, will be necessary for the mortgagee to initiate action through FHA or VA. He may receive these a few days later directly from the mortgagee, have them filled out by an agent of the seller at time of deposit, or they may be sent to the mortgagee to have them executed.

Under the two programs, these forms will be three in number if he is employed. A slightly different procedure has been established for a self-employed person. The basic paper will be a FHA Form No. 2004c entitled "Supplement to Mortgagee's Application; and Mortgagor's Statement," and under VA, Form No. 26-1802, entitled "Application for Home Loan Guaranty or Insurance." These are necessarily elaborate forms since they constitute the basis upon which both the mortgagee and either FHA or VA will make their determination as to the qualifications of the prospective mortgagor for a loan and for government insurance or guarantee. Basically, they disclose the assets and liabilities of the home-buyer and attempt to project into the future by providing information on estimated expenses, employment situation, and other income and assets which will indicate the financial soundness of the individuals in question to qualify for the mortgage loan. Basic formulae are employed by government agencies who will be insuring the loan, as well as by the mortgagee, to reach a general determination as to the buyer's ability to assume the mortgage. However, each case rests on its own particular peculiarities which may be evident or disclosed by way of the other forms to be completed, along with the very important credit report.

Other forms which the home buyer will have to have filled out are FHA-VA Form No. 2004f entitled, "Verification of Deposit" and FHA-VA Form No. 2004g entitled, "Verification of Employment," assuming he is employed and has a bank deposit. If he has more than one employer, or if the wife also is employed, they will have need of more than one employment form, likewise for any deposits in more than one institution.

The basic and complicated VA Application or the FHA Mortgagor's Statement, which may be filled out with the assistance of the builder-seller or mortgagee representative, may indicate a qualifying case. However, a poor credit report and/or employment status report indicating possibility of future termination or uncertainty of present employment status, can have a very marked effect on the granting of a loan or the insuring or guaranteeing of a mortgage loan. The home-buyer may ask for additional copies of all of these forms for his own purposes, toward having information indicating what he reported in connection with his case. Information supplied by the prospective mortgagor is for confidential use by the mortgagee and FHA or VA.

CHAPTER III

FHA STATEMENT OF APPRAISED VALUE -- VA CERTIFICATE OF REASONABLE VALUE

Prior to issuance of commitments for mortgage loans, inspections of the property or analysis of building plans, locations, and improvements to be constructed is made by both lenders and government agencies insuring or guaranteeing such loans. An appraisal is made of the value of the property and a conditional commitment issued by FHA and a Certificate of Reasonable Value by VA.

Where mortgages are not insured or guaranteed by either FHA or VA, usually conventional lenders will develop a conservative appraised value, and then loan only up to 50% - 60% - 70% of that appraisal. In the event the loan is to be insured or guaranteed by FHA or VA, then the lender may or may not issue a full commitment matching the government program authorization and/or the prospective mortgagor's request. In the case of mortgage companies versus conventional lenders, the former will frequently lend to the maximum that can be insured by FHA, or under a VA guarantee will provide for a full loan. In FHA cases, and where the buyer has requested a large mortgage, the maximum allowed to be insured by FHA (97% up to $15,000, a lesser percent on graduated increases) will usually be the same as the commitment by the lender.

Under the VA guarantee program, a loan is guaranteed up to 60%, or $7,500, whichever is the lesser. VA does not require any down payment so a mortgagee may, if it elects to, make a full loan to the veteran. On a $15,000 home the VA will guarantee $7,500, or exactly one-half of the loan. On a $12,500 home VA would be able to likewise guarantee $7,500 under application of either the $7,500 or 60% of value provision. On homes costing more than $15,000 the VA guaranteed loan will drop as a percentage of the value of the house. For example, on a home valued at $20,000 the VA will guarantee only $7,500, equal to only 37 1/2% of valuation. At $25,000 valuation, the $7,500 loan would only amount to 30%.

The question might be asked, in view of this, why a mortgagee would be willing to go so far beyond the VA guarantee and make a full loan with no down payment to a veteran, particularly here in Nevada where most VA guaranteed home sales are in excess of the $15,000 valuation. An example should be given to illustrate how the lender (mortgagee) is protected. Take a $15,000 home on which VA has guaranteed only $7,500 of the loan. After the veteran has paid his mortgage down to $14,000, a depression strikes the area where the home was constructed. Conditions are such that even with the VA appraisal of a market condition sale, the home can only bring $10,000. At $14,000 still owed on the property, VA would have as its continuing guarantee from the original base guarantee $7,000 ($500 less than original since it guaranteed one-half of the loan). The mortgagee sells the home at the $10,000 market value established by VA as a foundation (actually in such cases the mortgagee would probably let the VA take over) and sustains a net loss of $4,000. However, VA still has an obligation to protect the lender against loss in an amount up to $7,000, so the $4,000 loss to the lender would come from this $7,000 VA guarantee.

Before the mortgagee could sustain any loss, exclusive of foreclosure costs, the market sale price of the house in the above illustration would have to fall to below $7,000.

Such a situation would be extremely remote. In many cases, lenders prefer to deal with VA because the VA supports the mortgagee with cash settlements. Under FHA a debenture payment method is employed resulting in a market loss to the lender when he negotiates these debentures under discounting practices common to such transactions.

We now reach a critical foundation upon which to base a commitment. The commitment is obviously dependent to a large extent upon valuation which, in turn, rests upon an appraisal. The appraisal will fluctuate when consideration is given to a single property, and with some justification appraisers will come up with different figures. However, there should be a close correlation among appraisers in a situation where many homes are almost identical, built in the same period of time, in a similar location, and with identical materials and labor costs, on standard-size lots. Also, there should not be much variation on appraisals in the event there have been resales in the area and the development is an "active one." An opposite situation would exist where an isolated ranch containing a variety of unusual buildings not duplicated elsewhere in a county had not changed hands for many years and might be up for appraisal. Here we might expect a considerable degree of latitude between valuations set by several appraisers since the market value would rest on a number of variables, and comparisons with actual cost or resale factors would be almost completely lacking. The appraisal problem and some of the abuses are covered in a following chapter.

The FHA statement which the buyer should be given prior to entering into an agreement to purchase, FHA Form No. 2562, is a fundamental document frequently overlooked by both parties to the purchase contract. Since it is of basic protection to the consumer, extra consideration should be given to this form. The buyer should take notice to make sure an appraised value has been properly filled in on this form to indicate in particular the FHA Valuation. The space for this will be in an area set aside in bold type on the face of the form near the top. The information on the form will not be original, but will be a carbon entry from the FHA Form No. 2007 entitled, "Commitment for Insurance" which was in position ahead of it and upon which FHA will have entered the valuation figure. This purchaser's copy is the only copy of FHA Form No. 2562, although it is bound together with five copies of FHA Form No. 2007. The purchaser should make certain that he has his copy and that it has been made available to him prior to his making any deposit. Provision for this governmental protection to the home buyer is provided for, as follows:

> Section 226 of the National Housing Act requires that the purchaser of a property to be covered by mortgage insurance by the FHA receive a statement of 'appraised value' prior to purchase of the property. (From FHA Form No. 2562 - Rev. 1/61) (underscoring supplied)

The reason for the requirement is fairly obvious since a sales price quoted to a prospective mortgagor which is much above this FHA Valuation would possibly indicate that the property being offered for sale was priced above "market." This situation is not always typical in the "spot loan market" for resales where "market" may be well above FHA valuation. Many tract homes are offered for sale at exactly the FHA valuation figure. When this is done, the home-buyer feels he is being dealt with fairly. However, consideration should be given to a further statement contained in the same "Purchaser's Copy" of the FHA form, as follows:

> The word 'value' as used by FHA is an estimated total price of a property including estimated closing costs incidental to acquisition of the property but excluding payments for prepaid expenses such as taxes and insurance. (underscoring supplied)

Since most purchase contracts provide that the home-buyer shall pay for closing costs in addition to the sales price, it can easily be seen that if the sales price of the home is equal to that of the FHA valuation, then the home-buyer is either paying for closing costs twice, or paying more than necessary for the home in the first place, if he is availing himself of the FHA protective feature. Where a normal agreement to purchase provides for the buyer to pay closing costs, then the stated sale price of the house should be several hundred dollars less than the FHA Valuation, if the buyer is to afford himself of the protective provision of the FHA valuation notice to him. This is not to imply that FHA requires that the sale price of the home should not exceed the FHA Valuation after proper consideration of closing costs. The buyer may pay any asking price the seller establishes, or agreed upon by buyer and seller, and FHA will still insure a mortgage loan on a property sold under such conditions. Under the VA program, they will not guarantee a loan on a house sold for more than the Certificate of Reasonable Value. However, under FHA the implication that there should be a strong relationship between valuation and sales price is fairly obvious. For what other reason would the government require that the valuation figure be given to the buyer prior to his execution of an agreement to purchase? Likewise, there is nothing to prevent the builder-seller from selling to the buyer at considerably lower than the FHA or VA valuation established. The following statement is also taken from the "Purchaser's Copy" of the FHA Statement of Appraised Value, which indicates FHA's acceptance of sales prices which do not coincide with valuations:

> The FHA estimate of appraised value or replacement cost does not establish a sales price. (underscoring supplied)

We may add, from an interpretation in the same form, that it also does not establish the maximum amount of an insured mortgage or that the FHA has approved a purchaser of the property as a mortgagor.

It is adequately clear that if a consumer wishes to obtain a home at a price which does not exceed the valuation placed upon it by FHA, he should proceed as follows. Take the FHA valuation and subtract from it any closing costs he is being required to pay for in his agreement to purchase or that the builder-seller is paying for (if any) incidental to acquisition of the property. In this computation, no inclusion should be made of certain monies being collected at closure (trust impounds) which will be deposited in the purchaser's reserve account, a matter to be discussed later.

At this point we are also assuming that the government appraised value of the property is a true one and does not recognize, nor has it been expanded to take into consideration, certain builder costs for obtaining financing of the mortgagor's loan (frequently referred to as a "discount," to be discussed in a later chapter).

The home-buyer will wish to avail himself of the FHA valuation, which should be given to him prior to making a deposit with the builder-seller, Form No. 2562, "FHA Statement of Appraised Value." At closure, the buyer will be required to sign a Mortgagor's Certificate with the sworn statement in the case of this finished home example that:

> The FHA Statement of Appraised Value was given to me prior to my signing the contract to purchase the property identified herein. (From FHA Form No. 2007, Rev. 1/61, reverse side) (underscoring supplied)

The builder-seller also must sign an agreement with FHA that he delivered to the buyer at the proper time the FHA statement of appraised value, as follows:

> The undersigned as Builder-Seller-Other in the captioned case hereby agrees that he will deliver to the purchaser, prior to the execution of the contract for the sale of the property, a written statement setting forth the amount of the FHA's appraised value of the property. (From FHA Form No. 2004, Rev. 11/61) (underscoring supplied)

Section 203.15 of FHA Regulations contains the basic provision for this agreement:

> Certification of appraisal amount. An application with respect to insurance of mortgages on one- or two-family dwellings must be accompanied by an agreement satisfactory to the Commissioner, executed by the seller, builder or other person as may be required by the Commissioner whereby such person will deliver to the purchaser of such property a written statement in form satisfactory to the Commissioner setting forth the amount of the appraised value of the property as determined by the Commissioner. (underscoring supplied)

The FHA Mortgagees' Handbook, Section 106 contains the following directive:

> The agreement with respect to FHA valuation, shown on reverse side of Form 2004, (on front side of new forms) is to be executed in all instances involving the purchase of 1 or 2 family dwellings. (underscoring supplied)

For homes purchased under the VA program of guarantee for the mortgagee's loan, the buyer has some basic protection not offered under the FHA insured loan program. VA, in place of a FHA valuation, issues to a builder-seller what is called a VA Certificate of Reasonable Value. This is made available to the builder-seller prior to his commencement of construction on sales type homes.

Under VA regulations, there is no requirement that the home-buyer be shown the VA Certificate of Reasonable Value before he makes his earnest money deposit and before signing any contract to purchase. Apparently this would offer less protection that under the FHA program. However, an important difference exists between FHA and VA in regard to the sale price of the home. Under FHA the house may be sold, and the mortgage associated with it may be insured by FHA, for any sale price that the buyer agrees to. FHA does not prohibit the seller from charging more than the FHA Valuation figure. Under the VA program, the seller is prohibited from selling the home for more than the VA amount established by the Certificate of Reasonable Value. He could sell the house for more than the VA established figure, but VA would refuse to guarantee any loan associated with the transaction.

The protection to a buyer under a VA transaction is automatic, he cannot be charged directly more than VA has established. The buyer could pay a lesser amount than the VA sale price established and, possibly if he was aware of the VA figure, could be placed in a better position to bargain on a sale price. He could thus be apprised of information as to whether or not the seller was selling at or below the VA figure and be better advised as to how far he might maneuver on a downward price.

PRACTICAL APPLICATION:

The intentions of FHA government protection to the consumer are evident in transactions involving their government insured mortgage loans. Theoretically, the home buyer is placed on notice prior to his execution of a contract in regard to what the FHA Valuation is on the house which has been offered to him for sale. It is then at the option of the buyer as to whether he wishes to pay more than FHA Valuation after a consideration of certain closing costs which are included in such a valuation formula. Likewise it is up to the seller as to whether he wishes to price his sales type home in any particular relationship to the FHA Valuation. As heretofore explained, the VA Certificate of Reasonable Value establishes a ceiling and the buyer has a built-in protective feature.

In practice, considerable difficulty has been experienced in guaranteeing that the buyer will be given this FHA Statement of Appraised Value at the proper time, if at all. FHA seems to have recognized the fact to some extent, recently having changed FHA Form No. 2007 containing the Mortgagor's Certificate on the back side. This Certificate now includes an added statement "(e)" where the mortgagor certifies that he received the FHA Statement of Appraised Value at the proper time. This certification has been handled in various ways at different times by FHA, in some years as a separate certification. In spite of these controls, a number of mortgage transactions are endorsed for insurance by FHA, with both builder-seller and mortgagor's certifications executed, in the absence of any delivery of the FHA Statement of Appraised Value to the home-buyer at the proper time, or at any time thereafter.

An examination of wording contained which provides for this delivery to the home-buyer is interesting. The builder-seller's agreement on FHA Form No. 2004, makes reference to "a written statement setting forth the amount of the FHA's appraised value" while the Mortgagor's Certificate specifically identifies what kind of a written statement by reference to the "FHA Statement of Appraised Value," which is the title of a specific FHA Form No. 2562. This form is also identified as that which the mortgagor will have to certify as having received at closure in the Mortgagor's Certificate itself. We can only conclude that the builder-seller would be fulfilling his obligation under his agreement with FHA on Form No. 2004, by delivering to the home-buyer a statement written on the back of a postage stamp identifying the FHA valuation, provided that he delivered such a notice prior to the execution of the contract for sale of the property. FHA Regulations, under Section 203.15, indicate that the "written statement" must be in a form satisfactory to the Commissioner. From this we suspect that a reference is made to the FHA Form No. 2562. However, if this is the intent, then it is loosely passed along as a directive to the builder-seller in his agreement with FHA on Form No. 2004. This is an extremely weak link in the procedure since obviously it is the builder-seller's obligation to make such delivery. It is he who must act in the face of an ill-defined agreement, if in fact the intent is to have the FHA Statement of Appraised Value in the hands of the home-buyer at the proper time.

SUGGESTIONS:

(1) FHA should immediately move to clarify its agreement with the builder-seller on Form 2004 and specifically state that the seller will deliver FHA Form No. 2562 (properly executed) to the home-buyer prior to signing the contract, in all cases where FHA has issued a valuation figure on completed or unfinished dwellings.

(2) In addition to having the mortgagor certify at closure that he received FHA Form No. 2562 at the proper time, the builder-seller should be required to obtain such a certification from the home-buyer at the time of delivery of FHA Form 2562 on an entirely separate receipt form which FHA would require the mortgagee to submit with

his Supplement to Mortgagee's Application; and Mortgagor's Statement, FHA Form No. 2004c. Similar provisions should be made for a VA Certificate of Reasonable Value to be given to the veteran prior to execution of any purchase agreement. Duplicate FHA 2562 forms and VA Certificates of Reasonable Value should be available for those cases which do not close and would require new copies for the following prospective purchasers. These suggestions are based on the fact that, when the mortgagor certifies at closure many weeks will have passed and he may have only a hazy recollection of whether or not he ever received such a form. If it were necessary to obtain his signature certifying to the delivery at the very time he should receive the form, it would be evident that he would be in a logical position to so certify. It is recognized that additional paper work is highly undesirable. However, the point is such an important one to the veteran or home-buyer and represents one of the few protections he has been afforded by the government under the FHA program, that a major effort should be made to guarantee that he receive the FHA Statement of Appraised Value or the suggested VA Certificate of Reasonable Value, and at the proper time.

(3) No provision is now made under the VA program requiring a builder-seller to provide the veteran with a separate notification indicating the Certificate of Reasonable Value which VA has established, prior to execution of a purchase contract. It has been pointed out that, since VA will not guarantee a mortgage associated with a sale in excess of the Certificate of Reasonable Value, the veteran has adequate protection. This is true in many cases. However, the veteran purchasing a new tract home would certainly be placed in a far better position to evaluate or bargain if he knew of and had been furnished with Certificate of Reasonable Value information. He would be able to compare offerings of several builder-sellers, and know whether they were selling at or below the Certificate of Reasonable Value. This report strongly suggests that VA move to immediately insure to the veteran information as to the Certificate of Reasonable Value prior to contract execution. A system similar to FHA's should be employed and, in addition, the receipt procedure suggested in this report for guarantee on time of delivery of the FHA's "Statement of Appraised Value" should likewise be applied to the VA notice of Certificate of Reasonable Value to the prospective mortgagor.

(4) Should the Nevada Legislature wish to take direct action in addition to including suggestions (2) and (3) in a memorialization to the Congress or to the FHA Commissioner and the VA Administrator, then the following is suggested:

> Legislation could be enacted which would require that the builder-seller deliver the FHA Statement of Appraised Value or the VA Certificate of Reasonable Value information to the home-buyer prior to execution of an agreement to purchase, and further have the buyer execute a certification of such receipt upon a State of Nevada Certification of Delivery form to be delivered by the seller to a state agency. The agency in turn could request a list of FHA and VA cases (by the month) indicating the numbers assigned to such cases, and who the mortgagors are who have applied for a government insured or guaranteed loan. In this way a control could be established which would quickly indicate the compliance or non-compliance with the law.
>
> In those cases where an already existing home is not the case, and proposed construction is a part of the agreement to purchase, a similar control could be established covering the usual FHA action that the seller deliver the Statement of Appraised Value to the buyer promptly

after such appraised value statement is made available to the seller. Such control could be made applicable to both FHA and VA transactions.

(5) A subdivision report, as identified in Chapter I and required in many states, might also be a consideration which the Nevada Legislature would wish to make mandatory in this state and operated under a planning agency. In the event the Legislature made such information available to our home-buyers and veterans through mandatory legislation, such a report copy should be required to be given to the home buyer prior to his making a deposit of earnest money.

CHAPTER IV

DEPOSIT OF EARNEST MONEY

The deposit made by the veteran or home-buyer to the builder-seller indicates that the prospective mortgagor is a willing buyer and wishes to proceed with transactions which will eventually lead to his purchase of the dwelling. Under normal circumstances, where extreme competition is not a factor, the builder-seller will require at this time a deposit in the amount of usually $200 or $250, if he is operating a volume business. Smaller operators may require a deposit of $1,000 or more, since they cannot afford to tie up a major portion of their sales homes unless it is a large deposit. Smaller builders do not wish to traffic in borderline cases which a volume tract area may at times toy with and manage eventually to obtain approval on. Some large operators may require only a token $1.00 or a few dollars as a down payment. In any event, there should be adequate protection to the buyer in the matter of this earnest money deposit.

Usually protection is afforded under the terms of the contract executed with the builder-seller at the time the deposit is made. In some cases, a specialized form of deposit receipt has been prepared by a volume tract seller which may be executed at the time of the deposit, likewise protecting the deposit.

At this point extreme caution should be exercised on the part of the buyer, since a plain receipt for cash or a check (or the cancelled check itself) only establishes the fact that the buyer deposited with the seller a certain amount of money. Under FHA, it does not provide protection for the deposit relative to conditions under which the deposit shall be returned to the buyer. Under the VA program of guaranty on sales type homes in VA approved tracts, the veteran's deposit is protected. This point should be clearly established by provisions contained in the contract, deposit receipt, or agreement to purchase, and such agreement should be executed at the time the deposit is made. To make a deposit, and not have a contract or agreement relative to the deposit executed until several days or weeks later, leaves the deposit exposed in the interim. Only in those cases where a home-buyer orders a very special alteration and major change in a model home to be built in a tract (which might make the quotation of a sales price unlikely due to estimates yet to be provided to the salesman) should a deposit be made without a contract. This situation is not an element of the example we are illustrating, but, even in such cases the buyer should obtain a short agreement from the seller which would incorporate the option of a return of the deposit, in the event the final quoted sales price was not acceptable to the buyer.

It is obvious that the builder-seller should also be protected at this point by a deposit since he must have assurance that the buyer will go through with his purchase unless unusual circumstances arise. The primary provision for return of the deposit, which should be a part of the contract, deposit receipt, or agreement to purchase, is one which will automatically refund all monies deposited by the buyer in the event that the FHA loan application is rejected by either the mortgagee or the government agency. Obviously, the type of such loan, its terms, and the amount, should be specifically set forth in the agreement. Without this protection the builder-seller could retain the deposit. The buyer could, of course, obtain mortgage funds from other sources which might or might not meet the terms of the contract or agreement, and which FHA might insure. Other provisions for a return of the deposit could be included. However, the contingency on obtaining the specified loan usually provides adequate protection to both buyer and seller. This is not meant to imply that a builder-seller would not return a deposit in the absence of such a provision and under circumstances which would make it impossible for the buyer to proceed. The implication is leveled at those few who might take advantage of the situation.

As a further protection to the FHA home-buyer, provision should be made for the monies deposited with the builder-seller to be placed in a trust account and separated from any funds belonging to the builder-seller as now required by VA tract purchases. Nevada has no such provision in its statutes. The reason for this further protection has basically to do with the possibility of the seller taking the deposit, becoming involved in financial difficulties (a situation not uncommon to the building industry) and not being able to refund the deposit to the buyer who has the agreement to protect him at hand. Where the deposit had been placed in a trust account or in escrow, and the assets of the builder-seller were being liquidated by his creditors, the buyer would have his earnest money deposit fully secured to him and separated from the bankrupt's funds and assets. A provision for such legislation is a part of the suggestions in this section, and follows.

At time of closure, the buyer should follow through and make certain that he has been given credit for whatever deposit he made, as well as other monies paid as a down payment, on his statement of charges and credits for the entire transaction. Cases are known where this deposit has not been credited in the closing statement.

PRACTICAL APPLICATION:

Builder-sellers may follow through after a deposit for purchase under FHA and open a formal or informal escrow account with a title company or bank, and place such deposit in this established escrow or in a separate trust account. However, this is only required under VA tract purchases and builder-sellers may only notify an escrow, title company, or bank that a certain amount has been deposited with them and they do not necessarily turn the FHA purchase deposit over to the institution which may be handling the closing of the transaction or place the deposit in a trust account.

In this connection, the following information from the Department of Veterans Benefits, issued as Bulletin No. IB 26-47 on February 9, 1962, is of particular interest. The bulletin was entitled, "Responsibility of Sellers to Escrow Payments for Optional Items." Optional items and deposits made were in point. However, the bulletin bases its directive upon a former bulletin (IB 26-40) which covered the broader matter of deposits made for construction purposes. This, in turn, deals with proposed construction, not the exemplified type of transaction with which this report deals. In any event, the broad wording contained in section (2) of the bulletin apparently covers any deposits made prior to closure, which would include a deposit made on a complete finished dwelling ready for immediate occupancy. The Veterans bulletin reads as follows:

> 1. In IB-2640 attention was called to the provisions of Section 1806 of Title 38, United States Code, requiring sellers or their agents to place in a trust account any deposit or down payment received in cases involving construction of proposed residential properties to be financed or purchased with loans made, guaranteed or insured by the VA. The question has been raised as to whether this requirement of the law pertains only to initial deposits and down payments or whether it includes deposits and payments made later (but prior to loan closing) for optional items and 'extras.'

2. The VA considers that the words, 'Any deposit or down payment made by an eligible veteran,' as used in 38 U.S.C. 1806, clearly means the initial deposit or down payment and any subsequent deposit or down payment made by the veteran to the seller, or the agent of the seller, prior to loan closing. To construe the law otherwise could result in depriving the veteran of a large measure of the protection that Congress sought to afford him in enacting the law. (underscoring supplied)

While it is true that a home-buyer would stand to loose considerably more through substantial down payments frequently required for a custom-built home, there is no logical reason why such protection should not also be afforded to the consumer who makes a relatively smaller down payment to purchase a tract home already constructed. In either case, the builder-seller could become financially bankrupt. In the first case, where construction was under way, the assets of the builder would be seized, and the purchaser could be out his deposits if they were not held in a separate trust or escrow. In the second case, that of a completed dwelling, the builder-seller becoming bankrupt would likewise have his finished products taken over for liquidation. Although the period of time and the amount of the deposit might be less in this second case, the home-buyer would still be minus his deposit if not placed in trust or escrow.

SUGGESTIONS:

The following suggested legislation is presented as a measure which the Nevada Legislature might well consider toward protecting the home-buyer in regard to deposits made toward the purchase and also the construction and repair of dwellings and other buildings.

FHA does not regulate the matter of the deposit by stipulating provisions and conditions which would require it to be returned to the home-buyer, since at this stage of negotiations FHA will not have become immediately involved. It is not suggested here that a regulation of deposit monies be provided for under Nevada law requiring that a receipt given for same must provide conditions under which it would be returned. This is based on the presumption that anyone who would give over a deposit of money and not secure in return for the deposit some agreement indicating what it was for, and under what circumstances it would be returned, is hardly a prospect to be saved from throwing his money around for any purpose whatsoever. However, government does have an interest in how an agreement which is entered into with the seller can protect the buyer by insuring that a deposit will be returned in keeping with provisions of the agreement or contract. By placement in escrow or trust, such separation from the builder-seller's funds will offer this protection.

Excerpt from Program of Suggested State Legislation (1959), of Council of State Governments:

DEPOSITS RECEIVED FOR PURCHASE, CONSTRUCTION OR REPAIR OF BUILDINGS AND STRUCTURES

Numerous individuals planning to purchase, construct or repair homes or other buildings and structures have suffered financial losses due to the misappropriation of funds deposited with builders, contractors and others. Sometimes contract terms are not fulfilled or for other legally valid reasons, individuals may cancel contracts. In such instances, they may find that funds paid as deposits are not available and there are no feasible means for securing restitution. Even though there appears to be only a small minority of builders, contractors, developers, etc., involved, situations of this type appear to occur frequently enough in some areas to justify special legislative action.

The act suggested here requires persons receiving advance funds in connection with the purchase, construction or repair of residences, buildings and structures to deposit such funds in trust accounts. It provides limited conditions under which moneys may be withdrawn from such trust accounts. As an alternative to the establishment of trust accounts, the act permits the use of surety bonds to guarantee performance of the contract and to provide protection against faulty workmanship or the use of inferior materials. Finally, the act prohibits the issuance of a completion certificate until all work required by the contract actually is completed and the contractor has furnished the owner signed releases or waivers of lien by laborers, materialmen or contractors.

Suggested Legislation

(Title should conform to state requirements)

(Be it enacted, etc.)

Section 1. Any person, firm, corporation, association or partnership, or agent or employee thereof, receiving funds as payments, advances or deposits made pursuant to a contract to purchase, erect, construct, complete, add to, alter, improve or repair any building or structure, shall deposit such funds in a trust account to be used only as provided in Section 2 of this act. Provided, that such funds need not be deposited in a trust account if such person, firm, corporation, association or partnership, or agent or employee thereof, shall furnish a surety bond in accordance with the provisions of Section 3 of this act.

Section 2. All funds deposited in trust accounts required by Section 1 shall be placed in banking institutions licensed to do business as such in this state. Funds may not be withdrawn from these accounts except for one or more of the following purposes:

(a) For immediate deposit in another banking institution in this state in a similar trust account.

(b) For return in full to the party from whom the payment, advance, or deposit was received.

(c) For direct payments to persons, firms, corporations, associations or partnerships, supplying labor or materials actually used in the performance of the contract. Provided, that such payments may be made only on the authority of the owner, prospective owner or other contracting party or his duly authorized agent.

(d) Upon fulfillment of the terms specified in the contract or agreement including, if the contract pertains to the purchase of real property, the closing and passage of title and the conveying of the property to the buyer by a valid deed or instrument. Fulfillment of terms under this subsection shall include the signing of a valid completion certificate in accordance with the provisions of Section 4 of this act.

Section 3. In lieu of the establishment of trust accounts under the terms of Sections 1 and 2 of this act, a person, firm, corporation, association or partnership, or agent or employee thereof, may furnish to the owner, prospective owner or other contracting party a surety bond in a sum equal to the contract price for such work, conditioned for the faithful performance of the terms of such contract and conditioned that the contractor shall make prompt payment to all persons, firms, corporations, associations or partnerships supplying labor or materials used in the performance of such work and indemnifying and conditioned to save harmless such owner or other contracting party, his heirs, executors, administrators and assigns, for any damages sustained by him for or by reason of faulty workmanship or by reason of any improper, defective or inferior materials used in said work which may appear within two years from the date of completion of such work. Said bond shall be issued by a person or corporation authorized to issue surety bonds in this state.

Section 4. No person, firm, corporation, association or partnership, or agent or employee thereof, who, having entered into any contract, such as is described in Section 1 of this act, for the purchase, erection, construction, completion, addition, alteration, improvement or repair of any building or structure, shall obtain the signature of the owner, prospective owner or other contracting party upon a completion certificate for such work before the actual completion thereof, and until such person, firm, corporation, association or partnership, or agent or employee thereof, shall have furnished such owner, prospective owner or other contracting party with a signed release or waiver of lien by all laborers, materialmen or subcontractors.

Section 5. Whoever violates any provision of this act shall, upon conviction, be punished by a fine of not more than ($500) dollars or by imprisonment for not more than (six) months, or both.

Section 6. The provisions of this act shall not be construed to give a labor or materials supplier a cause of action.

Section 7. The provisions of this act shall not be applicable to the purchase, erection, construction, completion, addition, alteration, improvement or repair of any public building or structure.

Section 8. (Insert severability clause, if desired.)

Section 9. (Insert effective date.)

(underscoring supplied)

Such legislation would, of course, go far beyond the matter of protecting deposits made for the purchase of a completed dwelling. However, while the Legislature is about it, protection might well be considered for adequate coverage to veterans and home-buyers for dwellings yet to be constructed (not considered in this study).

CHAPTER V

CREDIT REPORT CHARGE

Simultaneously with the earnest money deposit, the builder-seller may also ask the veteran or home-buyer for a credit report fee, although there is no authority for him to collect this fee under current FHA regulations. Many sellers, anxious to close the contract or agreement to purchase, will not make mention of this charge which only the mortgagee may collect under FHA, and will absorb it temporarily to be recovered by the mortgagee through escrow closure as a charge to the buyer. The charge being a small one, usually $5 to $10 and depending on the necessity for a "foreign," out-of-state report, may be absorbed by the seller. The reason this particular fee may make an appearance at the inception of the FHA or VA transaction is that a credit report must be made on the prospective mortgagor to place the mortgagee in information upon which to base his determination as to acceptance of the prospective mortgagor for a loan, and initiate action toward having either FHA or VA also review the report for their decision to insure or guarantee the mortgagee's loan.

In the event the home-buyer does pay for a credit report fee at the time of making his earnest money deposit, such a payment should be acknowledged in the contract, deposit receipt, or agreement to purchase. Differing from the earnest money deposit, the buyer should not expect to be protected in any way against the possibility of it not being returned to him. This fee will have been actually expended in making a credit report on the buyer, whether a loan is secured or not. It will be a cost to the buyer and not returnable to him even in those cases where the deposit is returned.

Where the buyer has made such a credit report fee payment, he should be on guard to make sure that he is not again charged for such a report on his itemized statement of charges at closure. This can occur, unless he has also been given credit for it in a like amount under credits. If he is charged with the cost of a report at closure, and no corresponding credit is given, he is either paying twice for the report, or the mortgagee may be "back charging" him for a new up-dated credit report ordered by the mortgagee, which will be necessary in many cases for the mortgagee to move the loan into the secondary market, and represents a charge which the buyer should not assume.

FHA regulations cover the matter of the credit report charge under Section 203.27 by including specific reference to it as one which only the mortgagee may collect from the buyer, as follows:

> The mortgagee may collect from the mortgagor the following charges, fees or discounts: (3) (ii) Credit Report; (underscoring supplied)

FHA again covers the point in its Mortgagees' Handbook under Section 1101, under permissible charges and fees as follows:

> The Administrative Regulations for Section 203 permit the mortgagee to collect the following charges and fees from the mortgagor: (c) (2) Credit Reports; (underscoring supplied)

Since the FHA regulations make mention of such a charge in the singular, it may be reasonable to assume that the intent is a charge for one credit report. The Mortgagees' Handbook, however, specifically mentions such charges as being proper in the plural. It is realized that foreign out-of-town reports may be necessary to cover a two year financial background under FHA. Since the regulations are more binding and controlling than the handbook, it is reasonable to suggest that no charges should be made to a mortgagor for more than one credit report under current regulations, and no charge for that one made on the report to the FHA Commissioner if such a charge has been taken care of and paid for outside escrow at the time a contract to purchase was executed. FHA should certainly clarify the point so that both mortgagees and regional FHA offices have a clear understanding. It is entirely possible that the term credit report in the singular (as employed in the regulations) has a meaning to those processing the loan as "any and all reports necessary" to disclose the financial background on the mortgagor. This is further reason for a precise clarification.

On the reverse side of VA Form 26-1802, January 1960, the VA provides for and allows the veteran to pay for a "credit report." The singular form of "report" is significant.

Section 501, of VA Regulations on Loan Guaranty, Part I, entitled "Loans for the Purchase, Construction, Repair, Alteration or Improvement of Residential Property," issued pursuant to and implementing the provisions of Section 36.4312 of the VA Loan Guaranty Regulations promulgated under Title III of the Servicemen's Readjustment Act of 1944, as amended, applies to all VA guaranteed or insured loans. In Part A (3) of Section 501, again reference is made to "credit report" in the singular as an item the veteran may pay.

PRACTICAL APPLICATION:

A volume sales tract operation, working through an exclusive mortgagee, usually does not collect this credit report fee from the veteran or home-buyer. The seller merely notifies the mortgagee of the prospective mortgagor and the mortgagee, usually a mortgage company, will order a credit report from a credit bureau agency. In turn the agency bills the mortgage company periodically for all credit reports ordered. The mortgagee charges the mortgagor for the report on the statement of charges sent to the escrow office and collects the credit report fee through escrow at closure. In these cases, the buyer will find the item as a charge to him on his closing statement.

In cases where the credit report is ordered by the mortgage company, and, as a result of the information contained in the report, the mortgagee will not make the mortgage loan, or where FHA or VA turns down the insurance or guarantee of a loan acceptable to the mortgagee, the mortgage company will bill the builder-seller for the cost of the credit report. In turn, the builder-seller will have provided in his contract with the buyer that, in the event of the inability to secure the loan identified in the contract, the buyer will be refunded all of his earnest money deposit, excepting any costs for credit report(s). In this way the buyer will pay for the credit report after it has been ordered and the amount will be taken from his deposit money.

In those cases where the builder-seller is collecting the credit report fee at the time the buyer makes the earnest money deposit (and is working his tract through an exclusive mortgage company) the mortgage company will bill the seller for the reports it was required to order from the credit bureau, and such a charge should not appear in any closure statement to the buyer as it will in fact have been handled outside escrow. The matter of the home-buyer being charged for two or more credit reports is discussed in a following chapter. Usually this is associated with a sale of the mortgage into the secondary market.

SUGGESTIONS:

A credit report is a requirement of both FHA and VA, as indicated on the list of forms, documents, and exhibits necessarily included with the mortgagee's or lender's transmittal to the government agencies. At this point FHA and VA become interested in charges made to the home-buyer. FHA provides that the cost of the credit report may be charged to the home-buyer by the mortgagee only. VA does not limit who may charge for the credit report. However, as pointed out, it is not clear as to whether the provision is extended to a second or third credit report under FHA. Under VA, such a report is identified in the singular. As a part of many other suggestions, the Nevada Legislature may wish to memorialize the Congress, or the FHA Commissioner and the VA Administrator to <u>expressly forbid the mortgagee or any other person from charging the mortgagor for any credit reports which primarily are required by the mortgagee to move his loan into the secondary market. It may be wise further to restrict such charges to a single and initial credit report, and prohibit a second or third report charge for any purpose whatsoever</u>.

If it is the intent of FHA to allow parties other than the mortgagee to charge for the credit report, then their regulations should be changed to reflect a policy they evidently subscribe to in practice.

CHAPTER VI

CONTRACT, AGREEMENT TO PURCHASE, OR DEPOSIT RECEIPT

One of these papers will represent the initial basic document the buyer should make sure he has executed, and has a copy thereof, after obtaining the purchaser's copy of the FHA Statement of Appraised Value, Form No. 2562 (or ascertaining the amount of the VA Certificate of Reasonable Value). This document or information he should have at hand to examine at the time he makes an earnest money deposit.

Since the contract, agreement to purchase, or deposit receipt are not government forms, the buyer will have to pay strict attention to the terminology employed and the provisions covered or not covered. It would not be out of order for him to avail himself of the services of an attorney, prior to the execution of this contract.

The amount of detail and points covered by one of these forms of contract will be dependent on whether the document is to be followed by a formal escrow agreement between the buyer and the seller, or if the initial document is a deposit receipt incorporating escrow type instructions. FHA and VA do not require a formal escrow agreement prior to any request for mortgage insurance or guarantee. However, from a practical standpoint, it is difficult to visualize the complete absence of some form of agreement (an escrow or deposit receipt) between buyer and seller. Recently, due to involvements of builders' control programs and package sales and servicing by exclusive mortgagees, title companies, banks, escrow services, and builders' control agencies, there has been a tendency to eliminate the individual escrow agreement between buyer and seller. In such instances, a general (or master) escrow agreement is executed between the builder-seller and the various other agencies he is working through. In cases of this type, the buyer will have no knowledge of the master escrow and will have to exercise unusual caution (in the absence of a deposit receipt) to insure that all necessary provisions for his protection are included in the initial agreement or contract to purchase.

The deposit receipt variation which has been developed works in the reverse direction. Rather than the elimination of the escrow agreement, the agreement or contract to purchase is incorporated with a combined deposit receipt and an escrow instruction document, forming one paper. When properly prepared by a title company, and not employed by the builder-seller to circumvent the provisions of a normal escrow agreement, this has the value of combining the items which should be a part of the agreement or contract to purchase and, in addition, will cover such matters as pro-rations and other provisions necessary for escrow officers to close a transaction. The deposit receipt closes an important gap where contract and full escrow instructions are separate.

The combined deposit receipt and full escrow instructions (frequently a standard form prepared by a title company) is a lengthy document if properly prepared and if it covers all necessary points common to an agreement to purchase and escrow agreement. The buyer may be less aware of obligations in regard to down payment, deposit, and provisions in the event of failure to secure a loan, since such a large number of other directives is included, normally common only to an escrow agreement. In short, since a lot of paper is presented to the uninitiated at the same time (and under the excitement of making a purchase) he is hardly apt to read all the fine print. By comparison, an agreement to purchase usually has more fundamental simplicity.

The deposit receipt, when properly understood, does bridge an important gap which shall be pointed out shortly. However, the sheer mass of material (even though reduced to small print on one page) could keep an experienced attorney at labor for some time.

In spite of the necessary length and complexity of provisions common to a properly executed deposit receipt, this report strongly recommends the exclusive employment of the deposit receipt in all FHA and VA transactions. Only through its use can the veteran or home buyer be assured that the gap between the agreement to purchase and some following escrow agreement is properly bridged. If the purchaser is at all concerned with his future obligation and the cost factors to him, he would do well to execute a deposit receipt only after consultation with his attorney, who should go over the document in minute detail. While this precaution should be exercised with any contract which is lengthy and complex (as a properly prepared deposit receipt will be) it will be particularly necessary at this stage in one's life for the adequate protection of the whole family. As explained in the following paragraph, the gap which exists between most purchase contracts which have separate escrow agreements will be covered, and disputes which could arise and cost factors which the prospective mortgagor may not wish to accept, can be taken care of at the outset. Afterward, it will be too late to rectify provisions which could amount to substantially more than an attorney's charge for the review of the document, as suggested.

The agreement or contract to purchase covers only those points in the transaction identifying sales price, property, acknowledgments of deposits made, amount of down payment and when due, and frequently, but not always, the matter of closing costs and documents associated with them, either in a collective amount or item by item. Usually these contract agreements do not cover basic points concerned with various prorations between the buyer and seller, such as taxes, assessments and other matters common to an escrow. The agreement may or may not contain a provision (usually found in an escrow agreement) covering proration or issuance of new fire insurance, if so, by what party. This issue forms at the moment one of the most common points of dispute between buyer and seller and should be clearly covered in either the contract agreement, the escrow, or deposit receipt. The necessity for a separate contract and a formal individual escrow agreement between buyer and seller, or preferably a document embodying the elements of both papers, should be evident.

The serious aspect of having the two separate documents, a contract and then escrow instructions executed at a later date, lies in lack of carry-over from one document to the other. The purchase provisions of the contract will be carried over into the escrow agreement without change and there is no concern here, provided they are identical. However, where is the agreement between buyer and seller for the additional matters which must be provided for in the escrow? Who has agreed to certain charges and how are the various prorations to be made? What of the hazard insurance to cover the property? All of these may not, and frequently are not, covered in the purchase contract. If the purchase contract did cover for all of these factors, then it would, in fact, be a deposit receipt. The veteran or home-buyer may have agreed to all of the provisions of the purchase contract and yet be unwilling to accept some of the provisions which will follow in an escrow agreement. He is obligated under his first executed contract, but it does not necessarily follow that he must execute another and separate contract which may have provisions he never agreed to under the first, or provisions which he does not desire to accept. That such a situation would be allowed to continue for so many years under both conventional and government backed mortgage transactions is inconceivable.

Under the provisions of a properly drawn deposit receipt all of the following items will be provided for. In the case of a purchase contract, to be followed by an escrow agreement, most of them will be included. The deposit receipt will, in addition, cover items in Chapter X. With the employment of a deposit receipt, or a contract to purchase followed by a formal escrow agreement, the buyer should make sure that the following provisions are covered, all of which are basic protections to him. It should be remembered that this report strongly recommends that the deposit receipt be employed in place of the general purchase contract, which may only cover some of the following items:

(a) Receipt of the buyer's deposit of earnest money should be acknowledged, with the indication that this shall be returned to the buyer, less any credit report charges not being paid for separately, in the event the full rate, term, and amount of the loan specified in the contract and the government insurance or guarantee under FHA or VA cannot be obtained by the buyer.

(b) An acknowledgment of any amount paid for a credit report at the execution of the contract.

(c) The full sale price of the home, including the lot, should be indicated on the contract and properly identified, usually by a FHA or VA project number, street address, or lot and block number of a subdivision unit, plus plan number or model name of the house.

(d) The amount of the loan proceeds to be obtained from an approved government lender, which loan amount, rate of interest, and time factor (if not obtained) shall provide that the buyer is not obligated to purchase the home and shall further provide that any deposits and payments made under the terms of the agreement shall be returned to the buyer, any credit report charges excepted. Likewise, that failure of FHA or VA to approve the buyer will provide for the same return to the applicant.

(e) The amount of the down payment for the home, which is in addition to the deposit, and the date by which this down payment must be made.

(f) A provision should be included to the effect that the down payment in no case shall be due on a date prior to obtaining a firm commitment from the lender relative to acceptance of the mortgagor for a loan for the term, rate, and in the full amount of that specified in the contract, and prior to FHA or VA approval of the mortgagor for insurance or guarantee of the loan. This will prevent the buyer from having to tie up funds in the event he is finally not approved by the mortgagee. Government insurance or guarantee disapproval could disqualify him after mortgagee acceptance. However, mortgagees usually screen out the hopeless cases. Mortgagee approval does not necessarily imply automatic FHA or VA approval, particularly in some cases where a mortgage company is making application for the prospective mortgagor. This important protective provision is not included in most agreements.

(g) In lieu of (f) above, protection can be afforded to the buyer by a provision that the down payment will be made simultaneous with the execution of a deed of trust. This would, of course, have to follow both mortgagee approval and FHA or VA approval of the mortgagor, and prevent the necessity of the down payment being made by a specific date, which might be premature. It is felt that a specified point in the transaction has far more logic than an identified date which may bear little relationship to progress made. In cases where the buyer requests occupancy prior to closure, and the seller is willing to allow such occupancy, the seller should be provided with security in the form of a down payment prior to closure. Such a provision should be incorporated, with occupancy prior to closure at the seller's option.

(h) The matter of hazard insurance to cover the property (usually fire and extended coverage) should be settled in the agreement. A separate chapter is later devoted to this problem. It should be clearly understood and provided for in the contract as to who will be responsible for placing the insurance and what authorization the buyer has given for possible proration of existing insurance, or ordering of a new policy.

(i) Closing costs should be entered as: (1) not to exceed a specified amount; (2) specifically identified by item and cost, or; (3) a notation that costs of the items will be actual. If no formal escrow agreement follows, items the buyer is assuming as a charge should be very carefully identified, or a total amount of closing costs beyond which the buyer shall not be responsible may offer sufficient protection. However, following paragraphs will point out weaknesses in this. It is the lack of understanding relative to closing costs, impounds, and prorations which results in so much confusion as to what charges the buyer has assumed.

(j) Where no deposit receipt is executed, it should be clearly indicated in the agreement or contract to purchase that the document is being followed by an escrow agreement. The escrow agreement, to be later executed, should provide for prorations between the builder-seller and the buyer.

PRACTICAL APPLICATION:

Most home buyers are only too happy to have obtained a home and do not exhibit great interest in agreements, contracts, escrow instructions, and other papers which have led up to their occupancy of the dwelling. However, as the time for the down payment draws near, and they are notified of certain costs in regard to closing the transaction, many do show interest. There are builder-sellers and escrow officers who will have explained in detail the meaning and the necessity for the papers the buyer signs. There are, of course, those who solicit the buyer's signature to the many papers required by the transaction and only suggest that it is all a matter of form and hardly necessary to dwell upon. In either case, usually the buyer will start to show added interest at the time of closure, by which time he may have occupied the home for several weeks under an agreement with the builder-seller. Following a properly executed closure, the buyer will receive various documents, papers, and a closing statement. This last item may or may not be provided him as an itemized accounting of every individual charge made and a showing of all credits separately. If there is not much detail shown on the closing statement, he should request an itemized accounting.

There are two important points which should not be overlooked at the time the buyer is contemplating the purchase of a dwelling, which have not been covered prior to this time, since they do not necessarily arise in all transactions. They are common enough, however, to warrant consideration by a prospective buyer, since either of them may be associated with many sales type homes sold. There should be a clear understanding between buyer and seller in regard to them at the time the agreement or contract to purchase is executed.

These two matters, changes in the basic home requested by the buyer, and rental agreements pending closure of the transaction, are covered in the two chapters which follow.

The agreement or contract to purchase, or deposit receipt (as the case may be) is all too frequently filled out in a sloppy fashion to the point where the copies of it, even the original, may not be legible. Evidence suggests that, with some frequency, the veteran or home-buyer may not receive his copy, although he should certainly have basic intelligence enough to request a copy at the time of execution. Many copies examined show lack of proper attention given to completion of the document. Figures and notations are entered which cannot be read with certainty, and important blank spaces have not been filled in or properly completed. The buyer should insist that the document be complete, and that no provisions be left blank for later insertion over his signature.

SUGGESTION:

Although the use of agreements to purchase, and other forms of contracts which require following escrow agreement, are common in the trade, this report must suggest in the light of the factors pointed out in this chapter, that both FHA and VA move immediately to the requirement that a mandatory form of regionally standardized deposit receipt be used as the basic contract of purchase under their guarantee programs.

(A) DEPOSIT OF EARNEST MONEY

PRACTICAL APPLICATION: Acknowledgment of receipt of the deposit is usually made in the contract. Frequently lacking is any reference as to what may happen to the deposit made and the terms under which it may be forfeited or returned to the veteran or home-buyer. A provision may be included that, in any event, it will be kept by the seller at his option as a consideration for having executed the document, an onerous provision for the buyer.

SUGGESTION: Deposits required by the seller pending the acceptance of the buyer by a mortgagee and FHA or VA should be specifically protected by a clearly worded provision that the deposit shall be returned to the home-buyer or veteran in the event the transaction referred to in the document cannot be completed by reason of non-acceptance of the buyer by either the mortgagee or the respective government agency. An exception should be made to protect the seller in the event that he has incurred the cost of a credit report which was not paid for in addition to the deposit by the buyer. In such a case, provision should be made that the deposit would be returned less cost of a credit report, which cost shall be actual. Care should be exercised in the wording as to what is meant by completion of the transaction, to properly identify that this specifically has reference to the failure to secure for the buyer a mortgage or an insurance or guarantee of a mortgage, in the full amount, at the rate and for the term specified in the document.

(B) CREDIT REPORT PAYMENT

PRACTICAL APPLICATION: Payment for a credit report, if requested at the time of deposit, may be acknowledged only by a separate receipt, or proof of this payment may rest upon a cancelled check.

SUGGESTION: Any such payment should be clearly acknowledged and incorporated in the basic document, not left to chance that someone at a later date will acknowledge that it has been paid. A closing officer may not be aware of such a payment, unless it is a part of the agreement or contract to purchase or the deposit receipt. Unless the payment for the charge is a part of the basic document, the buyer is quite apt to again be charged for this report at closure.

Where the charge is collected in advance of the credit report being made, and at execution of the basic document, the seller should be protected by a provision that it shall not be returned to the buyer. Obviously, the seller will have to pay for a credit report to find out whether the buyer is eligible for the mortgage stipulated in the document, and should not be expected to have to return moneys expended in behalf of the veteran or home-buyer.

(C) SALE PRICE OF THE HOME

PRACTICAL APPLICATION: The sale price should be well known to the purchaser in advance of his execution of the purchase document. In those cases where deletions or additions are requested by the buyer, usually the price will be adjusted accordingly. Such cases are discussed in the following chapter.

In VA guarantee cases the sale price of the home must not be more than the Certificate of Reasonable Value issued by the VA office. It does not have to be equal to the Certificate of Reasonable Value amount established by VA, but usually will be, unless there is heavy competition for sales. The sale price under a FHA guarantee case may be the same as the FHA valuation, or it may be higher or lower depending on builder policy and market conditions. As previously pointed out, the inclusion of closing costs in the FHA valuation should be recognized.

SUGGESTION: The total sale price should be all-inclusive, not excluding the cost of the building lot. The cost of the lot and the structure may be stated separately in the document, but the total cost should also be clearly indicated.

A poor description of what house is being sold, along with a vague locational definition often has led to considerable disagreement at a later date, particularly in cases where the structure has not been completed or where the structure has yet to be built and located within the tract area.

Costs expressed as extras, land or lot cost, and basic structure, in all instances should total out to the same as a total sales price, and such total sales price should be properly entered.

Description of the property being purchased should be clearly identified by builder's model number, plan, or model name, and the location preferably by a lot and block number, or street number address (if assigned).

(D) AMOUNT OF THE LOAN PROCEEDS

PRACTICAL APPLICATION: A mortgagee or government agency may be willing to proceed with a mortgage or insurance or guarantee of a mortgage based on different terms or for a lesser amount than that specified in the agreement or contract to purchase.

SUGGESTION: The original document should leave no doubt that, in such an event, where the full amount of the loan and terms could not be obtained, the buyer would have no further obligation to proceed with the terms of the document, and that his deposit would be refunded in full less any credit report cost not paid for previously.

(E) (F) (G) THE DOWN PAYMENT AND WHEN IT SHALL BE DUE TO THE SELLER

PRACTICAL APPLICATION: The matter of the down payment and the date on which it shall be due to the seller is a provision usually indicating one of the following periods of time:

(a) A certain number of days (5, 10, 20) after a notice or demand from the seller.

(b) A like number of days from date of acceptance by the seller.

(c) A specific date may be entered in the agreement.

(d) At the time a notice is received from the mortgagee that he will make the loan and/or when FHA or VA have indicated that they will insure or guarantee the loan.

(e) At the time of execution of note and deed of trust, which is usually near or at the date of final closure.

As a practical matter, the builder-seller may include a provision so that he could require a very early collection of the down payment by employing provisions typical of those indicated in (a) or (b). He may or may not avail himself of the opportunity and, depending on just how the escrow is being handled, there might not be much advantage in calling upon such a provision. It is ill-advised to enter into any basic document that would carry such provisions as those under (a) or (b), without additional protective provisions.

It should be clear that, as far as the buyer is concerned, there should be no provision requiring him to make any additional payments in addition to the deposit of earnest money, until such time as he has been notified that both the mortgagee and the government loan-insuring or loan-guaranteeing agency have approved him as a mortgagor. If he allows himself to be governed by a provision which leaves the control for such a date in the hands of the seller, then he could be forced to make a down payment well in advance of any indication that he will be able to proceed with the transaction. This would be an unnecessary tie-up of funds, even though final approval will have been received, and a ridiculous payment to have to be made in the event of disapproval. However, where the seller has allowed the buyer to occupy the dwelling prior to closure, the buyer should expect to provide the seller with a down payment under appropriate provisions of the contract.

It is likewise evident that, by a provision for a specific date for making the down payment, he is also leaving himself open to the same possibility. Neither buyer or seller have any guarantee that such a date will necessarily be after the approval or qualifying of the veteran or home-buyer for the loan. Even though the date may be well in advance of the date of execution of the basic document, there are still situations which could prevent final notice of acceptance or qualifying by both mortgagee and FHA or VA occurring prior to such established date.

SUGGESTION: It is strongly recommended that legislation be designed which would expressly prohibit an agreement, contract to purchase, or a deposit receipt, from containing provisions which could force a FHA or VA applicant for mortgage insurance covering a dwelling in a sales type tract development to make a down payment prior to the time he has been accepted or qualified by both the mortgagee and the government agency. Under such a prohibition, the basic document could contain a provision for the down payment to be due upon the date of such final clearance, or within a period of ten days after the seller has notified the buyer of his final acceptance. Another type of provision could provide that the down payment would be due simultaneously with the execution of the note and deed of trust, which would occur at or near closure. However, modification of such suggestions would be in order where occupancy had been granted prior to acceptance or closure.

FHA and VA should incorporate one of these protective provisions in the suggested standardized deposit receipt to be forwarded to them with the application for mortgage insurance or guarantee.

(H) HAZARD INSURANCE (FIRE INSURANCE FOR DWELLING)

PRACTICAL APPLICATION: This insurance will be required by the mortgagee in an amount sufficient to cover the loan granted. Not many agreements or contracts to purchase (nor all deposit receipts and escrows) contain provisions and directives to cover the matter of hazard insurance.

In the absence of any protective provision, usually the buyer will be sold an insurance policy with which he is totally unfamiliar and will not have ordered. The coverage will be provided to him "automatically" so to speak, but of course at his cost. Usually in large tract areas, this is a part of a "package deal" on the house purchase, and cases are not unknown where the seller will insist that it go hand-in-hand with the house transaction. One insurance agency or a subsidiary of the mortgagee usually handles all the insurance in a given tract and closing officers, lacking any directive to the contrary, usually will either prorate an existing policy between buyer and seller in an increased amount necessary to cover the loan, or have a new one- to three-year policy issued. The cost of the proration or the cost of a new policy will be collected out of the buyer's impounds through closing.

The matter of this builder insurance agency practice, as well as tie-in mortgagee subsidiary insurance companies, has been the cause of so much difficulty in sales type house transactions that the subject is covered separately in Chapter XIV.

At this point, it should be emphasized that the buyer be aware of what complications may develop. Possibly he would wish to provide for the matter to be adequately covered at the outset. The absence of any reference to hazard insurance in the purchase contract would leave it for him to cover the issue in the escrow agreement. However, it would be better to cover at the outset, or directly in a deposit receipt.

Where a deposit receipt is made as the purchase contract, then there may be a provision in regard to hazard insurance. In such cases, the buyer should strike out any onerous provisions and indicate that he will take care of the matter through his own broker or by himself. That is, he should do this unless he wishes to accept the package insurance being sold with the tract, usually somewhat more expensive than he could obtain by himself.

SUGGESTIONS: (These are contained in the separate chapter covering hazard insurance, Chapter XIV.)

(I) CLOSING COSTS

PRACTICAL APPLICATION: Usually closing costs are covered in any of the forms of basic home sales contracts, but the matter is frequently stated in such a fashion as to leave much to be desired for the purpose of clarity.

In the first place, there is some disagreement among persons in the trade in regard to the meaning of the term "closing costs." It may mean one thing to the builder-seller, another to the buyer, and the closing officers as a group may have differences of opinion as to what is encompassed by the term.

In its broadest interpretation, "closing costs" mean all those charges incident to the transaction which have been imposed by the mortgagee, government guaranteeing agency, title, escrow company, savings association, or bank, and in some cases, by the builder-seller. In addition to these charges, the term in a broad sense could go on to include any moneys which the buyer was required to place in a trust account to be serviced by the mortgagee, for the purpose of paying taxes, hazard insurance, and FHA insurance premium payments, if any. Usually this trust account is called a reserve or impound account.

A more abbreviated definition of "closing costs" would exclude a consideration of the impounds which the buyer would be required to pay into his reserve or trust account.

Another variation of the definition for "closing costs" is associated with either of the two previously mentioned considerations which include or exclude the buyer's impound costs. This is the matter of whether or not "closing costs" include the "up to 1%" provision of the original principal amount of the mortgage loan usually charged to the home buyer. A higher percentage is allowable where the mortgagee makes partial disbursements during the course of construction.

Still another variation is that associated with the question of prorations of taxes, insurance, etc., being considered as included under the broad interpretation of "closing costs." If the basic document is a deposit receipt, these matters should be covered all at one time in one instrument, and such a form of contract is strongly suggested.

It is obvious that the sale of homes under FHA and VA and for that matter, without any government guarantee program, is being practiced without a general understanding of the term "closing costs." An examination of most agreements or contracts to purchase and deposit receipts fails to disclose provisions which clearly indicate what is included in the term. Some of these basic documents do itemize costs to the buyer with specific amounts indicated for each item. However, some of them include impounds and some of them leave the matter of impounds uncovered. The "up to 1%" of the original principal amount of the mortgage seldom is covered. In those cases where "closing costs" are itemized but actual impounds not dealt with, the buyer will be unaware that at closure he will be required to pay for impounds which the government agencies require as reserves to be established for the mortgagor. Of more serious concern is the common practice of lumping "closing costs" together in a simple purchase agreement with the statement: "closing costs shall not exceed 'X' dollars to the buyer." Any "closing costs" in excess of the amount agreed upon would, of course, have to be paid for by the builder-seller. Naturally, the serious question as to what costs are properly included in the term "closing costs" would follow.

SUGGESTION: Either the Nevada Legislature or the Congress, as well as the Commissioner and Administrator of the government insurance or guarantee programs should immediately move to provide either legislation or regulations that would result in providing all parties associated with the home buyer's transaction with standardized instructions on the point. Requirements should be effected which would establish the following:

> Any agreement or contract to purchase, deposit receipt, or escrow agreement, shall specifically set forth in regard to closing costs whether or not the following are included or excluded in "closing costs" to the buyer.

(1) Impounds for any FHA insurance premium payments, real estate taxes, hazard insurance costs, and any other impound costs which will be credited to the mortgagor's reserve or trust account.

(2) The charge of up to 1% of the original principal amount of the mortgage, or a higher percentage where the mortgagee makes disbursements during course of construction.

(3) Prorations of any nature whatsoever, such as those covering taxes, fire insurance, escrow costs, assessments, etc., and, if not covered, has the buyer agreed to accept prorations of this nature in the basic document. If so, as of what date. Note: Most of these prorations would be covered in a following escrow agreement where a deposit receipt is not employed, but the buyer should be aware of them, and should acknowledge any agreement to accept charges or credits associated with them. Further, it should be clearly understood which, if any, of such prorations are included under "closing costs." By the time these matters are properly covered, it would be evident that a deposit receipt should have been used in the first place.

(4) Any hazard insurance costs, either prorated or initially charged for a new policy, insurance reserve to impounds excepted.

The clear identification of these four areas of costs, either as portions of the closing costs, or those which are not included in the closing costs, will form a foundation to clearly identify which are included in each transaction under the term.

Following such a procedure at the outset in the basic document will eliminate misunderstandings among buyers, sellers, and closing officers, and strongly suggests the use of the standardized deposit receipt form of contract. In those cases where a total amount is established as the limit of the buyer's liability for closing costs, it will then be possible to determine with accuracy the extent of the buyer's liability.

The common difficulty observed in relation to closing costs is dependent to a large extent on two factors, either one or both of which may be associated with a purchase contract. They are as follows:

(1) The purchase contract employed may itemize closing costs to the buyer but not provide how other costs are to be assumed by the buyer. Frequently the gap is covered in a following escrow agreement but its terms may not necessarily have been agreed upon by the buyer at the time of his deposit and execution of a purchase agreement. Again, the deposit receipt covers this issue.

(2) Many basic documents employ a short statement that the buyer agrees to pay closing costs not to exceed a certain amount. However, there is no indication of what is included in the term "closing costs," the problem identified at the outset of this section.

We have not attempted to identify every item of possible closing cost to the buyer in this section. Following chapters will so identify most of these charges and explain and comment upon them in detail. The purpose of introducing the matter of "closing costs" at this time is necessitated by the fact that the matter must be covered in the agreement or contract to purchase or in the deposit receipt. We have only discussed in broad categories these costs at this point and identified them as impounds, prorations, etc., which, of course, will usually contain a number of separate items by themselves. The hazard insurance and the 1% mortgagee's charge are separate items admittedly, and are covered separately since they do not fall distinctly into either a pure impound, proration, or a completely agreed upon closing cost, and have caused unusual difficulties.

(J) ESCROW AGREEMENT

PRACTICAL APPLICATION: The escrow agreement is covered in detail in Chapter X. Introduction to the agreement is made at this juncture since there should be a reference to it following the purchase agreement executed at time of deposit, unless the more desirable deposit receipt has been employed. All too often the buyer is unaware that he must later enter into a formal escrow agreement which should incorporate the provisions of the basic purchase document and extend further to such matters as prorations between buyer and seller, and other items common to an escrow. These additional provisions can very easily result in additional costs to the buyer and will be shown on an itemized settlement statement at a later date. Where an informal escrow or master escrow agreement exists between the builder-seller and the buyer, the buyer may be utterly unaware of the existence of any escrow agreement, since he will not have executed one on an individual basis and usually will not be provided with a copy of the master escrow covering his tract.

The details of what should be provided for in an escrow will be covered in Chapter X. At this point, unless he has executed a deposit receipt, the buyer should be put on notice that the escrow will follow.

SUGGESTION: All agreements or contracts to purchase (other than deposit receipts) should contain a statement that the document is to be followed by an escrow agreement between the parties, or that a master escrow agreement is taking the place of the individual formal escrow agreement. In the latter case it should be provided that the buyer be furnished with a copy of the master escrow agreement.

To eliminate the necessity for the escrow agreement notification, FHA and VA should move immediately to require that a regionally uniform FHA-VA deposit receipt be employed as the basic purchase document, and provide for a form of deposit receipt which would cover all matters that should be properly identified and are normal to a purchase contract and escrow agreement. FHA and VA also should require that they be provided with a copy of such a complete deposit receipt. Further, FHA and VA should require that all district or regional offices survey this document at the time they review the charges made to the veteran or home-buyer, to ascertain whether the mortgagor actually has been obligated for such charges, regardless of whether or not they are charges acceptable in a FHA or VA closure.

CHAPTER VII

CHANGES IN BASIC HOME REQUESTED BY THE BUYER

The veteran or home-buyer may be purchasing a completed home, or one nearing completion, and may ask the builder-seller about significant changes. Such changes, if they involve additional materials, labor or installation of more expensive equipment, will usually be charged to the buyer. Where competition is strong, such as in the Las Vegas area, the seller may make these requested changes and absorb them in his overall cost of several homes in order to clinch a sale. In areas of extreme competition, or when competition is strong in many areas, builders have been known to offer such items as wall-to-wall carpeting or partial furnishings at no additional markup from the price at which they have been selling comparable homes. The extent of inducements offered by the builder-seller depends to a large extent on supply and demand, his usual policies, and his situation relative to how anxious he is to reduce any interim expenses by making an immediate sale.

Where a seller's market exists, or a tendency toward one, the builder-seller will more than likely point out that any changes will have to be paid for by the home-buyer. Since the builder has already established a selling price, which may be near the FHA valuation, and under VA will usually be equal to the amount of the Certificate of Reasonable Value, some degree of inflexibility in absorbing extensive changes necessarily will develop.

Under VA regulations, any additions requested by the veteran would necessitate a change order, VA Form No. 26-1844, advising VA of the change. This may or may not increase the amount of the VA Certificate of Reasonable Value. Should an attempt be made on the part of the seller or buyer to take care of these additions by a separate agreement apart from the basic purchase contract, difficulties would develop when the VA inspectors found such additions had been made to the home. A detailed check list employed by VA would disclose, for instance, the installation of a more elaborate built-in range, the addition of a door, or more expensive flooring. Any private agreements or payments would constitute fraud, since under VA the lender certifies to VA that the veteran has not paid in excess of the Certificate of Reasonable Value. It should be pointed out that such additions would have to be basic to the house structure and appliances and installations covered by the approved house plan. This would not include such items as wall-to-wall carpeting, drapes, furnishings, etc.

Under FHA, any requests for modification by the buyer would also necessitate a change order (FHA Form No. 2577) which likewise could result in an increase in the appraisal and the issuance of a new FHA Valuation. The FHA inspection would also reveal any changes made, and if they were not in conformity with the originally-approved FHA house plan (plus authorized changes) they could present difficulties for both home-buyer and builder-seller.

The fact that FHA and V.A provide for inspections which obviously would (if conducted with care) disclose any changes made that are not in conformity with basic plans and approved changes, will still not control violations in many cases where the home-buyer is purchasing a completed home. FHA and VA may have made their final inspections where a house is standing and completed. VA provides for a certification on loan application VA Form 26-1802 and again on VA Form 26-1876 that the veteran has not paid more than the Certificate of Reasonable Value for his house. The VA mortgagee also is charged with the full knowledge of any changes which have been made and is equally responsible for any irregularities. Under "Practical Application," a discussion indicates what actually happens under both FHA and VA cases.

The interest of both FHA, VA, and mortgagee, in any changes made to the home is a practical one, in addition to providing extra physical security for the loan. The government agency and mortgagee may want to reassess their approval of the mortgagor, if he has been given approval. If requested changes are contemporary with the initiation of a request for making or insuring or guaranteeing a loan, they will want to carefully examine just how the additions are to be financed. Will additional changes be covered by the mortgage, or has the buyer elected to pay for such charges in his down payment and not request any corresponding increase in the mortgage loan? In the latter case in particular (and also in cases where it is to be included in the loan) the mortgagor could be a borderline case whereby the assumption of an additional burden could lead to disqualification of the loan by the mortgagee or non-approval by FHA or VA. It is easy to understand why any large cash payment to include extras could alter the mortgagor's statements on financial ability to assume the mortgage. Even by the inclusion of extras within a mortgage, this could result in exceeding a reasonable margin of safety established by the mortgagee or government agencies.

In some large tracts the matter of standardized changes and additions requested by the buyer is employed to automatically increase FHA Valuation or VA Certificate of Reasonable Value. This is made possible where the builder-seller has requested a number of standardized additions and changes to receive a prior review by either FHA or VA. Both agencies establish the increases in either FHA Valuation or VA Certificate of Reasonable Value for such additions when ordered by the veteran or home-buyer. In the case of FHA, provision is also made for items to be eliminated and establishes values for them. Under VA, only additions to a basic model are provided for. VA provides these automatic increases in the Certificate of Reasonable Value by authorization on a VA Form VB-1843a called a Master Certificate of Reasonable Value, at the request of the builder-seller. Unlimited additions can be made under this form, and automatic Certificate of Reasonable Value increases incorporated without resort to further notice to VA of changes and additions. Under FHA, any net increase or decrease of more than an established percentage <u>could require that the standard change notice be forwarded to FHA for review</u>, prior to the granting of a new FHA Valuation. In Nevada, large and numerous changes have evidently not been requested for review by FHA, the additions or deletions of several of which could have resulted in extensive valuation changes. In any event FHA has not made use of their provision establishing a percentage of increase beyond which it would be necessary to return to the usual request for changes. The FHA form employed to list these alternates is No. 2007a, entitled "Supplement to the Commitment-Schedule of Alternates and Effect on Value." The FHA form contains the statement that:

> Changes made within the limits stated herein <u>may result</u> in corresponding changes in FHA's estimate of value in fee simple which serves as the basis for the commitment amount. (underscoring supplied)

In practice, it has been observed that, where requested, usually there are corresponding increases in FHA valuation.

PRACTICAL APPLICATION:

(Under VA) -- Since most homes being sold under VA are priced at or near the VA Certificate of Reasonable Value, the only way the builder-seller could properly collect costs for additions requested by the buyer would be to have a "Request for Acceptance of Changes in Approved Drawings and Specifications" (VA Form No. 26-1844) executed and presented to VA for consideration of a new and possibly higher VA Certificate of Reasonable Value. The builder-seller cannot sell his home for more than the Certificate of Reasonable Value issued by VA.

(Under FHA) -- A somewhat different situation could develop under a FHA insured mortgage. The builder-seller would execute the same form carrying a dual FHA and VA number, and specifically request that a new FHA Valuation be issued and hope that it would come out high enough to provide for a reasonable increase in the sales price. However, in many FHA cases, he already may have put the sale price above FHA Valuation (allowable under FHA regulations). Usually a further increase can be made and passed on to the buyer, whether or not the new FHA Valuation has resulted in a comparable increase. The builder's interest in obtaining a higher FHA Valuation would be to enable the buyer to obtain FHA loan insurance on an amount high enough to include the extras, thus holding to a minimum the down payment. At this point the interests of the mortgagee must also be considered. He must agree to the changes and be aware of them even prior to obtaining the FHA or VA appraisal of the changes. The mortgagee also must endorse the FHA Form 2577-VA Form 26-1844 request.

PRACTICAL APPLICATION:

(Both FHA and VA) -- All too often additions and extras are handled separately from the mortgage and insurance or guarantee by FHA or VA. Some degree of collusion is necessary in such cases, at least the buyer (lacking an understanding of FHA and VA procedure) will follow along with a builder-seller's suggestions.

When changes and additions are made without the required notification to FHA or VA and the mortgagee (which can easily occur if final inspections have been made by all parties prior to requests for changes) it becomes an agreement between builder-seller and buyer with no knowledge of the transaction on the part of others involved. It may be a formal agreement and contract or just a matter of word agreement. In either event, the builder-seller merely bills and collects from the buyer certain predetermined charges for extras. In very loose cases, it may be almost a cost-plus basis of charge to the buyer and paid for in cash, entirely apart from the mortgage transaction associated with the purchase of the home. In some cases, this procedure has been achieved and acknowledged by means of a charge to the buyer through escrow, this paid to the seller, with the charge appearing on the buyer's itemized closing statement. It must be remembered that neither FHA or VA require a copy of this itemized statement of closing costs to the buyer for their examination. Under FHA, only the charges made by the mortgagee are required on the document for presentation to FHA. Under VA, the mortgagee must prepare a statement for VA indicating the charges that have been made to the buyer by all parties. This doesn't guarantee that such builder charges and any rental payments collected through escrow will be so incorporated in the mortgagee statement. Many lenders meet the FHA requirement for the statement of charges made by the mortgagee by submitting the actual itemized closing statement to FHA. All mortgagees do not do this, nor does FHA require such a copy for examination.

SUGGESTIONS:

As a step forward in the direction of controlling an almost wholesale violation in the area of changes and extras, it is strongly recommended that FHA and VA take immediate steps to require that they be furnished with a complete and exact copy of the actual itemized closing statement issued by the bank, savings association, escrow or title company to the veteran or home-buyer. This would be in addition (should their procedure make it necessary) to a mortgagee's statement of charges made by the mortgagee only, or a mortgagee statement made from such a closing statement relative to any and all charges to the mortgagor. This itemized statement of charges and credits to the buyer should be examined by either FHA or VA prior to their endorsement of the loan for insurance or guarantee. In the event charges were made to the buyer which were in violation of FHA or VA regulations, the loan should not be insured or guaranteed. At the same time any charges which the buyer had not agreed to pay for in his purchase agreement should also provide grounds for refusing to insure or guarantee the loan.

Any and all requests for changes and additions to the dwelling should be covered in a separate agreement or in the original contract between the builder-seller and the buyer. When separate, usually this is a work-order or change-order form provided by the builder-seller. There should be complete agreement between buyer and seller as to exactly what the changes are (in detail) and how much this extra work and equipment will cost. The work-order if employed, should be acknowledged by both the buyer and builder-seller and a copy should be made available to the buyer, in addition to notification forms sent to FHA and VA.

It is admitted that the first suggestion would control only those additions and changes actually reported through closure, a procedure usually employed to guarantee to the builder that he is paid for his extras which are outside the down payment. There must be adequate provision to place the buyer on notice that he is equally responsible for any circumvention of FHA or VA regulations, whether or not collusion is evident. If FHA or VA expect the buyer to be equally aware of these particular regulations and wish him to be directed by them, they must be pointed out to the buyer from among the many provisions of FHA or VA procedure. This could be provided for by a conspicuous home-buyer or veteran certification made a part of the Certificate of Reasonable Value or FHA Valuation Certification (suggested in Chapter III). Included also in this important buyer's paper should be the FHA or VA regulation covering changes, setting forth penalties for violation, as well as buyer and seller liability under such violations, for the buyer to certify.

CHAPTER VIII

RENTAL AGREEMENTS PENDING CLOSURE OF ESCROW

(When buyer occupies home prior to closure)

Possibly no other area of the home-purchasing transaction receives less formal attention in the contract than the matter of who pays for certain costs arising in the interim period, or what rentals are to be collected, in cases where the purchaser of the home occupies the house prior to closure.

During this period of time, title to the house (ownership) rests exclusively with the seller. Technically, he is responsible for all costs whatever associated with the occupied property, yet frequently he will impose charges on and collect from the veteran or home-buyer, large amounts of moneys without any agreement, written or otherwise.

Usually the builder or seller is pleased to have the occupancy of the house take place at an early date since by this procedure he may be able to cut down any interim costs, which run everyday until actual transfer of the dwelling at escrow closure. He may be relieved of patrol costs and concerns relative to unoccupied finished homes being liable to vandalism, as well as maintenance costs for any recently-planted lawns. He does run some risk that, in the event a pending loan is not granted to the occupying buyer, he must evict the tenant, possibly have to remedy any wear and tear on the property, then have to resell what is actually a "second hand" house.

No one would think it unjust if the builder or seller asked in a formal agreement that the purchaser assume from the day of occupancy the responsibility of certain utility charges such as water, sewer, power, fuel, phone, etc. However, the assumption by the veteran or home-buyer of any additional charges, no matter how they may be identified, should be made only after execution of some form of written agreement between the seller and buyer as a part of the contract to purchase, or as a separate document.

In this connection, it is interesting to note that FHA anticipates incorporation of a rental item in some closing statements made to that agency. The following is quoted from FHA Circular Letter No. 97 of the Reno, Nevada, regional office, dated April 17, 1962.

> II. Submission of Closing Documents. It is also requested that mortgagees show the beginning and ending dates of interest and rental charges, and an explanation when. . . (underscoring supplied)

In almost all cases examined, no formal written agreement was entered into between buyer and seller covering this fundamental issue which can easily amount to over $300.00 to the buyer, and which he will be expected to pay (justly so) to cover builder-seller costs.

PRACTICAL APPLICATION:

In most cases the builder-seller may have an oral agreement, with the general understanding that the buyer is going to pay so much per month for rent. This is common in cases where the buyer occupies a house immediately after execution of the basic document to purchase, and it is realized that an extended period of time will necessarily follow before closure. The rate at which he will pay rent is not always stipulated in this informal type of agreement, but is frequently a flat rate of $80, $100, $120, etc., per month. Sometimes it is based upon the interest which the buyer would be paying on his anticipated loan, yet to be made. In other cases, it is based upon any actual builder-interim interest cost, a more realistic approach, but seldom employed. Possibly the former method would be more acceptable to the buyer since the interest rate would be lower. Undoubtedly this accounts for its popularity as a basis. However, the latter method (that of any actual builder-seller interim loan cost) even though at a higher rate of interest, usually would result in a slightly lower cost since it would be based on a lower principal, representing total progress payments from an interim lender.

The employment of interim builder cost, if given in any detail as a certain rate of interest in relation to the sum total of the progress payments made to the builder, will disclose to a knowing buyer certain builder cost factors. In most cases the disclosure of this information would not promote much good feeling between buyer and seller.

In some cases, the builder-seller will maintain a wait-and-see attitude. There will be no mention of rental payments to the buyer when he executes his basic purchase document. It may be expected that closure will be made within a couple of weeks or so after anticipated occupancy. However, should difficulties arise which force a postponement of closure for any extended period of time, the builder-seller frequently will bill the buyer for rental payments when they extend past three or four weeks, effective from date of occupancy.

Whatever the nature of the "rental," there should be a formal agreement at the time of execution of the purchase contract so that both parties will be aware of what the obligation provides, and when and how it shall be paid. Whatever his incidental benefits may be, the seller should certainly be compensated by providing shelter to the home-buyer. <u>However, to bill and collect for such rental service without a formal agreement is highly unethical and open to serious misunderstanding between the parties involved.</u>

SUGGESTIONS:

It might be well to incorporate the rental provisions themselves in the basic sales contract. In the event it is desired to have the rental payment collected at escrow closure (to protect the builder-seller) such instructions should also be incorporated in any purchase contract.

No matter how the rental agreement is handled, it should be a <u>written document</u> setting forth precisely when, or after what date, rental costs shall be an obligation of the buyer. Secondly, the rate of rental should be agreed to and set forth in the document, with adequate protection to the buyer for prorating portions of a month where the rental is expressed in monthly terms. Thirdly, the method of payment, to the builder-seller directly or to be collected through escrow at closure, should be clearly indicated. In the event the loan is not approved, provision should be included which would increase the rental due the seller, possibly two weeks after the date of notice of refusal to make the anticipated loan has been received from the lender or government agency. The buyer should have some form of minimum protection over this period of time to acquire a new location. Also, the seller should be protected with the right to collect an increase to "true market rent" in the event the party continued occupancy for some period of time, which would tie up the home for renegotiation to a new potential applicant, with any builder's interim costs still running.

CHAPTER IX

UTILITY CHARGES AND INSURANCE

In those cases where a buyer is occupying a home prior to closure (and whether or not he is to pay rent) certain utility costs and any municipal charges for sewer and trash service should be assumed by the buyer. Where the period of time is short, and closure is imminent, there may be no need for any formal agreement, though still advisable. There is no doubt that the builder-seller should be protected, and the buyer should be placed in awareness, where an extended period of time may elapse between occupancy and closure dates, and a rental agreement may not be in effect. The seller may wish to protect himself on this point in cases where only a few days may elapse between occupancy and closure. In any event, certainly it will be an advantage to both parties to have a firm agreement regarding utilities and municipal charges to prevent later disagreements. In cases where the builder-seller may insist on a very high interim rental charge, some utility and municipal charges might logically be allocated as a seller's cost.

PRACTICAL APPLICATION:

In most cases where a dwelling is being occupied prior to closure, and the house has been completed for some time, some of the utilities will already have been connected. Most commonly these will be water, electricity and sewer connections; others may be gas, and possibly telephone installations made where the home was employed by the builder as an office or model home. There may have been deposits required by the municipality or utility companies in question to initiate service. There is an increasing tendency to eliminate deposit requirements, especially to builder-sellers and persons who are purchasing their own homes. Bookkeeping costs and certain interest requirements have worked toward elimination of such deposits, except for renters. In any event, where such deposits are made they should be returned to the seller and new deposits made by the buyer.

Since the buyer is occupying the house and using the utilities he should be expected to pay for them. Therefore, as of the date of occupancy, the seller's obligations for utility costs should terminate, and the buyer should be expected to assume them, in addition to any additional ones he may wish to arrange for. The buyer's rental, if any, should be well below that for like accommodations elsewhere in the community, and he should not feel that his rental payments will cover these utility costs.

One item which is not a utility cost will frequently be transferred to and made a cost to the buyer, <u>and should be specifically prohibited</u>. This is the insurance which the builder-seller may have obtained to cover the cost of any interim financing. <u>The matter is treated at greater length in the chapter on hazard insurance</u>. At this point, it should be emphasized that this cost is still a builder-seller cost and will continue to run just as his interest on progress payments representing his interim financing costs will continue. This will be so even in those cases where the rental agreement is a reimbursement to the builder-seller based on his interest costs for any interim financing. No automatic assignment of the builder's hazard insurance on the property to the buyer should be allowed at this time. In most cases where a home is being occupied prior to closure, assumption of the cost of hazard insurance on the dwelling at the time is not included in any agreement. Lacking any specific instructions on the matter, frequently closing officers will act on verbal instructions from the builder-seller to assign the policy to the buyer on date of occupancy. At closure, adjustments and prorations will be made without any precise escrow or contract provisions.

SUGGESTIONS:

Even in those cases where the period will be short between occupancy and closure dates, a formal written provision relative to utilities should be incorporated in either a separate rental agreement or in the basic purchase contract. Where no rental is being charged, the seller should certainly cover the point of any buyer obligations for any utility charges. The agreement should stipulate that, as of date of occupancy, the buyer shall be required to serve notice to any and all utility companies and/or the municipality, that, as of a given date, the servicing account should be placed in his name. The buyer should require the servicing agency to make meter readings where necessary for his own protection.

A specific provision should be incorporated in the basic purchase contract of sales type homes on the matter of hazard insurance, as discussed in that chapter. The provision should include (to cover the matter, which often develops at this point) builder's policies covering the amount of any interim builder loan. It is strongly suggested in connection with these hazard insurance policies that the builder's policy be cancelled at date of closure unless the buyer wishes to accept it as an amended policy, or as a newly issued policy with the same agent. To protect the buyer from assuming any hazard insurance cost from date of occupancy (not an assumption on his part and not covering any loan ever made to him) it should be expressly set forth in the rental agreement, or in the basic purchase document, that the buyer assumes no obligation in respect to such a policy or the costs thereof, and that any existing policy shall not be assigned to the buyer on his date of occupancy or on any date prior to closure; in no event at closure, unless specific authorization has been obtained from the buyer indicating an acceptance of such a policy properly amended to cover the increase necessitated by a higher loan in his name; further, that no proration shall be made for policy costs which shall pre-date time of closure.

CHAPTER X

DEPOSIT RECEIPT VERSUS ESCROW INSTRUCTIONS -- PACKAGE ESCROW AND BUILDERS CONTROL

Repeatedly this report has advised in favor of the desirability of employing a deposit receipt rather than a contract to purchase, followed by an escrow agreement. Only through the use of the deposit receipt can prorations common to an escrow agreement be covered and agreed to at the very inception of the transaction. Where an agreement to purchase is followed by an escrow agreement, there is a gap which is not properly covered, as heretofore pointed out. The parties may be in agreement as far as the purchase contract is concerned and fail to agree on those items which must be covered in an escrow agreement. In practical application, usually the veteran or home-buyer accepts whatever the escrow agreement calls for, without realizing that he has not necessarily agreed to all of its provisions when he signed the basic contract to purchase. This is an injustice to the consumer and obviously can lead to difficulties where the purchaser of the dwelling may realize that he is under no obligation to accept provisions of the escrow agreement he is asked to sign which are over and beyond those agreed to in the purchase agreement. In the interests of removing both the injustice and also the possibility of future difficulties, the deposit receipt is strongly recommended by this study.

Such a deposit receipt (and other forms of purchase contracts) should have provisions for any rental agreements and utility costs which may develop in the event the sales type home is occupied by the prospective mortgagor prior to closure. These matters were covered in the preceding two chapters. Likewise, any change orders necessitating additional costs associated with the dwelling should be included in the deposit receipt or any form of purchase contract, not made as separate written or oral agreements which can cause difficulties for both the builder-seller and home-buyer.

Material presented in this chapter is typical of escrow agreements, yet items emphasized are not typical of an ordinary agreement to purchase, therefore must be covered in a following escrow agreement. <u>All of the items covered by an escrow agreement, as well as those covered by the basic agreement to purchase, will be included at the outset by a properly drawn deposit receipt</u>.

Under a formal escrow agreement between buyer and seller, items of expense associated with the escrow usually are clearly indicated on the printed form of the escrow, along with any deletions and/or additions which may affect the document. Provisions are set forth indicating what considerations must be complied with before property transfer and the purchaser is as aware as the seller of necessary compliances, what charges will be made and which party will be paying various costs. Under this form of an escrow agreement, costs become easier to trace and the reasons for them become obvious.

Escrow instructions will follow the basic contract or agreement to purchase, and may be entered into almost immediately after the sales contract or later, when the mortgagee or FHA or VA will have indicated approval. In cases where a deposit receipt is executed, escrow instructions will be incorporated in such a receipt, as heretofore explained. In those unusual cases where a master "package" escrow covers an entire tract or portion of a tract, a separate escrow agreement usually is not entered into, to the disadvantage of the buyer.

Escrow instructions, or similar instructions incorporated into a deposit receipt, are necessary so that the closing officer will have information on how to proceed. The contract or agreement to purchase provides for an understanding between buyer and seller as to what is being sold and on what terms. The escrow instructions actually provide information on how this is to be achieved and still keep within the terms of the contract. Thus prorations, insurance, and other vital provisions usually are covered only by the escrow instructions. It should be remembered that any escrow officer represents both buyer and seller.

Escrow instructions on new sales type tract homes should cover the following points:

(a) A reiteration of property description and terms of the sale.

(b) A tabulation of what moneys have been deposited and what future considerations will be made, resulting in a total consideration or sale price.

(c) An indication that the escrow or title company is authorized to transfer the property upon the meeting of certain requirements by buyer and seller.

(d) That closure of the escrow is subject to a list of directives (usually standard in form) providing for proration of taxes, interest, insurance, rentals, and other matters which may be subject to proration.

(e) Inclusion of any additional instructions peculiar to the case at hand and not properly covered by usual printed instructions. Also any modifications of standard instructions.

(f) Any escrow company usually protects itself with language so that it cannot be held for knowledge of unusual conditions.

(g) A time limit, stated in the instructions with provision for any extension usually is included.

(h) A very important provision is the indication of related charges and costs the buyer has agreed to pay, listed as either a specific amount, actual charges or costs incurred, or a total amount past which the buyer is not liable.

(i) Likewise, a listing of costs which the seller has agreed to pay in connection with the sale.

(j) Impounds or trust account funds which FHA and VA require the buyer to provide to the servicing agency or mortgage company. Frequently these are referred to in the sales contract, but, as pointed out previously, not in a very complete way.

The above costs and charges usually are items such as, who is to pay for the policy of title insurance, escrow fee, recording fees, revenue stamps, conveyancing fees, preparation charges, etc. Usually these matters will not be covered in the basic contract if it is a simple agreement to purchase.

With a properly executed contract and a formal escrow agreement, the home-buyer will be in a position to review his closing statement with some degree of intelligence and handle the entire checking procedure as a simple grade-school mathematical problem. Although he might not avail himself of the opportunity to understand the details of his transaction, he would have the tools at hand to make such a review for his own satisfaction. It should be kept in mind that an informed buying public may be the best leverage we have against unscrupulous practices which are a part of some transactions. With a clear indication of what costs, deposits, and credits are associated with the purchase, public knowledge of procedure and policy in the industry will not be the enigma it is today.

Where a properly prepared deposit receipt has been executed, these matters will be covered in one document at the inception of a contract to purchase, and such form of purchase is strongly recommended by this report.

In summation, the escrow agreement or deposit receipt provides the closing officer with instructions to determine when he is ready to close the transaction and record. He acts in the interests of both buyer and seller and will not close the transaction until he has made the proper prorations, charges, and credits, and has seen to it that the requirements of both buyer and seller have been met and that both parties have performed in accordance with the terms of the escrow.

In some few cases, homes are sold to purchasers under an "agreement to purchase" covering certain terms of sale, with no formal escrow following. Normally closing costs incident to the transaction are stipulated. However, most of the rest of the transaction, such as prorations, insurance, and other costs are not a part of such an agreement. Usually the contract or agreement is turned over to a bank or escrow officer and forms a part of an "informal escrow action." Under this type, the closing agent receives instructions from the lending institution, builder-seller, and guaranteeing agency, which are unknown to the purchaser and do not necessarily form a part of the agreement the buyer has signed. In a formal escrow agreement, much of all this will have been identified. Obviously, the buyer is not provided with a very clear picture of what is taking place and usually pays an escrow fee without the benefit of a formal escrow. Frequently the informal type is a part of an overall builder-control service which is rendered to the builder-seller by the bank, savings and loan association, or escrow agency or title company disbursing funds received from their own or an interim financing institution. Naturally, all these matters would not appropriately form part of an escrow agreement between buyer and seller. The convenience and protection to the builder, contractor or seller, and the lender, is obvious. However, the purchaser of the dwelling is left at a considerable disadvantage in obtaining information which would assist him in understanding what charges he has or has not been made responsible for.

When this method is employed the builder-seller usually has an agreement and "package escrow" with the bank, savings and loan association, title or escrow company. Such institutions, acting as agent for the sale of all homes in a development or tract, receive instructions from the lending institution, government insuring agency, and builder-seller relative to charges and procedure in selling the house to the buyer. The closing officer also has a copy of the contract or purchase agreement. However, this last mentioned document frequently is a very general one and does not provide detailed instructions or indicate all itemized charges. Costs to the buyer are not properly stated when indicated as a total sum and the final closure charge may easily exceed the cost which was indicated as his obligation in the purchase contract.

In such an informal closure, the builder-seller actually may act in the capacity of an agent for the buyer and advise the closing officer in behalf of the purchaser of the property on such matters as insurance, prorations, and other details. Likewise, the lending institution will act independently of the purchase agreement and instruct the closing officer to make collections for a variety of impounds for the buyer's trust account as well as charges made at random by the lender. Caught in this crossfire, the closing officer, trying to satisfy primarily the builder-seller, governmental insurer or guarantor, and lender, will often be forced to act against the best interests of the consumer since the buyer would be the last to know what was afoot and be in a position to protect his interests. The net result is a loose arrangement at best as far as the buyer is concerned. More often than not, the advantage taken of him monetarily and otherwise is considerable. Many charges are made, and insurance reassigned, without any agreement whatever from the purchaser.

Only within the past few years has this type of transaction become common in Nevada. There is an obvious advantage as far as the builder and lending institution are concerned. The mechanics of the control are as follows: The interim financing agency, usually a bank or savings and loan association, makes a construction loan to a contractor. The disbursement of the interim money is a matter of progress payments upon completion of a stipulated portion of the construction. The proceeds of the progress payments are not kept by the contractor but are turned over to the builder's control account held by the institution, escrow, or title company. The contractor may apply the method to a one house venture or several houses at a time. In the latter case there is a package escrow covering similar instructions on a number of homes being constructed. The builder's control account may be handled directly by the institution or through an escrow service, or it may be serviced by a specialty builder's control organization associated with, but separate from, the institution or escrow company. In either event, whether handled by one company or "let out" to a specialty building control organization, the net result is as follows: Progress payments are made available by the interim lender to whoever is servicing the building control for the builder. The builder is billed by his sub-contractors upon completion of all or portions of their contracts. He reviews these and acknowledges that they are correct charges for the work performed. The builder-control service then acts to disburse checks to these sub-contractors (usually after their own verification of work completed) as they are received and so authorized. In this way, the lender or a separate builder's control agency will have issued from 30 to 60 checks to sub-contractors on a single construction project. The advantages to the interim lender and contractor are as follows:

(a) The builder does not have to maintain a staff to handle payments to his sub-contractors.

(b) Control is maintained and costs charged, with minimum error, to one house at a time.

(c) The control agency frequently checks on the sub-contractors to see that they are not too far in arrears on materials payments.

(d) The lending institution enjoys added security since they know they themselves, or a professional organization, is disbursing their interim progress payments, and has physical security to fall back on.

(e) Frequently the contractor can obtain interim financing more easily when it is known that he will employ a builder's control program over the progress funds to be disbursed.

(f) A construction performance bond may not be necessary under a builder's control, where properly established.

(g) Any title or escrow company or a separate specializing builder's control company has an added income since they charge for the builder's control service, usually an amount less than the cost of a performance bond.

(h) The buyer of a home would be pleased also, in the unlikely event the records containing building controls were made available for his inspection. He could quickly estimate the actual cost of building the home, and with proper consideration given to land and development cost and discounts, come close to estimating the builder's profit in the transaction. Closing costs to the contractor also should be considered in arriving at such an estimate, as well as interest charges to the contractor for any interim financing and building control program.

(i) Such information could provide a valuable foundation for assessment purposes, for lending institutions, and FHA and VA appraisals, were it used effectively.

The chief concern relative to builders control systems, or separate organizations established to disburse funds for home construction, centers about what controls exist over the building control. It is understood that individuals in the control organizations are under relatively heavy bond ($100,000.00) and a series of internal controls and frequent reconciliations work to protect against possible losses. It should be realized that a couple of million dollars may pass through a medium-size service in a period of only a month. Obviously, the strongest reliance is found where such an organization has had a long record of experience in the field and is above reproach. The complex nature of surveying a project before acceptance under a control program, the execution of the payments, and proper protective features for both the builder and the control system, requires extensive experience in the field. In Nevada, it is understood that some builder control organizations are in operation in Las Vegas, and California organizations service the Reno area. To a large extent a modified builder-control service is offered by title companies and by some direct lenders. This report can only suggest that there may exist a very large area for concern where such services are lacking in experience and are not adequately protected by heavy bonding. It would not be out of line to suggest that such operations in Nevada should be investigated, licensed, and bonded for adequate protection to all parties concerned. The report must state that insufficient time was available for a detailed study of this facet of the construction of homes and incidental charges to the purchasers of dwellings.

As far as the purchaser of the dwelling is concerned, in all probability such a program as outlined above has been a part of a package or informal escrow but any consumer advantage thus gained undoubtedly is far outweighed by the loose agreement mentioned and the consequent numerous disadvantages to the purchaser of the home. Here again the buyer is the last to be considered.

In the case of builders-control agreements between the builder-contractor and financial institutions covering tract area sales, when a deposit receipt or escrow agreement is not part of the sales transaction, a formal escrow agreement should be insisted upon by the purchaser of the dwelling, or at least a copy of the master escrow in lieu of such a document. Without such an escrow agreement, and having only an agreement to purchase at hand, the buyer will not be well-informed on charges and obligations. In fact, on many instructions to an escrow officer the seller may "represent" the buyer to his disadvantage. In the event the buyer of the home stands by his agreement to purchase as identifying the only cost obligation he has, the result may be a variety of misunderstandings, overcharges, even chaos to the officer handling the closing.

PRACTICAL APPLICATION:

Although the closing officer supposedly acts impartially, and has the interests of buyer and seller equally in mind, there is a tendency to make certain that he meets the exacting requirements of the builder-seller. This is a practical matter since the builder-seller can send much business his way and he must be cultivated. On the other hand, the home-buyer is a one shot deal and may never have need of the services of a closing officer or the particular institution again. Also, he is not very apt to fully understand his rights under the terms of the sales contract. When it comes to a matter which is not covered by the contract or escrow instructions, the closing officer is far more apt to call the builder-seller than he is the home-buyer, on how to cover the situation. Such common areas are certain prorations and hazard insurance.

It should also be remembered, under the terms of the sales contract, the home-buyer will have to provide sufficient funds to cover impounds, the usual 1% fee of the mortgagee, and a number of other charges made by the mortgage company which may or may not be allowed under FHA and VA regulations. These charges made to the buyer, and trust moneys (impounds) to be collected, usually are provided for in the sales contract. However, the specific items, and the amounts to be collected or charged, will come to the closing officer on a statement from the mortgagee (lender). Collections will be made through escrow and turned over as cost items or impounds to the mortgagee or servicing agency. The home-buyer seldom sees or obtains a copy of this statement from his mortgagee, although on certain documents he must certify that no charges have been made to him except as shown on this statement. The home-buyer must sign a certification to this effect under FHA procedure, but seldom will be shown the statement. This ridiculous situation will be treated in more detail in chapters following.

In addition to instructions and statements from the mortgagee to the closing officer, such officer may also receive instructions from the builder-seller to collect certain charges from the buyer through closure. Such charges may or may not have been agreed to by the buyer. Likewise, the buyer seldom sees such a statement from the builder-seller and usually is only aware of these charges when a detailed closing statement is made available to him, this also becoming an increasing rarity.

In any event, the purchaser should be allowed full access to all papers and documents in his escrow file. The mortgagor may be discouraged by the closing officer from seeing some of these. However, all papers in his escrow file are associated with his purchase and he should have access to them at all reasonable times. If there are documents involving financing the building, showing construction costs and building profits, they do not belong in escrow of buyer-seller.

The closing officer has additional burdens under both FHA and VA cases he handles, since these government institutions will require a number of copies of several documents, usually FHA or VA forms in two or more copies. Processing of these documents is such that they are sent via the mortgagee to the FHA or VA, with the mortgagee retaining his copies. Usually the last to be considered is the veteran or home-buyer. The mortgagee demands his copy, the FHA and VA demand their copies, but the copy which is supposedly to be delivered or held for the veteran or home-buyer frequently becomes "unavailable." All others must be satisfied first. The buyer is given little consideration. After all, he is only the party purchasing the home and evidently should have little interest in the entire proceedings. The closing officer admittedly has a sea of papers to process. He must follow instructions, statements and directives from the mortgagee and frequently from the builder-seller, and comply with FHA or VA procedure.

SUGGESTIONS:

(1) FHA and VA should make immediate and forceful amendment to existing regulations so that the buyer will receive all statements or directions that the closing officer receives from the mortgage company and the builder-seller, as a result of contract provisions or in addition to them. Again, it is realized that additional paperwork enters the scene. However, how can the home-buyer certify to certain parts of his transaction in the absence of having at hand the information upon which to make such certifications demanded of him by the government agencies? If it is important to have such certifications, then it is likewise important to provide the one required to certify with his copy so he is not placed in a position where the falsifying of a certification becomes possible. The government agencies should make every effort to see that the veteran or home-buyer has complete information. In the event the federal agencies refuse to promulgage such regulations, then the Nevada Legislature could provide a law that any mortgagor be provided with such information in connection with FHA or VA loans or any and all forms of home mortgages.

(2) Mention has been made that FHA and VA do not require that copies of any escrow agreements be made available to them. The two agencies should move immediately to require that they shall be provided with copies of any escrow agreement. Only with this at hand can either FHA or VA be assured that the mortgagee is not charging the home-buyer certain costs to which he has not agreed in these documents. FHA and VA currently review the mortgagee's charges for items FHA and VA will not allow. But how can they, in the absence of an escrow document (where a deposit receipt has not been used) know that such allowable charges have been agreed to by the home-buyer? They may very well be allowable FHA or VA charges on the mortgagee's statement to the FHA or VA, but have they been agreed to and are they provided for as charges to the buyer under the terms of the escrow agreement, sales contract, or deposit receipt?

(3) In those cases where a master escrow agreement is entered into by the builder-seller to cover a number of sales in one tract under a builders-control program, the FHA

and VA should likewise require that the home-buyer be provided with a copy of such master escrow (or an individual escrow agreement). In no other way will the buyer be aware of what charges and prorations he should expect on his closing statement. FHA and VA should also require that they be furnished with the master escrow agreement (or individual escrow) to provide them with information enabling them to check on charges made to the mortgagor, as suggested heretofore.

The areas of concern mentioned in these three suggestions form an important missing link in any interests FHA and VA may have in their policies offering the veteran or home-buyer some measure of protection. The buyer has a false sense of security when FHA or VA is reviewing his cost factors. Under a conventional mortgage, he would realize he is entirely on his own.

(4) In view of the possibility for irregularites, builders-control services should be considered by the Legislature with a view toward state licensing and bonding for adequate protection to all parties concerned.

(5) As a final suggestion, and one which will eliminate numbers (2) and (3), this report strongly recommends that both FHA and VA move immediately to require that deposit receipts be employed in all cases where a mortgage transaction is to be guaranteed under their programs.

The second and third suggestions present an awkward situation which could develop whereby these agencies would be charged with examining both a purchase contract and an escrow agreement. As heretofore pointed out, there is a dangerous missing link between the two documents in the first place which can only be covered by a properly prepared and executed deposit receipt.

There is no question that a deposit receipt which covers all the provisions of the sale, including full detail on all closing costs, impounds, prorations, etc., is highly desirable and necessary. Such a document would eliminate the possibility of a home-buyer (after his signing of a purchase contract) being impressed with escrow provisions he has not agreed to. This would also necessitate the correlation of provisions of any "informal escrow package agreement" with a purchase contract so that the buyer would know what is required of him in advance of his signing a contract.

The suggestion is also made that FHA and VA would do well to provide a standardized deposit receipt contract form and require that it be employed in all mortgage transactions being prepared for government insurance or guarantee. Such a contract would cover all possible matters concerning the sale, how various costs were to be handled, and would itemize all closing costs, impounds, prorations, and credits. Certainly, with such a general form, both FHA and VA could quickly determine what the mortgagor had obligated himself for and what charges are to be made to him from among those authorized by either FHA or VA. The VA has proceeded part way in this direction with the application of its Form 26-1802, which, on the reverse, goes into many of these details. However, it is not in the form of a basic contract of purchase and does not go far enough. It is entirely possible that standardized regional or state deposit receipts would have to be established as now utilized by various FHA-VA deeds of trust. In any event, a salutary service would be rendered the veteran and home-buyer by such FHA and VA interest in his protection, afforded by such a deposit receipt requirement.

By employing such a standard deposit receipt FHA and VA could also protect against, and even eliminate many questionable practices. For example, the matter of placing hazard insurance as identified in Chapter XIV could be regulated by the proper selection of a method by the home-buyer or veteran on such a standard FHA-VA deposit receipt.

This report would also strongly suggest that both FHA and VA require that a copy of this executed deposit receipt be reviewed by their regional offices at the time they processed the loan and endorsed it for insurance or guarantee. With this deposit receipt, along with the mortgagee's statement of charges made to the mortgagor (as now required) federal agencies would be placed in a position to determine whether the mortgagee's charges were ones agreed to by the veteran or home-buyer, regardless of whether they are charges FHA or VA would accept. With the employment of standard FHA and VA deposit receipt forms, such processing would be highly efficient.

This report, in the absence of a governmental move to require a standard deposit receipt, must point out that both FHA and VA now require cumbersome processing by their regional offices (prior to endorsement for insurance) by the use of mortgagee statements, copies of the sales contract, following escrow instructions, or non-standardized deposit receipts. Such processing, due to the vast variety of contracts, agreements of purchase, and deposit receipts, could be difficult and actually require legal analysis to determine the relationship between these documents and the mortgagee's statement of closing charges made to the mortgagor. It is the elimination of this awkward development which the suggested federal form of standard deposit receipt contract could completely eliminate.

This report is aware that FHA and VA may not be overly interested in the veteran or home-buyer's position in regard to the host of practices identified in this report which work to his disadvantage, many of which are unauthorized by either FHA or VA and likewise no obligations which the veteran or home-buyer has agreed to in his contract. However, the Congress, if properly informed may take a different view. It is strongly suspected that most Congressmen would be greatly disturbed to know the variety of costly practices and misrepresentations being impressed upon their constituents.

In a chapter toward the end of the study will be listed the originals or copies of many documents which the home-buyer should insist upon having, particularly those which FHA or VA now provide that he should have. At that point, suggestions will be made as to how the home-buyer could be guaranteed delivery of these important documents.

CHAPTER XI

DEED OF TRUST, DEED OF TRUST NOTE, DEED TO PROPERTY

These three documents are of basic importance to both mortgagor and mortgagee. The manner in which they are executed (two of them recorded) and finally disbursed, is of special interest to this report.

The deed of trust and deed of trust note, are FHA or VA forms which are uniform within a state or region where employed. The FHA forms are numbered 2146m and 9146, and the VA forms numbered 4-6326 and 4-6326a, for the deed of trust and deed of trust note, respectively.

PRACTICAL APPLICATION:

Usual practice is to have the mortgagor sign the deed of trust and note, after appropriate information has been filled in on the FHA and VA forms identifying the lender, the amount loaned, method of repayment, rate of interest, and term of the loan. The deed of trust will incorporate the terms of the note, identify the property associated with the obligation, and will set forth agreements (13 in number) on the FHA form and (16) on the VA form, which are agreed to by the mortgagors.

It has come to our attention that, in some cases, the mortgagors are being asked to sign large numbers of FHA or VA forms which are not properly filled in and are, in effect, being signed blank. It is possible that some of these forms may well be deeds of trust and deed of trust notes. Obviously the practice has inherent dangers to mortgagors, since unscrupulous persons could easily take advantage of such a blank "check." The lender will require the note and deed of trust to be executed by the mortgagor prior to his making the loan. This is normal procedure and the mortgagor should not feel this is unusual <u>if the note and deed of trust are fully completed to indicate the correct amount of the loan and all of its terms and obligations</u>.

Banks, savings and loan associations, and title or escrow companies handling the transaction should have the deed prepared, original and copies of the deed of trust, and original and copies of the deed of trust note, at hand when closing the escrow. On the day of closure, or if too late on that day then the following business day, the escrow officer will record the deed and deed of trust at the local county court house. Usually he instructs that they be returned to the title or escrow company after recording. Upon receipt of these documents from the court house, the officer closing the transaction will then disburse the recorded copies. The original deed, properly recorded, will be sent to the mortgagor. Customarily the original deed of trust is sent to the mortgagee, along with the original deed of trust note which was not recorded since its terms are incorporated in the deed of trust. The veteran or home-buyer will have received his copy of the deed of trust and note at closure, <u>if there are enough copies left to go around to all interested parties</u>. Frequently he will be minus one or both of these.

SUGGESTION:

FHA and VA should move to provide in their regulations directions for the disbursement of the original and mortgagor's copy of the deed of trust and deed of trust note. The regulations should provide that the mortgagee receive the original deed of trust <u>and</u> the original deed of trust note, with the deed to the property remaining with the mortgagor, as is now done in the practice.

The proper receipt of the mortgagor's copy of the deed of trust, note, and original deed to the property, would be provided for by application of the "transmittal to the mortgagor at closure form" suggested in Chapter XXXII, which lists most of those documents to be received by the mortgagor at or subsequent to closure.

FHA Trust Deed Versus Conventional Trust Deed

We are mindful of the fact that the primary purpose of a trust deed is to secure the repayment to the lending agency of the money loaned to finance construction or provide purchase money. However, they also constitute a device by which a family possessing only a small amount of money, generally only the down payment, and often only closing costs, can acquire a home.

It would seem proper then, in view of this dual purpose, that the trust deed provides adequate protection to the lender without unnecessarily onerous and hazardous provisions on the part of the home-owner, the borrower.

The FHA trust deed provisions could only have been conceived by a board of pawn brokers, or by a group having the concept of pawn brokers. For the purpose of demonstrating how onerous the provisions of the FHA trust deed are the following selected items are presented from a study of FHA, California and Nevada forms.

A comparison of the three will show that the title companies in the two states have determined that the numerous overly burdensome provisions contained in the FHA trust deed are not necessary to adequately protect the lender. To clearly show the difference between the FHA and conventional trust deeds, we hereafter set out in parallel columns, provisions from both types of trust deeds.

<u>FHA Trust Deed</u>	<u>Conventional Trust Deed</u>
Secures repayment of not only the $ loaned with interest and all advances or expenditures "as herein provided," but in addition <u>"all other proper costs, charges, commissions, half commissions and expenses</u>."	Secures "<u>performance of each agreement of trustor</u> incorporated by reference or contained herein; payment of the indebtedness evidenced by one promissory note of even date herewith, and any extensions or renewal thereof." (Note: The "indebtedness"evidenced by the promissory note, and "the performance of each agreement of trustor: is what is secured by the conventional trust deed.)

Whereas in the FHA Trust Deed, in addition to what is provided by the note and trust deed, it is required that trustor pay "all other proper costs, charges, commissions, half commissions and expenses." No provision provides just who is to determine what are "proper costs, charges, commissions, and half commissions, "nor the amount thereof".

FHA Trust Deed	Conventional Trust Deed
Paragraph 1, p. 2	No such provision
Privilege reserved to pay debt in full prior to maturity. <u>But</u>, if debt insured under FHA then a prepayment penalty is exacted in a sum equal to 1% of the original debt which is paid to Federal Housing Commissioner.	Generaly the note merely provides that the obligor shall pay an agreed monthly amount "<u>or more</u>" with no prepayment penalty. Prepayment penalties are often provided, but <u>to compensate the lender</u> for loss of a long-term loan.
Paragraph 2 (a)	No such provision
Mortgage insurance premium payable 1/12 of total charge each month.	
Paragraph 5, p. 3	Paragraph 2
Insurance loss may be used to rebuild or reduce indebtedness.	Same.

The two provisions are very similar; the only difference being that on the FHA Deed of Trust about ten times more verbiage is used than in the conventional trust deed. The reason for including a comment on these provisions is to call attention to the possible need for remedial legislation. The sole intent of Congress in the enactment of the Housing Act was to make it possible for families, particularly in the low income brackets, to acquire decent homes in which to live and rear their families.

Repeated inquiry has shown that most all such home-buyers are completely ignorant of the meaning of these insurance provisions found in such documents. The buyer, having paid for the insurance, believes that in the case of loss, the proceeds of the policy will be used to rebuild his home. It is true that in many cases this is done. It must be noted, however, that the lender has no obligation so to do. He can ignore the home-owner-borrower and apply all the insurance proceeds to the reduction of the indebtedness. Here, again, all protection for the lender and none for the borrower. Why shouldn't there be a requirement that the proceeds be used to restore the destroyed or damaged building? Furthermore, it would seem only fair, to provide specifically for an <u>amount</u> of insurance, rather than permit the beneficiary to fix the amount thereof. If it be argued that a fixed sum, as provided in NRS 167.030 might subsequently prove insufficient, then it could be provided that the insurance should equal the replacement value, and in the event of loss, the proceeds must be used to restore the dwelling. Nevada trust deeds provide for a specific amount of insurance.

FHA Trust Deed	Conventional Trust Deed
Paragraph 8, p.3	No such provision
If loan be found to be not eligible, lender may declare entire debt to be immediately due and payable.	

Why lead the borrower into such a financial mess? He often has sold another place to procure the down payment, and incurred substantial expense in moving and furnishing the new home; then awakens with a financial headache for which he has no remedy whatever.

Wouldn't it be far more desirable to determine eligibility before the home-owner assumes the new indebtedness that may bring him to financial ruin? Reason would seem to dictate such a course.

It is strongly suggested that FHA should move to eliminate or modify these provisions identified. Likewise, VA forms should be subject to similar revisions where necessary.

PART II

COSTS, CHARGES AND CREDITS

This section of the report describes how a dwelling purchase transaction is finally closed, and what charges, costs, and impounds are extracted from the veteran or home-buyer. This Part II traces the events important to the buyer while the transaction is in "escrow" and the final results immediately after closure and assumption of the home by the purchaser, under either FHA or VA programs.

Particular attention will be given to the variety of charges made to the veteran or home-buyer as well as a survey at the outset of what FHA and VA provide by way of general regulations which allow certain charges and at the same time supposedly prohibit other charges being made to the mortgagor. Certain questionable practices are emphasized and suggestions are offered to eliminate them.

CHAPTER XII

FHA AND VA REGULATIONS COVERING ALLOWABLE CHARGES TO THE HOME-BUYER AND CERTAIN ABUSES

CLOSING STATEMENT OF CHARGES AND CREDITS

At closure, a copy of a detailed and itemized statement of charges and credits which have been made to the home purchaser should be made readily available to the buyer. Only be reviewing this can the buyer be sure that certain charges, possibly not provided for in his purchase agreement, have not been made to him. He should also review the statement to see that he has been given proper credit for all deposits he may have made in connection with the purchase. Under some agreements he will have particular reason for reviewing the statement since there may have been stipulated a precise amount for which he is responsible such as "total closing costs." The sum of his charges for such closing items should not be greater than the amount he obligated himself to pay under the terms of the purchase agreement.

When a dwelling changes hands the usual practice makes available to the purchaser a copy of a closing statement indicating in detail the charges and credits made to the seller. However, this is not common to most FHA and VA closures on sales type homes in Nevada. For the purpose of clarity and a full understanding, both parties should receive copies of seller's and buyer's closing statement, setting forth in detail all moneys collected, how they were disbursed, and all charges and credits to both parties. Only in this fashion can it be made clear to the buyer that the closing officer has followed instructions correctly and made proper charges and credits, particularly in regard to instructions where the buyer and seller are splitting a cost or fee.

PRACTICAL APPLICATION: The buyer seldom receives a copy of the seller's statement and frequently his own statement of charges and credits will not be itemized. At best, the mortgagor usually receives only a condensed statement of closing costs and credits.

SUGGESTION: FHA and VA should move immediately to require that itemized closing statements of charges and credits made to both buyer and seller be made available to the veteran or home-buyer. These would be required under the suggested transmittal of closing documents form, suggested in Chapter XXXII.

ALLOWABLE CHARGES:

Both FHA and VA regulations provide for certain charges and costs to be made to the veteran or home-buyer under their insured or guaranteed mortgage programs. In practical application, these charges may be made by the bank, savings and loan association, title or escrow company, or by the mortgagee. Frequently charges are unauthorized, or the party making them has no authorization to make them under FHA or VA regulations.

The matter of impounds or trust funds collected through escrow, which remain the property of the buyer and are placed to his credit to cover costs for taxes, insurance, and FHA premium charges, are dealt with in separate chapters. Likewise, the matter of how the home-buyer will (in most cases) be paying for "points" or a discount on his loan is treated in a following chapter. A separate chapter also is devoted to charges being made without either FHA or VA authorization under their regulations.

The balance of this chapter will review by section each area of an allowed charge to be made to the mortgagor. In each section, both the FHA and VA regulation covering the type of charge is given, the actual practice reviewed, and suggestions given to prevent such abuses as may be in operation.

At the outset it should be indicated that both FHA and VA set forth at two places in official publications of these agencies what charges and fees the mortgagor may be assessed. FHA has established allowable charges in FHA regulations, Section 203, paragraph 203.27 entitled "Maximum charges, fees or discounts." Also, in an official Mortgagees' Handbook, "A Section 203 Guide for FHA Approved Mortgagees," FHA sets forth allowable charges to be made by the mortgagee in Chapter XI, Paragraph 1101. VA, in a combined publication, VA Pamphlet 26-7, dated August, 1961, entitled "Lenders Handbook," covers the matter of charges to the veteran mortgagor in Part I, Paragraph 4161. Part II of this publication contains the official VA regulations for Guaranty of Loans to Veterans and covers charges in Section 36.4312 entitled, "Allowable Charges and Fees." Not available in the VA publication in either Part I or Part II is the "approved schedule for a particular area." Such a schedule is available through the VA regional office serving the particular area involved. The schedule effective in all counties of Nevada is precisely similar to that set forth under VA regulations Section 36.4312 at Part I of said section with the exception of the elimination of number (8) and the addition of two specifically authorized charges. These are charges to the buyer for (a) Tax Service, and (b) Termite Inspection Report.

If the buyer of a home could review all the letters, papers, documents, and various cost statements involving disbursements and receipts which form the bulk of the papers the closing officer has as a part of the file on his home transaction he would be astounded. The welter of these documents covering the transaction from inception to final closure (and on past that date) make such negotiations a study in depth. To thread through every segment of the transaction with a full understanding of just what has happened, the reasons for it, and where the authorizations rest, requires dedication to a task usually well beyond the training and understanding of the average purchaser of a dwelling. As a matter of fact, the ordinary person should be considered well posted if he can comprehend the papers, closing statement, and documents signed by him or given over to him during the course of his acquisition of his home. In the event he has requested (or has been furnished) an itemized closing statement indicating charges, trust impounds, and credits, he will be a rare person if all of these entries are clearly understood by him.

A meticulous person, wishing to review his closure to find out if possible errors of a mechanical nature (or otherwise) have been made undoubtedly will have a number of questions to put to the closing officer who handled the matter. Cooperation of these officers usually is such that most questions can readily be answered and requests for additional information complied with. However, depending on the nature of the contract and any following escrow instructions, the availability of all information contained in the escrow may be a question. Closing officers are loath to divulge information which has a bearing on builder costs, or may contain a reference indicating the builder's policy on discounts, insurance, interim financing, etc. Information from such documents, statements, and cost factors, may not be given to the purchaser even though the information has to do with his own home and though he may be paying for his own escrow service. As a rule copies of such papers are not furnished to the purchaser.

An extremely lax situation exists in regard to just how FHA and VA actually review charges made to the veteran or home-buyer under their programs. Neither of these agencies requires that a copy of escrow instructions, if any, be sent to them (in cases where deposit receipts are not used) so that such a document can be examined at the time FHA and VA reveiw charges made to the mortgagor. What they do have (and require) is a statement from the mortgagee indicating what charges have been made. Many mortgagees will comply with this requirement by sending a copy of the closing statement to FHA or VA, or they may prepare a statement from this closing document. However, neither the closing statement nor a statement made from it necessarily correlate with what the buyer may have or may not have agreed to pay in the escrow document or deposit receipt covering the transaction. FHA and VA may meticulously examine the mortgagee's statement and determine without question of a doubt that each charge to the veteran or home-buyer has been one which, under either FHA or VA regulations, is allowable. Charges which are allowable, but not agreed upon as charges which the home-buyer has accepted under the terms of the escrow agreement or deposit receipt, do not become evident to FHA or VA via such a review.

In connection with this concern, our Counsel Bureau directed the following question to the FHA administration in Washington:

> Is there currently any required procedure established by FHA which would disclose whether or not fees and charges made to the home buyer through escrow, and otherwise allowed by FHA, have in fact been charges which the buyer has agreed by written instrument to accept and pay for?

The answer received from FHA in Washington was as follows:

> There is currently no required procedure established by FHA to disclose whether or not fees and charges made to the buyer through escrow and otherwise, have in fact been charges which the buyer has agreed by written instrument to accept and pay for. However, since the mortgagee furnishes the FHA insuring office with information relative to fees and charges, we accept its presentation as fact unless this information is subsequently amended by the mortgagee. In addition, a copy of the closing escrow account is submitted to FHA and we are, therefore, able to review the charges and fees paid by the mortgagor at closing.

The above reply to the Legislative Counsel Bureau indicates that FHA does have available the closing statement for review and also information relative to charges and fees made to the home buyer. However, it still fails to indicate that FHA has for its reveiw any escrow document indicating what the home-buyer agreed to pay. In the absence of such a document or a deposit receipt at this stage of processing, FHA does not know precisely what charges (in addition to those identified in a sales contract) have been agreed to by the home-buyer in a following escrow document. All FHA does know is that a certain fee or charge, if presented to them as a charge against the mortgagor, would be one acceptable under their regulations. In the absence of such an escrow document, the mortgagor can be charged fees and costs which he has not agreed to pay in a simple purchase agreement but happen to be acceptable charges as far as FHA is concerned. The net result is, he has no guarantee that he will not be charged in excess of that which he has agreed to pay. The FHA procedure only protects him against charges and fees which FHA does not allow, agreed to or not. VA procedure is similar, and does not properly protect the veteran.

PRACTICAL APPLICATION: There is no way of knowing just how serious this situation may be without a review of most closures made during a period of time in several areas of the state. Suffice it to say that a good deal of latitude certainly is allowed and a serious situation exists which could be used to the disadvantage of the home-purchasing consumer in unscrupulous practice.

SUGGESTION: It is strongly suggested that both FHA and VA immediately move to require that where a deposit receipt has not been used, any escrow agreement in the case being examined be made available to them in addition to their receipt of the sales agreement. Furthermore, both FHA and VA should move to direct the regional offices to examine these escrow or deposit receipt documents at the same time they review the mortgagee's statement of charges and prevent the charging of cost items to the veteran or home-purchaser which he has not agreed to in his contract.

It is realized that in connection with some sales, an escrow agreement may not be entered into until after FHA or VA approval of the mortgagor. However, in such cases FHA and VA should require their copy of the escrow agreement prior to their endorsement of the loan, for their review.

AREAS OF ALLOWABLE CHARGES UNDER FHA OR VA

Section 1. (Application Fee)

Under FHA, the mortgagee is allowed to charge to the home-buyer the cost of the application fee ($20). This fee is collected by FHA when an application is filed for a commitment from FHA to insure a FHA loan.

Under VA, the veteran is allowed to accept charges for a VA appraisal fee (if made specifically for the veteran) and VA compliance inspection fees. These fees are similar in nature to the FHA application fee, and treated in much the same way.

PRACTICAL APPLICATION: In many cases involving sales type homes in tract areas, the builder-seller will have submitted this application many months prior to the buyer entering the picture and prior to the actual construction of the home. This will be necessary so the builder can obtain a conditional FHA commitment, line up financing, and, in fact, have substantial information upon which to develop his tract area in general. In effect, the builder-seller absorbs this cost. Technically the mortgagee would have made the application and have paid the fee, but the builder-seller will have done so in advance. The mortgagee has no funds to recover so is not interested in charging the home-buyer for this application fee at closure. In some cases, where a builder-seller is selling under both VA and FHA, he may have made original application for a VA commitment only. When a buyer wishes to purchase under FHA, then the mortgage company may make application to FHA and pay the $20 application fee. However, the mortgage company usually will bill the builder-seller for this amount and the home-buyer will not be charged for this application fee. Comments in regard to the FHA appraisal fee apply also under the VA program for the VA appraisal fee, as modified, and compliance inspection fees. However, the VA inspection fee for compliance is a fee which frequently is charged to the veteran.

Section 2. (Origination Fee - Not to exceed 1%)

Under FHA, the mortgagee is allowed to charge the home-buyer an amount not to exceed 1% of the mortgagee's loan in the case of existing tract type dwellings. This is a flat fee charge for the mortgagee's expenses incurred in originating and closing the loan. The same authorization exists under VA regulations, with the further stipulation that this flat charge shall be in lieu of all other charges relating to costs of origination not expressly specified elsewhere by VA regulations. A 2 1/2% charge is allowed under FHA on property under construction or to be constructed where the mortgagee makes partial disbursements. VA also allows a higher percentage charge under somewhat similar circumstances.

PRACTICAL APPLICATION: Although the fee is stated as not to exceed 1%, cases examined indicated that mortgagees were charging the full 1%. The charge is stated on closures as an origination fee, origination charge, flat allowance, loan fee, etc. VA requires that the fee be reasonable and customary, FHA does not. In practice, a mortgagee under FHA could charge a full 1% as most do, however, such 1% charge might not be customary in the area. VA protects the veteran on this point.

Although it is common to the mortgage loan industry, such a charge for doing business with a customer is hard to understand. In effect, it is quite similar to a customer making a purchase at some retail store with the store charging the customer for having made the purchase at that establishement. If such a parallel is drawn to the attention of the mortgage loan industry, they immediately point to overhead and cost associated with making and closing the loan, a fact that is obvious and cannot be denied. It should be emphasized that the shopkeeper also has an overhead. However, the difference lies in the fact that the ordinary businessman selling at retail has already incorporated his overhead in the price of his wares at retail. Evidently the mortgage companies are not quite so straightforward and have calculated that they will express most of their return as a rate of interest, masking additional amounts which they feel necessary in the guise of an origination fee, as well as a much larger discount or points charge (covered in a following chapter). The net result is a higher rate of return to the mortgage company. Just why it is not made a straightforward cost, and full incorporated into the rate of interest, is not overly clear. The following may offer some explanation:

(a) Incorporating all the mortgage company return necessary into one stated rate of interest might make the loan appear not quite as attractive to some. It is a psychological matter.

(b) The incorporation of all return necessary into a single charge as a rate of interest would, especially here in the west, increase the already wide spread between the guaranteed rate of interest under FHA and VA (5 1/4%), and a rate of interest compatible with market conditions.

(c) The employment of the origination charge is a sales technique or "gimmick" which assists the mortgage industry to shadow the true cost of loans in general. It makes the terms of the loan more appetizing to the customer and does not generate the resentment that a higher rate of interest might.

(d) It should be kept in mind that the 1% origination fee is not equal to 1% of interest covering the term of the loan. Just what it would be equal to as a cost to the consumer would depend on the length of time the loan was kept by the home-buyer. However, as an added charge by the mortgage companies, they calculate the average time that loans in certain categories normally are held and figure a return necessary from that standpoint. Evidently the mortgage companies feel it necessary to obtain the limit allowed under FHA and VA regulations.

SUGGESTIONS: It is strongly suggested that no irigination fees of any sort be allowed to be charged to the FHA or VA home-buyer. This is not to suggest that the mortgage companies be deprived of any returns which they feel necessary to originate the loan. Only with elimination of the origination fee and other practices can the FHA and VA home-buyer be expected to draw comparisons, if he is in a position to "shop for money," or if he is taking what is offered in a tract area, being aware of what he is paying as a true rate of interest. The matter will be discussed further under points or discounts, revealing an even larger misrepresentation. In Chapter XXI, "Suggestions for Elimination or Control of the Discount," a suggested possibility is the employing of this fee as a safety valve.

Section 3. (Recording Fees)

Under FHA regulations, the mortgagee is allowed to charge the home-buyer for recording fees, recording taxes, or other charges incident to recordation. Under VA the veteran is allowed to accept such charges from the escrow or title company. Deed-recording is of primary concern to the mortgagor, while the recording of the deed of trust is a concern of the mortgagee. Both FHA and VA specify that such charges must be limited to those which are reasonable and customary. Obviously, just what constitutes a reasonable charge must be determined in an arbitrary way by the Federal Agencies. What might appear to be reasonable to one person might not appear to be reasonable to another, particularly depending on whether the party was making the charge or being charged. The matter of what is customary should be more readily determined. If the charge has been made in the area for some time, and such custom has been established, then it would be reasonable to assume that it is "customary."

PRACTICAL APPLICATION: Recording fees for deeds, deeds of trust, and assignments are common to most FHA and VA transactions in Nevada. The fees are, however, not paid by the mortgagee in many cases but are a cost to the escrow or title company handling the escrow, with that company paying these recording fees. In turn the escrow or title company charges these recording costs to the veteran or home-buyer. However, FHA regulations specifically identify that only the mortgagee is allowed to collect for such recording fees. In the mortgagee statement of charges to the home-buyer (sent to the escrow officer) such charges are not listed as collectable from the mortgagor. The mortgagee, in fact, would not know necessarily what these charges are. Thus, in such cases, the escrow or title company makes the charge to and collects from the home-buyer without any authority from FHA. The escrow or title company is not even acting as an agent for the mortgagee when he charges these fees to the home-buyer. The escrow or title company is charging the FHA home-buyer for costs it has incurred itself. Clearly, the recording fees charged to the home-buyer by any title or escrow company on FHA guaranteed loan closures, are being made without authority from the federal guaranteeing agency. Under VA regulations, the veteran may pay such costs at closure to the escrow or title company, since the mortgagee is not identified exclusively.

Another matter which should be identified in connection with recording fees charged to the home-buyer is as follows. In the event of both FHA and VA not having at hand a copy of any escrow agreement associated with the sale, neither of these agencies can be assured that the recording fees allowable by FHA or VA have actually been agreed to by the buyer as charges he is accepting in association with the transaction where deposit receipts or detailed sales agreements have not been employed.

SUGGESTIONS: Again it must be suggested that both FHA and VA move to require that they be furnished with a copy of any escrow document used in the transaction. Only in this way can it be reasonably assured that the veteran or home-buyer is being charged for acceptable fees and which he has agreed to pay. At the moment, both FHA and VA are only reviewing what they feel to be a justifiable charge under their regulations, but doing so in many cases with complete ignorance of what buyer and seller may have agreed in regard to who will pay for certain charges and costs.

On all FHA cases immediate steps should be taken to prohibit anyone but the mortgagee from charging the home-buyer for any recording fees whatever, as now provided by FHA regulation but not enforced. If it be the intent of FHA that the home-buyer be allowed to be charged for these fees by those other than the mortgagee, they should modify their regulations to allow certain charges to be made by any escrow or title company that may be closing the transaction.

Section 4. (Revenue Stamps - Notary Fees)

In regard to recording fees, under FHA and VA regulations, provisions contain authorization for the home-buyer to be charged for "other charges incident to recordation." Commonly these other charges will be for Federal Revenue Stamps (in FHA cases only) and for notary fees. Under FHA regulations, only the mortgagee may make such a charge to the home-buyer. Under VA regulations, the veteran may accept tham as charges from the mortgagee or any escrow or title company.

PRACTICAL APPLICATION: Federal Revenue Stamps and notarization of documents associated with the transaction are a prerequisite to their being recorded. Recording cannot be accomplished without these stamps and this service. In many cases, the escrow or title company will pay for these costs and charge the home-buyer for them at closure. The charge should be actual. However, under FHA regulations, only the mortgagee can charge these to the home-buyer and under VA no Federal Revenue Stamps may be charged to the veteran. Also, it should be kept in mind that the escrow instructions executed by the home-buyer may not have made him liable for these costs, even though FHA and VA have provided for some of them. In Nevada it is customary that the seller, not the home-buyer, pay for the revenue stamps, therefore in this state this practice should be carefully examined by FHA before they allow the charges to be passed on to the mortgagor.

SUGGESTIONS: Again, in many cases the FHA and VA would have to be in possession of a copy of any escrow agreement or a deposit receipt to determine whether the home-buyer has accepted the charge, this before a determination could be made that it is an acceptable charge and one agreed to by the mortgagor. FHA should immediately move to enforce their own regulations and prohibit anyone but the mortgagee from collecting the charge, or move to change their regulations if it is their intent that the home-buyer be allowed to absorb such costs.

Section 5. (Credit Report Charge)

Under FHA regulations, the mortgagee is allowed to charge the home-buyer for a credit report. Under VA, the veteran is allowed to accept such charge not limited to that made by the mortgagee.

As pointed out in Chapter V, under FHA this charge is referred to in the singular "report" in their regulations, and in the plural "reports" in the FHA handbook. Under VA reference is made solely to a "report."

PRACTICAL APPLICATION: In some cases the credit report cost will be collected by the builder-seller at time of earnest money deposit. In other cases the mortgagee will order the credit report and charge the home-buyer for this report on his statement to the closing officer, in effect collecting the credit report fee through closure.

Again, it should be noted that only the mortgagee has the authority to charge for and collect credit report fees under FHA. The builder-seller has no such authority except under VA regulations.

In practice, the home-buyer may pay for as many as three credit reports. Obviously an initial credit report is necessary to initiate action to furnish both mortgagee and federal agency with required information upon which to base their action toward making, insuring or guaranteeing the loan. Frequently it develops that some time may elapse between the time the first credit report is made and the time when the mortgagee may transfer his loan to the Federal National Mortgage Association, or to an independent secondary market company. FNMA, and many private companies, may not accept such transfer to them without having an up-to-date credit report on the mortgagor. In that case, there must be a second credit report. However, the cost of this second credit report is almost always back-charged to the veteran or home-buyer. The back-charge covers a transaction taking place after closure and is a cost associated with a transaction between two parties, neither of whom is the home-buyer. The charge for a second credit report is not a proper charge to the mortgagor. The mortgagee may argue that he also wishes to have an up-to-date credit report prior to his disbursement of funds at or near closure. However, the primary reason for this second credit report charge is almost always due to a requirement of the secondary market, most frequently a FNMA requirement.

It is conceivable that three credit reports might be charged for in the event the transaction consumed an unusual amount of time, and that all three would be charged to the home-buyer. However, the incidence of a third credit charge (or credit charges totaling more than double the amount of a single charge) stems from the possibility of the need of a "foreign" credit report. This will occur where the mortgagor is new in the area and most of his background and credit references will be located in another state. The charge for one "foreign" credit report may run to more than double that of a local credit report charge.

In this connection, the information contained in Circular Letter No. 97, issued on April 17, 1962, by the FHA district office in Reno, Nevada, under "II. Submission of Closing Documents," is of interest:

> . . . It is also requested that mortgagees show the beginning and ending dates of interest and rental charges, and an explanation when the charge for the credit report exceeds $7.50.

SUGGESTIONS: FHA and VA should immediately move to prohibit a charge for more than one credit report, under the terms of their own regulations, by augmenting the singular form of the word "report" to indicate, without any possibility of misconception, that this is a charge for one, and only one report. FHA in particular should adjust its Mortgagees' Handbook to reflect the same language as contained in FHA regulations which specify a single credit report.

If it is the intent of both FHA and VA that the words "credit report" are intended to mean the sum total of all credit reports necessary to establish the financial stability of the mortgagor, then FHA and VA should very clearly indicate that no charges for any credit report (or credit reports) shall be made to the home-buyer that are primarily for the purpose of satisfying the requirements of secondary market government agencies or private companies.

Builder-sellers should be expressly prohibited by FHA from collecting a credit report fee from the home-buyer since they have no authorization to do so. Immediately this would eliminate the possibility of such a collection not being credited properly to the mortgagor on his closing statement by the closing officer. Likewise VA should clearly identify those who may make charges to the veteran for a credit report.

Section 6. (Survey Charge)

Under FHA, the mortgagee is allowed to charge the home-buyer for a survey. Under VA, the veteran is allowed to accept such a charge from the mortgagee or others.

PRACTICAL APPLICATION: In cases of sales type homes in tract areas being insured by FHA or guaranteed by VA (the type of home being studied in this report) the mortgagee seldom, if ever, makes such a charge since, as a mortgagee, he does not require a survey to be made on a finished dwelling. Sometimes a mortgagee will require such a survey on spot loans on second-hand homes or homes to be constructed. For that reason FHA and VA include such a charge in their regulations which the mortgagee or others may make to the home-buyer.

Section 7. (Title Costs)

Under FHA, the mortgagee is allowed to charge the home-buyer for title examination and title insurance. Under VA, the veteran is allowed to accept such charges from any party.

Rate schedules of charges for issuing insurance covering title to the property are established by title companies doing business in Nevada and filed with the Office of the Insurance Commissioner. The filing of these fees and charges, which also include costs for providing a wide variety of services by the title companies, is thus made public and the Commissioner is aware of what charges are being made by the respective companies. The Commissioner does not, however, have any authority to review the schedule of charges with a view toward indicating what charges, if any, he may feel are excessive. No authority is vested in the Commissioner by administrative decision or otherwise enabling him to alter in any way such charges filed by the companies.

It is significant that all the schedules filed by the major companies doing business in Nevada are identical in verbiage, presentation, and charges, and cover some 43 pages. They differ only in matter of typography and other physical attributes.

Of particular significance, and of major importance to anyone searching through these schedules of charges to make sure he was properly charged, is an introductory paragraph on page 1 of general rules, which states as follows:

> The charges set forth herein are minimum charges. Additional charges will be made when unusual conditions of title are encountered, or when special risks are insured against, or when special services are requested.

An examination of this statement makes it clearly understandable that schedules of charges must be viewed as minimum and, at the discretion of the title company, may be departed from in any situation they may consider "unusual."

The matter of who pays for the title insurance is determined by instructions which should be contained in the deposit receipt or escrow agreement.

In cases where an informal escrow is operative the directions from the seller may indicate that the charge for the policy be borne by the purchaser of the dwelling.

PRACTICAL APPLICATION: Here again, where a title or escrow company is handling the closure we find that the mortgagee does not make such a charge and does not include such cost items in the statement of charges to be made to the mortgagor. Since frequently these costs run well over a hundred dollars, this is a matter of no small moment. The cost of title insurance again is a cost of the title or escrow company, not the mortgagee, and is being made directly to the home-buyer by the escrow or title company in the absence of any authority to do so under FHA regulations.

The matter of the veteran or home-buyer paying for title insurance in the first place is something which should be considered. It is the seller who should be required to prove that he has proper title to the property being sold. The title insurance and title examination associated with an owner's policy of title insurance should be furnished and paid for by the seller. It is interesting to note that, in the event the home-owner sells his property to another party, he will be expected to furnish an owner's policy of title insurance to the person he is selling the property to. In connection with most sales type tract homes being sold with FHA and VA insured or guaranteed loans in Nevada, the buyer pays for title insurance when he purchases the home and again when he sells the home.

SUGGESTION: FHA and VA should immediately move to prohibit the cost of any title insurance and title examination costs to be charged to the veteran or home-buyer, regardless of what peculiar customs may exist in an area. Under an interpretation of existing FHA regulations, escrow or title companies cannot make such a charge anyway, but are doing so under the authorization granted to the mortgagee. In the absence of FHA or VA action, the Nevada Legislature should prohibit by statute any buyer from having to pay the cost of the title insurance on real estate transactions, if no other way can be found to eliminate this questionable practice.

It is of interest to note that both FHA and VA make reference to title examination and title insurance charges, if any, under their regulations. The reason for this is that, in many areas outside Nevada, the onerous practice of charging these costs against the buyer is not in effect and not the customary procedure. Just why or how the practice became twisted here in Nevada is not fully understood. In any event, in formal resales of property in Nevada, usually it is the seller who pays for the title insurance, keeping in mind that the buyer and the seller may provide for this in any way they desire by mutual agreement.

Section 8. (Related Title Costs - ATA Policy)

Certain other charges to the veteran or home-buyer may arise which are directly related to title insurance. However, FHA and VA regulations do not state that any other charges associated with the issuance of title insurance are authorized charges. The language of both FHA and VA regulations specifically limits title charges to the cost of a title examination and title insurance (policy). Even in the face of this, the FHA and VA buyer may be subject to such associated charges as a fee for making out the policy. Certainly FHA and VA could refuse to allow such charges against the buyer if they elected to comply with their own regulations.

PRACTICAL APPLICATION: In every closure examined which had an itemized closing statement, the home-buyer was charged for and paid a fee which was itemized as an ATA Title Fee. An inspection fee was associated with this fee, but usually not separately identified.

The ATA Policy of Title Insurance actually is an endorsement (or series of endorsements) to the local title company's issued policy of title insurance. Any prudent lender dealing in newly-constructed homes on land recently undeveloped real estate (typical of the tract development of sales type homes) will require this extra measure of protection as security for the loan. The initials "ATA" stand for "American Title Association," and such endorsement(s) on a local policy of title insurance afford to it a measure of national insurance coverage. It might be thought of as title insurance insuring a policy of title insurance at a higher level and on the broad base of national security by this "Association" of title companies.

The mortgagee usually requires this extra title protection because local title companies would not be in a financial position to sustain any great losses. The possibility of a title company having to make good on a number of titles in one tract area at one time, due to a common error in a large number of title policies issued, is quite remote but must be admitted as a possibility. In such a situation, the ATA policy would offer additional necessary protection.

In practice, the usual FHA or VA case would require but one ATA endorsement specifically ordered by the mortgagee. The lender may have reviewed the particular area and requested several ATA endorsements for specific requirements peculiar to the tract area. Actually, there are over a hundred ATA endorsements which could be required, a vast number not usually applicable to the typical FHA or VA case. A charge for each endorsement is required, and, if the charge is somewhere around $25 - $35 for both the ATA policy and the inspection fee associated with it, this probably represents a single common ATA policy requirement by the lender. The charge could go much higher, in which case unusual circumstances would be indicated.

The mortgagor receives a copy of the local policy of title insurance, and the original goes to the lender. The ATA endorsements, making it in effect an ATA policy, will be attached to the lender's original policy of title insurance only. Usually title policies are delivered to the mortgagor without much difficulty being experienced and the veteran or home-buyer normally will receive his copy sometime after closure, directly from the lender, title, or escrow company.

SUGGESTION: Again, both FHA and VA regulations refer to title insurance in the singular form. There is no indication that authorization is granted for anyone to charge the veteran or home-buyer for any additional title insurance that a mortgagee might request. Both FHA and VA should immediately move to prevent any further charges to the buyer for such additional insurance which mortgagee may require. Their regulations do not now indicate such an authorization for the charges to be accepted by the purchaser of a dwelling under these government mortgage guarantee programs.

Also, any policy fees for making out any of the policies of title insurance likewise should be prohibited from being passed on to the veteran or home-buyer. Neither FHA or VA provide for such charges to be paid by the mortgagor under their current regulations.

Section 9. (Other Charges)

Under FHA regulations the mortgagee is allowed to charge the home-buyer for such other reasonable and customary charges and fees as may be authorized by the commissioner.

The Washington office of FHA was contacted in regard to whether or not the "Commissioner" had authorized any other additional charges and fees. Their reply was that the Commissioner had not authorized fees and charges other than those set forth in the regulations. They added, however, that authority was granted in Section 203.27 (3) (v) for the Director, in behalf of the Commissioner, to permit other reasonable and customary charges.

Note: Section 203.27 (3) (v) reads as follows:

> Such other reasonable and customary charges and fees as may be authorized by the Commissioner.

There is no such authorization in this sub-section which would grant to the Director such authority to act on behalf of the Commissioner.

Under the wording of this particular section no one other than the Commissioner has any authority to allow any additional fees or charges. Administrative rules and regulations are most always strictly construed. When the rule says "Commissioner", this is also to say "and no one else." (i.e. Rule of Exclusion)

Under VA regulations covering both regional areas of Nevada, no such catch-all provision is provided. Under generally allowable charges and fees, VA regulations Sec. 36.4312, Part I, paragraph "A" number (8), there is a loosely worded provision covering an additional charge "area," as follows:

> Such other items as may be authorized in advance by the Chief Benefits Director as appropriate for inclusion under this subparagraph as proper local variances.

However, the approved schedules for both Nevada VA regions have not promulgated this number (8) for inclusion under allowable charges and fees. The VA authorized charges for all counties in Nevada are therefore quite specific and obviously do not include any such additions.

Applicable to both northern and southern Nevada is VA regulation, Section 36.4312, a provision contained as Part V, which is as follows:

The fees and charges permitted under parts I through IV of this schedule are maximums and are not intended to preclude a lender from making alternative charges which would not result in an aggregate charge or payment in excess of the prescribed maximum.

A casual reading of this provision creates the impression that it would allow the mortgagee, or anyone else involved in the transaction, to provide some alternative charge for one not made, as long as the total did not result in an increase to the veteran. However, VA regional control has always interpreted this Part V (and has been backed by administrative ruling) that such alternatives are restricted specifically to replacements of charges within each enumerated allowable charge, and do not allow for the dropping of an entire allowable charge and replacing it with one completely foreign to the authorized list. For example: In the early days of VA operation in Nevada, it was not always possible to obtain title insurance as a specific policy in the Ely area. In place of an allowable charge for title insurance, the guarantee program operated for a time under "opinions of ownership" and such charge was made in place of a more direct charge for title insurance. This replacement, however, was for a similar purpose and did not bring into the picture a new form of charge foreign to the authorized list.

SUMMARY

At this point it is very clear that under FHA the mortgagee (and only the mortgagee) may collect from the home-buyer the following charges and fees, which have been covered as follows: Under VA, the veteran may accept these charges from the escrow or title company, or others (in addition to the mortgagee).

(1) The application fee under FHA. A similar fee for appraisal and for compliance inspectors under VA.

(2) An origination fee based on the amount loaned (not to exceed 1%) under both FHA and VA programs. Larger percentages in cases not common to this report.

(3) Recording fees and recording taxes or other charges incident to recordation (which are reasonable and customary) under both FHA and VA. However, under FHA these must be charged to the home-buyer by the mortgagee only.

(4) A fee for a credit report. Under both FHA and VA regulations expressed in the singular and under FHA must be charged by the mortgagee only.

(5) A fee for a survey under both FHA and VA.

(6) Costs of title examination and insurance, if any, under both FHA and VA, but restricted as a mortgagee charge under FHA.

Two additional charges are allowed to be accepted by the veteran under the VA program in all counties in Nevada. These are charges for (1) a Tax Service, and (2) a Termite Inspection Report. These charges have recently been expanded to cover the entire state, under VA San Francisco regional informational bulletin No. L-302, dated July 26, 1962.

CHAPTER XIII

CHARGES BEING MADE TO FHA AND VA HOME-BUYERS WHICH ARE NOT PROVIDED FOR IN FEDERAL REGULATIONS

In addition to the abuses identified with charges and fees which are allowed and authorized to be made under FHA and VA in Chapter XII, it should be realized further that some charges and fees are being made to the veteran or home-buyer for which no broad authorization exists for anyone to so charge. These are of a most serious nature. It is not fully understood just why either FHA or VA would condone such practices when they have full authority to prevent the passage of these cost factors on to the consumer under their existing regulations.

Before examining these as separate items, it should be understood that the language contained in both FHA and VA regulations makes reference to charges being authorized, as limited to those which are reasonable and customary. The only charges not subject to this modification are the application fee and the 1% limit on the origination fee under FHA. Both FHA and VA regulations employ these modifying terms not as reasonable or customary, but as reasonable and customary. They must, therefore, be both reasonable and customary, and the fact that the charge meets but one of these requisites does not authorize it to be made. For an example, both FHA and VA permit the home-buyer to pay certain recording fees (which should be actual) along with other charges incident to recordation. However, if a charge were to be made to the buyer which was incident to recordation (and that charge was not one customary in the area) even though it was determined to be a reasonable charge, it should not be allowed by either FHA or VA on the grounds that it failed to meet the other criteria of being a customary charge. Likewise, though it might be customary it could be excessively high, which should subject it to "not an allowable charge" to the veteran or home-buyer by FHA and VA regulations. The matter of how FHA and VA actually proceed under their regulations is incidental to the illustration, although we must admit application of regulations by their regional offices leaves much to be desired in protection to the consumer.

The following charges being made to the veteran or home-buyer, are not authorized under either FHA or VA regulations except the Tax Paying Service, as pointed out under VA. As previously identified, VA regulations do not provide for charges to be made other than those specifically listed by VA for the two regions covering Nevada. FHA, likewise, does not provide for any charges other than those specifically listed since the Commissioner has not authorized any in addition, and the Regional Director does not have authority to act in behalf of the Commissioner. (See Chapter XII)

Further, in this connection, the mortgagee must sign this certification on FHA Form No. 2007 (reverse side under Mortgagee's Certificate) as one of a number of itemized certification statements:

(g) No charge has been made or paid by the Mortgagor except as permitted under the Regulations.

A similar VA certification the mortgagee must sign is associated with VA Form No. 26-1876 (reverse side under Instructions for Lender, Execute Certifications -):

2. It has not imposed and will not impose any charges or fees against the veteran borrower in excess of those permissible under the schedule set forth in paragraph (d) of Section 36.4312 of the VA Loan Guaranty and Insurance Regulations.

The making of specifically unauthorized charges (and the execution of such certification by the lender) could place such mortgagee in a serious situation should the matter be pressed at some future time.

Section (1) Tax Service Charge

Most FHA and VA closing statements to the mortgagor will contain such a charge if the transaction has been made during the past 2 years or so (1960 - 1962). The charge represents a fee to the home-buyer for the purpose of paying his taxes and any assessments from his trust account. Usually the amount charged will be from $10.00 to $20.00, most recently quoted at $12.50.

PRACTICAL APPLICATION: A tax-paying service may be organized entirely separate from the mortgagee's servicing department or it may be a subsidiary of the mortgage company. In Nevada, the title company may act as a tax-paying service for the mortgagee, since there are few local specialty companies. The tax-paying service provides to the mortgagee (when acting as a separate company or a subsidiary) a method of guaranteeing that tax bills will be obtained by this service, covering the property offered to secure the loan. Taxes are not paid by the tax-paying service. The service forwards the tax bills to the mortgagee, who pays the tax bill from the mortgagor's trust funds on reserve with him. In effect, the tax-paying service guarantees to the mortgagee who is charged with servicing the loan (even though this may have been sold in the secondary market) that the mortgagee will receive notice of any taxes and assessments made against the mortgagor's property. In a way it is somewhat of an insurance to the mortgagee that he will receive accurate and complete tax statements prior to the time they become due. In actual practice the tax-paying service usually will have notified the municipal tax office to mail the tax bills directly to the tax-paying service. Evidently mortgage companies feel they do not wish to absorb this extra overhead expense and responsibility for obtaining the annual tax statements themselves. It is interesting to note, however, that the charge for this service is passed on to the home-buyer, though it is an obligation of the mortgagee and his responsibility under FHA regulations to service the loan and pay the taxes for the mortgagor. Obviously the mortgagee is escaping from his obligation and passing the cost on to the home-buyer.

Most of the large mortgage companies making FHA and VA loans here in Nevada employ the services of an out-of-state tax-paying service and pass the cost on to the home-buyer through closure as a lump sum cost (a payment in advance) for rendering this service for the term of the loan. Should the buyer refinance or sell his home he could not recover this tax-paying service charge even though the mortgage company might have made use of the service for only a year or so. A former procedure, which may still be in effect in some cases, is the annual collection of about $1.00 to cover this service for a year. In this way, even though it still represents a charge the mortgagee is passing on to the home-buyer, the mortgagor would not be paying for the mortgagee's service years in advance, only for the time the loan was actually serviced.

SUGGESTION: A review of FHA regulations, relative to those charges which the home-buyer may pay under a FHA insured loan, fails to disclose any provisions under which a tax-paying service charge or fee can be made. Recently the charge has been made an allowable one for VA cases in all of Nevada.

Immediate steps should be taken by the FHA office covering Nevada to enforce their existing regulations. This is not a matter which calls for a change in regulations or legislation at the state level. Full authority now rests with FHA to prohibit such costs being passed on to the home-buyer. Just why FHA has seen fit to allow the consumer to be saddled with this additional charge is not clear. In the absence of an explanation it must be assumed that FHA must have little regard for the home-buyer and an extra amount of concern and sympathy for the mortgagee.

In the event that FHA shall elect not to enforce their own regulations, then perhaps state legislation expressly prohibiting such a charge should be enacted to cover mortgage loans guaranteed by FHA.

This is another example of a hidden cost in borrowing money. If the mortgagees feel they must make such a charge (and this is necessary for the purpose of granting the loan) then such a cost factor should be incorporated in their expressed return on their loan in an all-inclusive rate of interest, a suggestion made further on in this report.

Section (2) Escrow Fee

This fee is common to a large number of FHA closing statements of charges to the home-buyer as well as some VA closures (although specifically not allowable under either FHA or VA schedules). Such a fee is for the purpose of paying for the cost of handling the escrow procedure and is a reimbursement to the title or escrow company for its overhead expenses. In some cases builder-sellers absorb any escrow charges. In other cases all or part of such escrow charges may be made to the veteran or home-buyer regardless of regulations.

PRACTICAL APPLICATION: Frequently the fee is split between buyer and seller, and may be so provided in the escrow agreement. Since both buyer and seller may have obtained the services of a title or escrow company, and the escrow officer is acting in behalf of both buyer and seller, such an arrangement would be a normal one were it not for FHA and VA regulations on acceptable charges. In some cases where the builder-seller may be working his entire tract through an exclusive title company, the charge to the seller will be only a fraction of that made to the buyer. Obviously this is due to a prearrangement between the builder-seller and the title company in consideration of the volume of business being channeled to a selected title or escrow company. The seller receives a special "rate," but the home-buyer pays for his full half of a theoretic charge which was never fully made by the title company to both parties, and made to the veteran or home-buyer in violation of FHA and VA regulations.

In the first place, an escrow service charge is hard to substantiate. The title or escrow company will be selling a policy of title insurance at a substantial premium rate. Nevada and many other states have no control over the rate charged by the companies for a policy of title insurance. In Nevada, the title company files a minimum escrow service charge with the Insurance Commissioner in addition to rates for policies of title insurance. The Commissioner has no authority to review these charges or rates in order to establish whether or not they may be excessive. As pointed out in the preceding chapter, the builder-seller should pay for any costs of title insurance since it is he who must provide proof of ownership and ability to pass title.

A further consideration should be given to the matter of escrow fees in general, to any party. Why should a title or escrow company charge a fee in addition to the high fees now being charged for the policy of title insurance? Again this is similar to the mortgagee through an origination fee charging the consumer to do business with him.

Since it is the builder-seller who should be paying for the cost of the title insurance as heretofore emphasized, then it should likewise be the obligation of the builder-seller to pay for any escrow costs which the title or escrow company feels are justifiable charges associated with issuance of the policy of title insurance.

SUGGESTION: A review of both FHA and VA regulations relative to those charges which the home-buyer and veteran may pay, for which he receives a FHA or VA insured or guaranteed loan, fails to disclose any provisions under which an escrow fee can be made.

Immediate steps should be taken by both FHA and VA regional offices covering the State of Nevada to enforce their existing regulations. Full authority now rests with FHA and VA to prohibit such costs being passed on to the home-buyer. In the absence of a logical explanation for not enforcing their own regulations, it must be assumed that FHA and VA have little regard for the home-buyer and an extra amount of concern and sympathy for the mortgagee and builder-seller.

Since FHA and VA fail to enforce their own regulations, then perhaps state legislation expressly prohibiting such a charge should be enacted to cover mortgage loans insured or guaranteed by FHA or VA.

The argument may be advanced that, if the builder-seller cannot pass this cost on to the home-buyer he will merely cover such a cost by increasing the sale price of the home. However, if FHA and VA appraisals were accurate the builder-seller would not be provided with a means of effectively covering the discount, and total of other charges such as this. Under VA the builder-seller cannot sell the home for more than the VA appraisal--an appraisal figure which cannot include a consideration of closing costs. Under FHA the builder-seller can sell the home for more than the appraised value, an appraisal which does take into consideration closing costs. However, under their regulations the escrow fee is not a closing cost to the home-buyer and therefore should not enter into the FHA appraised value. Furthermore, it is not usually easy to sell a sales type tract home that is too far out of line with the FHA appraised value. It must be admitted that the accuracy of the appraisal is a key factor, one which is dealt with in detail in a following chapter.

As will be pointed out in a later chapter, the desirability of the buyer having a copy of both the buyer's and the seller's itemized settlements of charges and credits is of interest in connection with the escrow charge. Only with these statements can he be aware of the circumvention of escrow instructions providing for the splitting of escrow charges between buyer and seller. If there has been a preferential treatment of the builder-seller it will be evident upon examination of both buyer's and seller's closing statements.

Section (3) Conveyancing Fees, Attorney's Fees

The itemized statement made at closure, and sometimes made available to the buyer, will, in many cases, contain charges for "conveyancing" or "attorney's fees." The term conveyancing is associated with passing title to property. The cost of preparation of the deed and the deed of trust necessary to the transaction and possibly other documents, depending on the complexity of the sale, is being passed on to the veteran or home-buyer. The mortgagee may include in his statement of charges to the mortgagor a charge for transfer of the mortgage into the secondary market. This cost will occur after closure and represents a "back-charge" to the veteran or home-buyer for steps yet to be taken, collected in advance at closure.

PRACTICAL APPLICATION: There is no established pattern among lenders as to how these charges are to be handled. The method employed will depend, to a large extent, upon the mortgagee and builder-seller involved, as well as any escrow or title company. In some cases, the mortgagee may absorb these costs or the builder-seller may absorb them, along with escrow service costs. Obviously, any charges made to the mortgagor for the purpose of selling his mortgage in the secondary market are hard to substantiate. At this stage of the transaction, the veteran or home-buyer is not in any way obligated. Such costs are mortgagee costs and obligations, but not being accepted as such by the mortgagee.

SUGGESTION: Since FHA and VA regulations fail to identify these costs among those which the buyer may be charged under the federal mortgage insurance or guarantee programs, both agencies immediately should move to enforce their own existing regulations. This is not a matter of suggesting new regulations since full authorization is now given to both FHA and VA to so protect the veteran or home-buyer from these unauthorized charges.

When such charges are made by the title or escrow company they are entirely out of line in an FHA case, since FHA restricts all of its charges to those made by the mortgagee only.

As a further consideration, it must again be suggested that FHA and VA move immediately to provide themselves with copies of the deposit receipts or escrow agreements to find out whether the buyer agreed to such charges in the first place.

Where the mortgagee is "back-charging" the buyer for costs of selling his mortgage in the secondary market, such charges likewise should be immediately prohibited under existing FHA and VA regulations.

In the event FHA and VA continue to elect not to enforce their regulations, then the Nevada Legislature should move to make such charges illegal under FHA and VA transactions on all home-sale transactions.

Section (4) Payment of Interest in Advance

It is common practice in Nevada to collect through closure interest in advance of the date such interest is due. This charge will normally be one of those itemized on the closing statement to the veteran or home-buyer and usually identified as interest covering a period of time less than a month. The interest is on the loan which has been made by the mortgagee and usually the mortgagee will collect (or direct any closing officer to collect) this advance payment from the veteran or home-buyer at escrow closure.

PRACTICAL APPLICATION: No one can deny that interest on a loan should be paid by the mortgagor from the date such money has been made available to him by the mortgagee. Usually this is the date of "funding of the loan" by the mortgagee, or when the mortgagee actually has funds issued to any escrow or title company closing the loan. The funding will be closely associated with closure date and usually is coincidental with closing. As of the date of closure the mortgagor will owe to the mortgagee interest on the full amount of the loan under the terms of percent and time, established in the note. However, it must be remembered that interest is not paid in advance but is due under FHA and VA programs on a monthly basis after the month has passed. Therefore interest is paid in arrear. Insurance policies are paid in advance, taxes and interest are payable in arrear.

An example of how such charges would come about is as follows: Where a closure takes place in, say, early October, and the first payment of principal and interest to the mortgagee will not be made until December 1st (a principal payment and an interest payment covering the month of November), there must be provided for the mortgagee a payment for interest covering the time from the closure date in October to November 1st. To have this interest collected in advance at closure on a date early in October (for the balance of the month of October) is highly irregular and represents advance interest payment by the veteran or home-buyer. Depending on what date in the month the closure occurs, the charge can fluctuate between a full month of interest to only one day of interest.

In this connection it is pertinent to quote from a FHA Circular Letter No. 97 issued by the Reno regional office on April 17, 1962, which makes reference to such advance interest payments evidently condoned on closing documents in the region, as follows:

> II. Submission of Closing Documents. It is also requested that mortgagees show the beginning and ending dates of interest and rental charges . . . (underscoring supplied)

Since these are associated with "closing documents," such interest could only be advanced interest. The mortgagor pays no interest otherwise until he makes his first payment to both principal and interest occurring a month or more after closing, or is billed for the irregular interest period by the mortgagee when properly due.

SUGGESTION: There is no reason why the mortgagor should have to pay this interest in advance. No provision for such advance payment is authorized to be so charged to the veteran or home-buyer under either FHA or VA regulations.

The matter is handled in a businesslike fashion by some mortgagees and title companies in this state, and very commonly in other states as follows: After the first of the month following closure the mortgagee bills the mortgagor directly for whatever interest is due, covering the irregular interest payment.

In some cases, the mortgagee will have obtained authorization from the mortgagor in the deposit receipt or escrow agreement (or in a separate authorization) allowing the lender to make such a collection. Actually there is no need to obtain such an authorization. However, the obtaining of the authorization places the veteran or home-buyer on notice that he will be receiving such a billing and will eliminate the possibility of surprise when the bill arrives. Under this system, the home-buyer is not forced to pay interest in advance.

The collection could be effected under one billing. The first payment to principal and interest could include the interest for that portion of the month of October (in the example) from date of disbursement of the loan to the end of the month. However, the mortgagee should receive this interest on the first of the month following.

It is admitted that the easiest way to make the collection is in advance through escrow. However, this provides no basis whatever for mortgagees, escrow offices, title companies, FHA, or VA for either instigating or allowing such an irregular practice to be impressed against the veteran or home-buyer, as a charge to the mortgagor at closure. Obviously, both FHA and VA should immediately take steps to eliminate the practice in the closure of FHA and VA home purchases.

Section (5) Additional Charges

The charges listed in this chapter do not represent an exhaustive coverage of all costs which may be passed on to the veteran or home-buyer under FHA and VA insured or guaranteed mortgages. However, the most common unauthorized charges are believed to be covered herein. Again it should be emphasized that both FHA and VA regulations covering what cost items they will allow to be charged to the buyer are rather complete provisions in themselves and do not allow for "associated" charges. One exception is the recording charges which specifically mention "other charges incident to recordation." In all other provisions there is no such extension to related fees.

FHA does provide for "such other reasonable and customary charges or fees as may be authorized by the Commissioner." However, the Commissioner has not so authorized any charges additional to those specifically set forth in FHA regulations. Furthermore, administrative rules and regulations do not allow the district directors to act for the Commissioner and provide for additional charges to be made to the home-buyer. (See Chapter XII).

Under VA, a similar "catch all" provision does not apply to Nevada since it has been excluded by the regional offices servicing all counties in Nevada.

SUGGESTION -- (FINAL OVERALL)

Under VA regulations the machinery for inspecting charges which have been made to the veteran are such that unauthorized charges are fundamentally more difficult to pass along to the home-buyer. VA requires that "Costs properly chargeable to the veteran-purchaser and paid by him must be itemized on VA Form 4-1802, Application for Home Loan Guaranty or Insurance, as well as on VA Form VB 4-1876, Certification of Loan Disbursement, or on VA Form VB 4-1802, Report of Home Loan Processed on Automatic Basis." VA specifically warns that "the costs may not be consolidated or lumped together."

Under FHA, a statement must be submitted which will indicate what charges have been made to the home-buyer by the mortgagee. Frequently this FHA requirement will be met by submitting a copy of the closing statement made to the home-buyer. Information in either case may or may not properly itemize closing costs. A suggestion is logically made, that the FHA should forthwith provide for the inclusion on their mortgagor's statement supplemental to mortgagee's application for an FHA loan (FHA Form No. 2004c), a similar provision for the listing of charges which are to be made to the home-buyer, or on some other form which is processed prior to actual indication of approval of the mortgagor. Likewise, such information should again appear on a certification of loan disbursement employed by FHA, as suggested in a following chapter.

FHA now provides for only a brief certification statement by the mortgagee that he has disbursed the loan. The suggestion is for a FHA Certification on Loan Disbursement, a separate and complete form such as now employed by VA as Form No. 26-1876.

CHAPTER XIV

FIRE INSURANCE POLICY PAYMENT

In the event the home-buyer has been assigned the construction fire insurance policy or a new one has been arranged for him at closure, and he has not ordered insurance and paid for same, a charge will be made at closure for such a policy. If he is assuming an existent policy which has been running for some time he will be charged a proportionate share of the policy, based on the period of time it has left to run. In other words, there will be a proration and he will be charged with costs of his portion of the unexpired part of the insurance. In the event he has a new one or three-year insurance policy issued to him, usually he will pay the first year's insurance cost in full at closure.

Should the purchaser have arranged for insurance on his own, he will probably have paid for this separately and outside of escrow. In that case, any charges for proration of existent insurance on the property or a charge for a new policy, made without proper contract authorization, should not be charged to him. In such case it is the obligation of the builder-seller to terminate any interim insurance, in his own interests.

A person who is purchasing a dwelling, and as a part of the transaction places the dwelling itself as security to cover a loan being provided by the mortgagee, will be required by the lender to provide hazard insurance covering the property to the extent of loss from fire and/or lightning. Normally extended coverage is likewise required by the mortgagee which includes coverage from loss due to windstorm, hail, explosion, riot, smoke, aircraft, and vehicles under most extended policies. This first extension of coverage may vary slightly among companies. Normally additional extended coverages are not required and usually a deductible policy, under which terms the home-owner pays initial minimum loss, will be acceptable to the lending institution.

Obviously, fire insurance provides necessary protection to the mortgagee for property offered as security for the loan. The amount of such insurance must be at least sufficient to cover the amount of the loan. The purchaser of the dwelling may provide himself with higher coverage, a broader policy, or additional policies covering the property. This is a matter which should rest entirely with him.

The insurance policy covering the house with a loss-payable endorsement made over to the mortgagee will be in the possession of the lender. However, the home-buyer should have a copy of this policy so he will be familiar with what losses are covered by the policy. There may be incidental loss coverage provided by the policy which could result in substantial savings to him. This is particularly true where a home-owner's policy may have been incorporated in the basic fire and extended coverage policy. Without a copy of the hazard insurance policy the veteran or home-owner would not be aware of a loss which might be covered. In addition to his copy of the policy, the home-owner always should be furnished with copies of any endorsements which have been made to the policy.

Should the veteran or home-buyer wish to sell his dwelling it will be to his advantage to be able to furnish the closing officer with his copy of the insurance policy for a proper proration and credit at closure. In the event the new owner is not accepting the current policy, he will likewise need to have a copy for ready reference and be in a better position to send the policy to the company and request an immediate cancellation and refund for that portion of time represented by the cancellation. When he has no copy, and the insurance has been handled by an intermediate agent, the actual date of cancellation and refund usually will not be made until the original agent has furnished the intermediary with a copy. This can take anywhere from a few days to a couple of months.

PRACTICAL APPLICATION:

In almost all cases the purchaser of a dwelling under FHA or VA does not provide for this required insurance protection by ordering a policy himself to become effective at closure.

Unfortunately, the procedure is "automatic" in most cases where a new home is being purchased in a large tract area. The closing officer, frequently acting under directives from the mortgagee or builder-seller, will automatically provide for issuance of an insurance policy or assign any existent builder-seller policy to the purchaser, without any insurance order to that effect from the purchaser and in the absence of specific contract or escrow instructions authorizing such action. Thus, under this common practice, the purchaser of the dwelling becomes the owner of an insurance policy he never order, or never authorized to be assigned to him, and with which he is totally unfamiliar.

To the veteran or home-buyer the matter is far from academic. By ordering the policy himself he might be able to select a company which insures at lower rates than standard "bureau" rates. He could also provide for a deductible clause at a savings, and would be assured that he had not purchased excess insurance to protect for an amount more than required by the mortgagee. Whether it is a wise move for the purchaser of a dwelling to provide himself only with the minimum insurance required by the mortgagee is not a matter for discussion here. Additional insurance, coverage of home contents, and liability coverages, commonly part of so called "homeowner's policies," is discussed later.

Where the purchaser of a dwelling is buying a new home in a tract area, the following practices (vicious ones, to say the least) have been found to be very common. The builder-seller constructing homes in the tract must acquire construction loan insurance to cover the total of progress payments made to him by his lending institution, unless he is self-financed. This construction or interim insurance usually is taken out through one company covering all homes in the tract. Companies covet this insurance because, in the vast majority of cases, eventually it will be increased and assigned over to the purchaser of the dwelling or reissued "automatically" without his order. The important business of insuring a finished home to the owner is the heart of their fire insurance business, and may lead to other types of coverage and home-owner's policies. Mortgagees may stipulate that a mortgage loan will not be granted unless insurance is purchased from a certain insurance company or a direct subsidiary insurance company controlled by the mortgagee. This likewise impresses an insurance policy on the mortgagor.

Without specific orders of the purchaser, or even his knowledge, he may be impressed with an insurance policy or an amended insurance policy assigned over to him as either a one- or three-year policy. To cancel this policy after closure to make way for the purchase of a less expensive policy, could be costly, dependent on the cancellation rate employed by the insurance company whose policy is being cancelled. It could cost well in excess of the savings gained under a new, cheaper policy he might select as a replacement.

Numerous cases have been disclosed where home-purchasers have been told they have to accept the insurance being provided with the home sale, that they cannot provide their own insurance. Such a practice is part of a "tie-in" sale and has certain overtones of violation of federal regulations outside the province of FHA and VA.

The matter of how hazard insurance is to be handled may well be provided for in a deposit receipt or agreement to purchase. In some few cases the veteran or home-buyer may be offered the alternative of providing this insurance himself. However, in the vast majority of cases, whether or not the contract covers the point, the issuance or reassignment of hazard insurance without the selection of the company or agent by the veteran or home-owner is almost universally practiced here in Nevada. Such an automatic "package sale" of a sales type tract dwelling and the insurance covering the dwelling is nothing less than an outright "tie-in" sale. This is true even when authorization for such action is set forth in a contract, deposit receipt or escrow agreement in the absence of an opportunity for selection on the part of the veteran or home-buyer. At this juncture it will be of interest to examine Section 1405.6 of the FHA Mortgagees' Handbook, Chapter XV, which reads as follows:

> Hazard Insurance Tie-In Practices: The Department of Justice has requested FHA cooperation in advising FHA mortgagees as to the position of the Department with regard to the practice of some lenders of tying-in sales of hazard insurance with mortgage loans.
>
> The Department has indicated that such practices may fall within the purview of the Sherman Act and an unreasonable restraint of trade. Mortgagees having any questions concerning their own hazard insurance practices or any legal questions relating to the application of the Sherman Act to such practices should consult their own counsel or the Department of Justice for further information.
>
> FHA, of course, does not have jurisdiction to investigate or enforce violations of antitrust statutes; <u>however, any instances of alledgedly improper tie-in practices which are brought to our attention will be referred to the Department of Justice, Antitrust Division, for appropriate consideration by that Department.</u> (underscoring supplied)

Reference is made in this FHA directive to the practice of such tie-in practice as related to the mortgagee employing such tactics. As indicated previously, the mortgagee may have an interest in where the insurance is placed. Mortgagees and mortgage companies may have directly-owned insurance operations or receive "considerations" for where the insurance is placed. Likewise, the builder-seller who has had need of interim hazard insurance may have obtained it through one agent with a "consideration" in return for channeling through that agent the insurance that will be required later by the veteran or home-buyer. It is not beyond the realm of possibility that such builder-seller may be receiving a "kick-back" from the insurance agent for such "automatic" provision of hazard insurance to the mortgagor.

Since the practice is so widespread and of almost uniform applicability throughout Nevada, it is wondered just why the regional FHA office has not cooperated with the

Department of Justice (as that Department has requested) and made such "tie-in" information available to the Department of Justice. Certainly FHA and its Nevada regional officers cannot be so unobserving as not to notice such practices associated with their own mortgage transactions being insured by FHA. With justification FHA points out that it has no jurisdiction or machinery to investigate the practice. However, all the Department of Justice requested of FHA was some notification to them that such practice existed. Thus it can only be concluded that FHA must be derelict in its duty when a most casual review of almost any FHA insured mortgage loan by that agency would show how the hazard insurance had been handled. Apparently FHA feels that it has cooperated as requested by the Department of Justice by merely advising in its handbook to the mortgagees that the Department has made such a request of the FHA. Possibly the FHA feels such cooperation with the Department of Justice is warranted only if and when some home-buyer should make a specific protest of a "tie-in" practice to FHA. Then, and only then, would they feel obligated to cooperate with the Department of Justice.

Obviously the home-owner, who seldom traffics in the matter of issuance of hazard insurance, would not be the one apt to approach FHA with such "tie-in" information accompanied by a complaint. How could he be automatically aware that this might be a violation of the Sherman Act when even the mortgagees who work in this field have to be specifically advised on the point by FHA in a handbook to them? If FHA desired to exercise cooperation at the request of the Department of Justice, it could incorporate in the mortgagor's certification the required affirmative answer to a question indicating that the home-buyer was offered a choice of placing his own insurance or accepting that which was offered with the dwelling. This will be dealt with under suggestions in this chapter.

After a party has moved into a home covered by unordered insurance the insurance company, having been given the exclusive on the fire and extended coverage policy, usually will send a salesman to the new home-owner. Customarily, the purpose of this visit is to sell additional insurance to the purchaser of the dwelling, frequently in the form of a homeowner's policy. This is a "cover-all" policy which includes not only the required fire and extended coverage but also covers the contents of the home and provides for a wide variety of other extensions, such as liability insurance and certain coverages which will be applicable when personal effects are being carried at large.

While such a policy may have some advantages to the home-owner, the sale of the policy and the increased cost involved frequently pose a problem to the mortgagee servicing the loan and handling the insurance reserve for the buyer. The existing policy may be amended, or a new policy containing the fire and extended coverage usually is issued. In any event, the payment for extra coverage may be handled in such a way as to create a situation whereby periodic payments for renewal from trust reserves may be insufficient, since a home-owner's policy may easily run double that of a minimum hazard insurance coverage. The home-owner may pay for the difference at the execution of the extra coverage and the problem will not develop until renewal time. Proper notification may or may not follow through to the trustee servicing the insurance and making the annual payments. The lender's loss statement may only indicate that a new policy has taken effect without a corresponding indication of increased cost. In this case, the mortgage company servicing the loan will not be aware that he should be collecting a larger amount than originally stipulated for insurance in the home-owner's monthly payments. At insurance paying time the servicing agency will, of course, become aware that insufficient funds are available and have to extract a large amount in a single collection from the home-owner as a deficiency.

Associated with the "tie-in" sale of home and insurance or the loan with insurance, sales of new homes in tract areas frequently will be misrepresented in regard to hazard insurance costs being sold with the first year's insurance paid for by the builder-seller. If question, an insurance agent representing the company holding the issued insurance frequently will indicate that the first year's insurance cost is of no concern to the home-buyer because it has already been paid for by the builder-seller, and he will not have to make any additional insurance payments for a year. This statement is a fact, but should be examined further. Yes, the builder-seller may have paid for a full year's insurance on the dwelling and the insurance company may have received such a payment in most cases. The strong implication is that the contractor is giving a year's insurance to the home-owner with the purchase price of the home. It is true also that the home-buyer will not have to make any further separate payments for almost another year.

However, this is what actually occurs in such cases. At closure a policy is issued or the existing policy is reassigned to the home-buyer. The buyer is charged with the cost of all of the new policy or most of the cost of the assigned policy except a small prorated portion representing the time insurance has been covering the dwelling prior to buyer's ownership. The buyer's payment for this policy, or major portion of the prorated policy, is accomplished through closure and extracted from or charged to his impounds deposit. It may be a one-year or three-year policy. By the proration method he is paying for a policy which the seller may have paid for, but the seller will have recaptured most of such payment as a credit through closure. The builder's policy, which may be reassigned through escrow, if not initiated at a high enough amount usually will have to be revised in order to cover the amount of the mortgage loan, which usually is higher than the interim loan to the builder. In many cases a new policy is issued by the same company and these arrangements will differ, dependent on the company. In any event, the buyer will be paying for this home insurance out of his impound charges through closure. The misrepresentations made by the insurance companies and salesmen that the builer-seller is paying for the insurance are vicious and obviously are made to protect the continuation of the interim insurance company or a subsidiary as an exclusive insurer of the individual houses after sale.

Cases are fairly common where the builder-seller receives a "consideration" from the exclusive insurance company for maintaining this continuity. Such consideration may amount to more than a casual profit to the builder-seller.

SUGGESTIONS:

To protect against these insurance practices, and make available to the purchaser of a dwelling a choice of how he wishes his insurance to be handled, it is suggested that the following provision be made at the time of initiating the contract, agreement to purchase, or deposit receipt, and followed through into any escrow agreement:

A statement would be required from the purchaser by FHA or VA at the time of contract execution that he wishes one of the methods listed for selection to be a part of the contract agreement. This statement would be a separate form provided by FHA or VA, on which a short explanation of the necessity for the insurance would be made, and the purchaser would indicate one of three selections in his own handwriting.

The selections would be as follows:

(a) I wish to provide for this insurance myself and will order a policy to become effective at closure.

(b) I wish to have my own insurance agent provide for and order the necessary insurance.

(c) I wish to accept any insurance provided by the builder-seller, mortgagee, escrow or title company.

Although it is recognized that the purchaser has the right to obtain the insurance to protect the property given to secure the note, and cannot be forced to take that which is assigned to him, in actual practice FHA and VA do not provide adequate protection. It would be only by such a written and signed choice required by FHA and VA that he would be aware of his rights. Such a provision also would provide for some measure of cooperation by FHA and VA with the Department of Justice.

The assignment of an insurance policy without specific authority of the person to whom the policy is being charged, is a questionable practice. In the event such reassigning or ordering is to be done, the authority should be clearly indicated by the home-buyer or veteran in the sales contract and suggested FHA or VA form.

As a guaranty that no assignment of a builder-seller's policy of hazard insurance will be made to the home-buyer, provision could easily be made that all construction insurance be automatically cancelled at closure date unless specific authorization from the veteran or home-buyer (in his own handwriting) has been made, indicating that the buyer is accepting whatever policy he may wish to be issued to him.

Failure of FHA or VA to curtail such insurance practices and "tie-in" sales of homes, loans, and insurance could lead to state control of the practice, in the absence of federal assistance and FHA and VA cooperation with the Department of Justice.

The suggested FHA or VA form requiring the purchaser to write in his insurance selection could be made a part of, or attached to the FHA Form No. 2562, "Statement of Appraised Value," as well as similar Certificate of Reasonable Value notice to the veteran as suggested in this report. It could be a perforated portion of the form, to be filled out and detached, with necessary copies, one to the home-owner, one to the closing officer, and one to FHA or VA.

Such a combined notice of appraised value under FHA and Certificate of Reasonable Value under VA coupled with an insurance selection indication by the buyer to prevent "tie-in" insurance and dwelling sales, would have a double value and would occur prior to the execution of any sales contracts or the entering of any escrow agreements. FHA and VA would have a copy of the insurance selection statement and, if they elected to cooperate with the request of the Department of Justice, could review or observe how the hazard insurance had been handled as a part of the FHA or VA insured or guaranteed loan, prior to their endorsement for insurance or guarantee.

The suggestion that the statement relative to the mortgagor selection be made in his own handwriting should immediately be recognized as a necessity by those familiar with forms the home-buyer or veteran is asked to sign. If such provision is not contained in the selection of insurance form, those closing the transaction can easily check an appropriate box opposite a printed statement and have the veteran or home-buyer sign the authorization. The matter could be represented as a formality while the actual selection of an insurance set-up will have been made by parties other than the mortgagor, one not necessarily to his advantage. When the veteran or home-buyer has to write out the full sentence containing his selection he is far more apt to be aware of the significance of what he is signing.

An additional suggestion, a further control in this matter of issuance of insurance, is one associated with a home-buyer's certification made at closure on such certification forms as are now employed by FHA (Form No. 2007) and by VA (Form No. 26-1876). These could easily be expanded to include a statement in the affirmative that the mortgagor was given a choice of insurance coverage prior to signing any purchase contract by having indicated in his own handwriting on the official FHA or VA form his decision as to whether he wished to place the hazard insurance himself, have his broker place it for him, or whether he was accepting any insurance the mortgagee (or others) wished to place on the property.

Though it is realized that the following suggestion can hardly be expected to receive much attention from socialistically oriented minds at the federal government level, the point is too important to be ignored.

Why is it necessary for some mortgagee-servicing agency to be engaged in the activity of collecting a small monthly payment from the home-buyer to place in a trust account for the purpose of paying the home-buyer's insurance policy on an annual basis? It is hard to see why the home-buyer cannot handle this himself. In most cases the annual payment on an insurance policy, even in the case of a three-year policy, is only a matter of som $30 to $50.

Certainly the policy required under FHA and VA regulations of having hazard insurance payments attended to by a servicing agency does much to bring our nation's owners of dwellings under further artificial "bottle-feeding." Surely, this tends toward weakening the individual fiber of the nation. Just how this contributes toward strengthening the people to resist the ever-pressing encroachment of government on the private rights, to preserve the reliance on the individual drive and responsibility that developed this great nation, is not overly clear.

Perhaps the real reason for this collection by the month, and the making of annual payments for insurance by the servicing agency is masked by the significant fact that, in so doing the mortgagee servicing the insurance policy will be provided with funds which can be deposited in trust accounts in institutions where they will serve as important lines of credit to the mortgagee. It must be kept in mind that such deposits do not draw interest for either the mortgagee or the mortgagor. However, they do provide a significant leverage to some mortgagees, since the institutions where the deposits are held make use of these funds as they do of other trust deposits and are in a position to extend credit to the mortgagees on a preferential basis. The deposit is of no value to the home-buyer, but forms a significant part of the financial operation of the lender.

Obviously the same points can be made for the much larger amounts collected for municipal tax funds held by the mortgagee and the FHA premium payments, both of which could be paid for directly by the mortgagor. To suggest that the mortgagor is not capable of doing this on his own is to intimate that we have home-owners in this nation who have no business involving themselves in the ownership of a home in the first place and had best remain as renters if they wish to be relieved of the responsibilities of managing their own affairs. We certainly tend to breed a nation of incompetents, who eventually would have the government do everything for them from birth to the grave, a government to which they would hand over their paychecks and have pocket-money doled back to them through some completely national control system. Certainly this tends gradually to break down the spirit of resistance to the inroads of communistic corrosion in our midst and fosters a weak foundation upon which to battle such tactics. Rather, we are providing the breeding ground for its further development.

AS A FINAL SUGGESTION:

FHA and VA should move immediately to eliminate the requirement in FHA and VA insured or guaranteed loans that the veteran or home-buyer make monthly remittance in his payments to the mortgagee for the purpose of paying for insurance on the physical property. Certainly the mortgagee would have ample protection, since the failure of the mortgagor to make his annual or semi-annual payments for insurance would result in notification to the mortgagee under the lender's -loss-payable provision of such insurance.

CHAPTER XV

CLOSURE CHARGES ASSOCIATED WITH ITEMS OF A CONTINUING NATURE

(Fire Insurance Reserve - Tax Payments - FHA Insurance Premium)

Section A - Fire Insurance Reserve

In addition to fire insurance closing costs for a full year (premium in advance) or a proration cost for an assigned policy which has been running for some time, charges also will be made to the mortgagor for a fire insurance reserve, a FHA insurance premium under FHA, and certain charges for municipal taxes and any assessments will be collected. All three of these are associated with continuing expenses the home-buyer will have to meet and all three of them will be covered in his monthly payment to the mortgagee, in addition to principal and interest payments. The monthly collections for these three items will be placed to the credit of the home-buyer in a continuing trust reserve, sometimes called an impound account, serviced by the mortgagee.

If the fire insurance policy has been purchased by the mortgagor, and paid for outside of escrow, no charge for a policy should be shown on the closing statement. However, there still will appear on the closing statement an amount collected for an insurance reserve, usually representing two monthly payments to the mortgagor's insurance reserve trust fund. The reason for what apparently (at first inspection) looks like paying twice for fire insurance is this--fire insurance policies are paid for in advance and, even if the policy has been paid for by the mortgagor outside of closure, immediate payments must be initiated to provide for a renewal of this policy next year in order to place the mortgagee servicing the loan in funds to make the advance annual payment. Usually two months of payments are collected at closure because the mortgagor's first payment on his mortgage (which will include his trust reserve payments) will not occur for at least another month, almost two months in many cases, dependent on when closure occurred. The mortgagee is directed to have such payments in the hands of the mortgagee within a period ending one month prior to the date on which such insurance becomes delinquent.

FHA regulations requiring these collections from the home-buyer at escrow closure are set forth as follows in FHA regulations, Section 203.26:

> Mortgagor's payments when mortgage is executed. The mortgagor must pay to the mortgagee, upon the execution of the mortgage, a sum that will be sufficient to pay the ground rents, if any, and the estimated taxes, special assessments, and fire and other hazard insurance premiums for the period beginning on the date to which such ground rents, taxes, assessments, and insurance premiums were last paid and ending on the date of the first monthly payment under the mortgage plus an amount sufficient to pay the mortgage insurance premium (FHA) from the date of closing the loan to the date of the first monthly payment. (underscoring supplied)

A further FHA section should be quoted which has specific reference to the continuing nature of the collections made by the mortgagee to cover costs of taxes and fire insurance. This Section 203.22 reads as follows:

> Mortgagor's payments to include other charges. (a) The mortgage shall provide for such equal monthly payments by the mortgagor to the mortgagee as will amortize the ground

> rents, if any, and the estimated amount of all taxes, special assessments, if any, and fire and other hazard insurance premiums, within a period ending one month prior to the date on which the same become delinquent. The mortgage shall further provide that such payments shall be held by the mortgagee in a manner satisfactory to the Commissioner. (underscoring supplied)

VA regulations relating to trust reserve collections at escrow closure, and continuing collections from the mortgagor (along with his monthly payment to principal and interest) are not similar to FHA. In the first place, there is no payment at closure or continuing collections for mortgage insurance. Under the VA mortgage guarantee program no insurance premium payments are made to the VA, as are made under the FHA insurance program. The VA guarantees the mortgage to the mortgagee and will pay for mortgagee losses actually sustained. VA then will, under its agreement with the veteran, recover actual payments it has had to make to the mortgagee from the veteran. VA does allow for a waiver of its rights to recover from the veteran in hardship cases. FHA covers the problem with its insurance program but issues debentures in place of cash payments to the mortgagee which must be sold (usually at a loss) in secondary markets by the mortgagee in order to make his position liquid.

Therefore, mortgagees are limited to but two closure charges and collections for the trust account under VA as follows: (a) collections for taxes and assessments and, (b) collections to pay for hazard insurance.

It is of interest to note the following remarks made in the VA Lenders Handbook in regard to tax and insurance payments to the mortgagee under Section 6075, as follows:

> Neither the law nor VA regulations require holders to collect periodic deposits for taxes and insurance or maintain a tax and insurance account. However, the establishment and maintenance of such an account is considered to be advantageous to all parties concerned and provision is made therefor in all VA approved mortgage and deed of trust forms. (underscoring supplied)

As the section indicates, there is no specific regulation providing for these payments to be made to the mortgagee under the VA program, as there is under FHA. However, as indicated by this section, the VA Form 4-6326 (Home Loan) Deed of Trust (the use of which is optional) covers the form prepared for the State of Nevada at the second and third pages as follows:

> (2) Together with, and in addition to, the monthly payments of principal and interest payable under the terms of the note secured hereby, he will pay to the holder on the first of each month until the said note is fully paid:
>
> (a) A sum equal to the ground rents if any and the taxes and assessments next due on the premises covered by this Deed of Trust, plus the premiums that will next become due and payable on policies of fire and other hazard insurance on the premises covered hereby (all as estimated by the holder, and of which the grantor is notified), less all sums already paid therefor, divided by the number of months to elapse before one month prior to the date when such ground rents, premiums, taxes and assessments will become delinquent, such sums to be held by the holder in trust to pay said ground rents, premiums, taxes, and assessments, before the same become delinquent. (underscoring supplied)

Section B - Tax Payment Reserve

The closing statement to the veteran or home-buyer will include an amount for taxes on the property under a tax reserve item. If carefully itemized on the closing statement, this tax reserve will indicate for how many months the reserve has been collected. This will depend entirely upon the time of the year the escrow closed, since taxes are paid on a fiscal year basis in Nevada. In the event a closure occurred shortly after July 1st of any year, the tax reserve collected would be a relatively small amount. If closure occurred later in the fiscal year, say February, it would be a much larger amount.

Usually the mortgagee will include on any statement of charges to the mortgagor information relative to how much is to be collected for this tax reserve, unless the mortgagee is handling his own closure.

The home-buyer should not be overly concerned about the amount collected through this tax reserve (if the closure is properly executed) since there will be a tax proration as a credit to him from the builder-seller to cover for the amount of time title to the property was in the hands of the seller. In effect, there will be an offset of charges and credits covering that portion of the tax reserve charge representing time for which the home-buyer is not responsible. The additional amount in excess of the tax proration offset is represented by a reserve amount collected (usually for two months) for which the buyer is responsible; this is collected at closure since his first tax payments on a monthly basis may not be made for up to two months. If closure occurred in early May, his first payment to trust funds, made with his interest and principal payment, would not come until July 1st.

The above paragraph assumes that the matter of tax prorations has been handled as the escrow or deposit receipt directs. In almost all cases these documents will provide for tax proration. This means that the buyer will receive a credit on his closure statement covering the period of time the builder-seller had title to the property. Apparently this matter is one subject to loose handling. Some closing statements examined contained no credit for this item at all for the buyer, in spite of specific escrow instructions covering the point.

Closing officers have a difficult problem in making tax prorations on most new sales type home closures under FHA and VA because of an incomplete tax basis. Since homes are being built in an area which may have been raw land or partially developed land the year before, there may not be an accurate tax basis upon which to make the directed proration. A reference to the tax roll may indicate a former tax based upon undeveloped land, which will not reflect what the buyer will be taxed for the full fiscal year. At tax-paying time, the servicing agency will deduct from the buyer's trust reserve an amount covering a full 12 months of taxes, very likely based on improved real estate. However, if the closing officer based his proration strictly upon unimproved land for the portion of time the seller owned the property, and made only such a proration to the buyer, it can readily be seen that in many cases the home-buyer may be paying a large tax bill with little proration from the seller to assist in making such a tax payment.

It should be realized that the closing officer is working in the interests of both the buyer and seller. In those cases where an obsolete tax basis is the only official figure available to the closing officer, he should make every effort to evolve a reasonable estimate based perhaps on other like homes in an adjoining or similar tract area in that section of town. Most officers will do this and will not strictly limit themselves to the figure given on an unimproved or partially improved land tax from the previous fiscal year. Both FHA and VA direct mortgagees to make reasonable estimates (to any closing officers) to prevent later billings for excessive deficiencies.

The entire matter is made difficult under the existing duties of tax assessment requirements of our Nevada counties. It would take a separate study of some depth to arrive at suggested changes in the matter of county assessments to bring the tax proration basis into current focus and, most important, enable closing officers in all Nevada counties to be provided with up-to-date assessment figures.

The home-buyer would be wise to inquire of the mortgagee or escrow officer, prior to closure, upon what basis the tax proration is being figured and if, in fact, the officer has taken into consideration a practical proration charge to the builder-seller. Where a closure occurs with several months of tax proration to be collected from the seller, and the actual credit to the home-buyer is scarcely equal to a month or more of tax reserve he is being required to pay, obviously the builder-seller charge is based upon undeveloped land and the veteran or home-buyer immediately should protest.

Section C - FHA Insurance Premium Reserve

In addition to the current 5-1/4% rate of interest for which FHA will insure mortgages, which interest rate the home-buyer will pay for monthly in his payments to principal and interest, an additional 1/2% is collected by FHA as a mortgage-insured premium charge. The total rate of interest on an FHA guaranteed loan therefore is 5-3/4%, while on a VA loan, where no such premium is charged, the base 5-1/4% rate of interest prevails. It should be pointed out that, in some cases and in some situations a small portion of this 1/2% FHA premium payment is returned to the home-buyer if he sells his home. However, there are limitations on what can be returned and the bulk of such payments are held in reserve by FHA to cover for and insure the loans they are making. Under the VA program, as heretofore pointed out, the veteran is responsible to the government agency. Under FHA, the home-buyer is paying for mortgage insurance protection. Any losses sustained by the mortgagee are paid for out of the FHA Mortgage Insurance Premium Fund.

This FHA premium charge will be collected at closure and will be a continuing collection from the home-buyer, along with his payments to principal and interest on a monthly basis, also with collections for the other two trust reserve or impound items. The amount will decrease each year, and the monthly amount and annual changes are indicated on the mortgagor's copy of the FHA amortization schedule, frequently not sent to him by the mortgagee.

In former years, the FHA premium insurance was collected in advance on the basis of a full year and, similar to the fire insurance premium charge, collected in advance. Since the mortgagor would not be making his first payment to his trust account for some weeks, an additional month of premium also was collected, resulting in a total of 13 monthly FHA premium charge collections at closure. FHA has moved to eliminate the necessity for the pre-payment of this FHA mortgage insurance, and the closure statement now contains a collection representing a charge for a single month's premium for FHA insurance. The government bills the servicing agency once a year and the mortgagee makes this payment from the mortgagor's trust account after the period of time covered by the insurance.

FHA regulations covering the matter of this premium collection are not overly clear. In one section this monthly collection by the mortgagee is optional. In the mortgagee's handbook obviously it is a requirement.

Again, it should be pointed out that the servicing agency has the use of this money collected from the home-buyer, which is kept in a trust account for him. He cannot receive interest on these funds. However, they do constitute deposits for the mortgagee when held in certain banks from which the mortgagee may receive preferential treatment in his requirements for funds.

Section 203.22 of FHA regulations offers the following language which clearly indicates, in regard to continuing FHA mortgage insurance premium payments, that the matter is elective, not mandatory. The section reads as follows:

> Payment of insurance premiums or charges; prepayment premiums. (a) The mortgage may provide for monthly payments by the mortgagor to the mortgagee of an amount equal to one-twelfth of the annual mortgage insurance premium payable by the mortgagee to the Commissioner. (underscoring supplied)

However, in the FHA Mortgagees' Handbook, the following directive is contained in Chapter XIII at Section 1305, as follows:

> Income for Basic Insurance Program: In addition to initial fees paid in connection with insuring a mortgage, under all of the FHA's mortgage insurance programs the borrower is required to deposit monthly with the lender an amount of money which will put the lender in funds for the purpose of paying to the FHA the annual mortgage insurance premiums when due. (underscoring supplied)

The two foregoing illustrations are given to emphasize the lack of consistency between the FHA Regulations and FHA Mortgagees' Handbook, relative to the continuing collection of FHA premium payments. Of practical consideration is the fact that FHA bills the mortgagee servicing the loan for the FHA monthly premium charges. Naturally, under the mechanics of the system, the mortgagee would have to secure the funds from the mortgagor. However, if regulations permitted, this could be done through one collection a month or so prior to the time needed by the mortgagee, thus eliminating the advance collections now impressed.

PRACTICAL APPLICATION:

In this chapter the practical application has been noted, along with an explanation of the three separate items.

SUGGESTIONS:

The basic principal of having provisions for a trust account in the first place is treated in detail in a following chapter on servicing the impound account belonging to the home-buyer. The chapter severely criticizes the trust account and points out the reasons why. Apparently it exists more for the advantage of the mortgagee than the mortgagor.

No suggestions are offered in the matter of the monthly charge collection for the fire insurance reserve, except to point out that this also might be collected at one time, when due, thus eliminating the advance collection now impressed. The matter of the issuance of the fire insurance policy itself is treated in the previous chapter.

The tax reserve collection likewise is based on actual taxes, which will be a charge against the home-buyer at tax paying time. If properly estimated, this should result in no significant overage or deficiency unless there have been changes in the taxing basis, new assessments, or veterans' exemptions.

There is one major flaw in the matter of tax prorations as a credit to the home-buyer, as pointed out in this chapter. The matter will be dealt with and suggestions made in a following chapter.

FHA insurance premium charges collected monthly are a basic figure which is not subject to change within a given 12 month period, and between 12 month intervals only very slightly reduced. These are separately indicated on the amortization schedule theoretically made available to the mortgagor.

The reader should specifically review the material presented at the end of the previous chapter on hazard insurance (under Suggestions) which emphasized the weakness which develops through application of government requirements for "nursing" the veteran and home-owner and providing an artificial set-up whereby he need have no concern relative to his obligations for taxes, insurance, and any FHA premium payments.

Such required surrender of responsibility under FHA and VA regulations can but contribute to a lessening of the structural fiber of individuality and initiative, upon which this nation was developed, and provides a breeding ground for capitulation of the individual to government rather than development of the government as a servant at the will of the people. We cannot too strongly emphasize that eventually such a tendency can lead to a totalitarian state.

CHAPTER XVI

CLOSURE COLLECTIONS WHICH ARE CREDITED TO BUYER'S TRUST RESERVE

Chapter XV indicated three items of a continuing nature which are charges representing collections FHA or VA authorizes and requires to be made from the veteran or home-buyer by the mortgagee. These collections, along with payments made each month when the mortgagor pays his principal and interest to the mortgagee, are placed in what is called a "reserve account," "trust account," or "impound account." Whatever term may be employed, the funds remain the property of the mortgagor and if he sells his property will be returned to him, less actual disbursements and prorations.

Difficulties from the buyer's standpoint in the servicing or administration of this account are discussed in a following chapter. Likewise, the necessity for the account in the first place is discussed in a later chapter. Eliminating these two considerations from this chapter, the following discussion will cover the mechanics of this reserve trust account.

The mortgagee servicing the account will place the collections made at closure, and future collections made each month, into the home-buyer's reserve trust account. Out of this account he will make payments as they become due for taxes, fire insurance, and FHA insurance premiums. The mortgagee is billed directly for these payments, the tax bills coming to him through any tax paying service heretofore mentioned, the government billing the mortgagee directly for FHA premiums, and the insurance company for hazard or fire insurance.

PRACTICAL APPLICATION:

Taxes and assessments are not stable and known items such as the FHA mortgage insurance premium, which is known in advance under the amortization schedule and which decreases very slightly every year. Taxes are subject to increases since new assessments may be made against the subject property, and decreases may develop through the filing of exemption certificates involving the property. The mortgagee will have to bill the mortgagor separately when it reviews the reserve held for taxes and finds that a deficit exists. At the same time, it is usual for the monthly payments to impounds to be increased in order to reflect the tax and assessment increase and prevent a deficit from developing the next year. Naturally, where taxes are rising with adjustments of an annual nature, the mortgagee may find the mortgagor's tax reserve deficient whenever the annual tax bill arrives and that he cannot keep ahead of the necessity for a separate billing for such deficiencies.

The hazard insurance policy may be an annual one or written for three or more years. If written for several years the annual premium will be the same and no deficiency should develop. However, rates can go up or down (more commonly the latter) and this fluctuation can also result in discrepancies in what is available for payment of the insurance, and what may be charged in the future.

Sometime after closure the mortgagor should receive from the mortgagee some form of statement (or payment book) indicating that funds collected at closure for taxes, fire insurance, and any FHA premiums, have actually been credited to his account. This is not the responsibility of any escrow or title company that may have closed the

the transaction and merely collects these closing items from the mortgagor and turns them over to the mortgagee. The mortgagee is charged with setting up and administering the trust account for the veteran or home-buyer under FHA and VA directives. He may have received the collections but improperly credited the mortgagor. In some cases, any evidence of credits to the buyer may not be forthcoming until some annual statement of disbursements and credits is received from the servicing agency (mortgagee). This critical aspect is discussed in a later chapter.

Under FHA and VA regulations these trust accounts must be kept separate from other funds of the servicing institution and placed in banks or other depositories as trust accounts. They earn no interest for either the trustee or trustor. However, the deposit of large sums of trust moneys with a single institution enables the mortgagees to establish "lines of credit" with banking institutions and is therefore an important asset to the lender. Without a "line of credit" to certain eastern banks or local institutions, some mortgagees would not be in such a favorable position and mortgagor's costs for borrowing might be increased, a matter also discussed further in a following chapter.

In this connections, it is of interest to quote from Legislative Document (1961) No. 8, issued by the State of New York as a Report of the Committee on Mortgage and Real Estate to the Assembly of the State of New York, March 15, 1961. The report had just finished a scathing attack upon the practice of the discount or placement fee, as evidenced by operations in New York. Reference was made to trust or impound accounts as a second hidden charge paid by the home-buyer, as follows:

> The second hidden charge paid by the mortgage seeker is born out of the practice of many institutions of requiring prepayment of real estate taxes and insurance with the funds being placed in an escrow account until disbursed to the municipality or insurance company. These funds are collected monthly by the institution along with interest and amortization payments and held without interest credit for up to three years in the case of insurance monies and one year in the case of taxes.

Under current FHA and VA regulations, the institutions trafficing in loans guaranteed by these government agencies are required to resort to this practice. Certain measures and suggestions relative to these trust funds will be given in the chapter devoted to servicing of the loan.

SUGGESTION:

If FHA and VA insist upon impressing the trust reserve system on the purchaser, then these agencies should review whatever evidence is afforded to see if he has been given credit for collections made by way of charges on his closing statement. It may be necessary for FHA and VA to institute new processing and requirements to cover this area. It is not unusual to find that the mortgagee may have specified a certain amount to be collected for tax reserve on his statement to an escrow officer, then, at a later date may have modified this statement due to a lag in closure to provide for a larger collection. The larger collection will have been made from the home-buyer and so indicated on the closing statement. However, credit on the mortgagor's trust reserve account established by the mortgagee may be for the smaller and original amount directed to be collected by the mortgagee. Changes in directives for collections are common and associated with cases where closures have not proceeded as anticipated. Naturally, the tax collection reserve will become larger as the weeks pass between opening and closure of escrows, which sometimes can take months where complications arise.

A similar check should be made by FHA and VA to see that collections for hazard (fire) insurance have been properly credited to the buyer, as well as any FHA insurance premium payment collected through closure.

CHAPTER XVII

CREDITS ON CLOSING STATEMENT TO BUYER

On an itemized statement of closure made to the veteran or home-buyer, most of the amounts entered naturally will be charges; however, an adjoining column will carry those items which are credits to the buyer. Although few in number, the sum total of these should be identical to the total of all charges. The nature of these credits, and the reason for their being made, will be discussed in this chapter.

The largest credit to the buyer will be the loan granted by the mortgagee, variously labeled, but usually identified as "By First Deed of Trust," which is the "mortgage" of eastern transactions, though differing in a number of importantrespects. This largest of all separate entires (excepting the sale price of the dwelling) will have been made available by the mortgagee or through the mortgagee to the escrow or title company closing the transaction immediately prior to and almost simultaneously with the closing. In other words, it will be "funded" shortly prior to closure so as not to tie up large amounts of money which would be a cost to the mortgagee (usually not investing any of his own funds if a mortgage company) on which he could not collect interest prior to closure. The loan entered as a credit to the veteran or home-buyer should be exactly the amount stated in the note. However, the full amount may not be disbursed by the mortgagee, a violation of federal regulations and a matter discussed separately in a chapter devoted to the problem.

The next largest item normally shown under credits is listed as a deposit or as deposits. The deposits may be listed separately, but more frequently in one lump sum. These are amounts which the home-buyer paid over to the builder-seller at execution of the basic contract as a down payment, if any, and amounts for closing costs. Additional amounts may represent any final payment called for under the contract or deposit receipt, to be made by a certain date (usually under FHA) for the balance of the sale price not covered by the loan. Other deposits may be required at later dates under terms of the contract and may be made as late as a day or so prior to closure when the closing officer has determined what is necessary to cover additional buyer obligations associated with closure costs and trust impounds.

There should be a credit for any prorations agreed to between buyer and seller, commonly the tax proration discussed in detail in Chapter XVI. Also, there may be an "adjusted" credit to the home-buyer for over-payment by deposits to balance the closing statement, and credits for closing costs charged to the seller. The total of all charges and credits will have to include these last considerations and some may result in credits to the buyer.

PRACTICAL APPLICATION:

This has been discussed along with the items of credits in this chapter.

SUGGESTIONS:

Since FHA and VA do not provide for a review of the original closing statement in regard to proper credits to the veteran or home-buyer, this is a matter where he must assert himself and make sure he has been dealt with fairly.

Since FHA and VA have been responsible for the complexity of the closing statement and associated collections for impound accounts (apparently an entire system not primarily of benefit to the mortgagor), it is strongly suggested that FHA and VA, having so confused the purchase for the home-buyer, should be charged with protecting the mortgagor by a review of credits to see if they have been properly recorded. This will undoubtedly require additional processing and regulations to be issued by FHA and VA.

Certainly a review of charges made to the home-buyer to see whether there are any which cannot be justified under FHA and VA regulations is highly important. However, if improper credits have been made, there is another area wherein the mortgagor can be dealt with unfairly. Both sides of the ledger must receive examination or we might as well let the whole process of FHA and VA review of closing costs pass by the board.

Again, FHA and VA (in addition to the ordinary sales agreement) should require a copy of any escrow agreements, in order to know what should be credited. As noted in a previous chapter, a standard escrow agreement will call for tax prorations. However, no proration may have been made. This is a loss to the home-buyer and fully as important as a charge not acceptable under FHA or VA regulations.

In the absence of any review by government insuring or guaranteeing agencies the veteran or home-buyer must examine for himself the closure statement of credits for the following:

(a) Have all deposits he made either to the builder-seller, mortgagee, escrow or title company, or other parties for the purchase of the home, been properly recorded as individual credits or at least shown as a correct lump sum total?

(b) Does the First Deed of Trust credit entry agree with the executed note covering that amount being loaned by the mortgagee?

(c) Has a credit been made for tax proration and is this a token amount or actually an amount representing the number of months for which he did not own the property, as reflected in monthly tax collections scheduled to be collected from him? It should be remembered that the tax bill will cover an entire year and the buyer will have to pay for a year's taxes although he may not have owned the property for several months in that fiscal year, hence the proration.

(d) Have the closing costs of the seller been indicated as a credit to him? Only by having a copy of the closing costs to the seller can he be sure, a document seldom made available to the home-buyer but strongly suggested in this report.

(e) Has he been given credit for any other prorations provided for in his deposit receipt or escrow document, and any over-collections?

In the absence of strict FHA and VA review of these credits, the buyer is on his own and must review them if he wishes to be protected.

FHA or VA, working in close cooperation, are not in possession of all information as to what collections have been made from the home-buyer. Some are only evidenced by a proper receipt to the purchaser. Cash may have been given for a credit report, a hasty call from the closing officer for a relatively small check or a shockingly large one in order to close. These are hard for the federal agencies to trace, the home-buyer must be aware of what he has paid. FHA and VA should immediately move to provide processing procedures which will provide an accurate review of all collections made from the purchaser and make certain proper credit has been given the buyer.

Machinery could be devised which would make a reporting to FHA and VA of what monies have been collected. These are now supposed to show on some statements made to FHA or VA, however, some may not be properly reported.

The proper use of a FHA-VA deposit receipt, as suggested elsewhere in this report, could go a long way toward elimination of some of the uncertainty as to what the veteran or home-buyer should be credited with at closure. By reference to such a required FHA or VA deposit receipt form, both FHA and VA would be in a much better position to protect the veteran and home-buyer, should they elect to do so.

PART III

THE DISCOUNT

The chapters presented in this Part III explain how the discount, common to business practice for many years, has been employed to cover an entirely new situation which has developed since the introduction of the FHA and VA mortgage insurance and guarantee programs. The necessity for the practice is clearly established and a history of governmental attempts to control it is traced. This report provides what is believed to be a very practical solution to the problem, one with political implications which may be hard for any incumbent administration to deal with objectively.

Chapters on appraisal practices under both FHA and VA are included in this Part III, since there is a close association between appraised value and the ability to cover for discount considerations. For the same reason a chapter on loan disbursements by the mortgagee is included, since this is directly associated with evasions of FHA and VA regulations apparently created by the discount problem.

CHAPTER XVIII

THE DISCOUNT -- AS A DEVICE

Since maximum interest rates allowable under either FHA or VA insured or guaranteed loans are lower than required to produce an income the investor feels necessary to make home loans a profitable venture, the discount is employed to increase the return on his investment above that which would accrue from a controlled and stated rate of interest.

To an approved FHA or VA borrower who offers his home as security, the mortgagee will make a loan at a stated rate of interest (currently 5-1/4%) but will either make a direct charge of points (payment of a specific amount to make the loan) or indirectly charge a discount (repayment of a loan and execution of a note by the mortgagor in a given amount but a lesser amount actually released by the mortgagee). By either method, the mortgagee or lending institution acquires in advance several hundreds of dollars, which is tantamount to additional interest, or yield, on the loan. An FHA release offers the following example:

> Assume that an investor has a choice of investing $10,000 in a high-grade corporate bond which will earn 6%, or of investing $10,000 in a mortgage having an interest rate of 5 1/4%. The investor would favor the bond unless it is possible to buy the mortgage at a reduced price so that the 5 1/4% interest and the repayment of the $10,000 will give the same yield as the 6% interest on the bond. (In computing yield, lenders generally assume that the average home mortgage will be paid in full in 12 years rather than the full term of the mortgage, which may be 30 years or more.) Standard investment tables show that 5 1/4% interest and the principal repayment will give a 6% return if the $10,000 mortgage can be purchased for $9,400, or 6% less than the amount of the mortgage. This difference is called discount or "points."

In addition, a direct service fee (or origination charge) usually is made. This amounts to a flat 1% of the face of the note or the amount of the loan. Also a variety of lesser direct mortgagor costs are imposed by the lender.

These devices result in the home-buyer paying an actual interest rate far above that stated in his note, expressed as the rate of interest associated with his monthly payment, and insured or guaranteed by FHA or VA. In the event that he is paying off a loan which was discounted (and several hundred dollars less than the face of the note were actually made available to him directly by the mortgagee) he will be paying back both principal and interest on money never loaned by the mortgagee, a matter discussed in detail in a following chapter.

A common practice of builders in association with lending institutions is for the builder to pay the differential of several hundred dollars by which the loan has been discounted by the lending institution, since both FHA and VA will not allow the mortgagor to pay this directly. Usually the builder pays this differential directly at closure so that the closing statement of the home purchaser can always show the full amount of the face of the note made available to him. The builder in turn (more often than not) merely adds on the several hundred dollars, or any portion of it the traffic will bear, in the sale price of the home. Thus, the home purchaser pays the discount indirectly. Directly or indirectly, the purchaser pays for the discount in most cases.

Just how the FHA or VA may establish the appraisal value of the house to justify the inflated sale price, and accommodate for this collection, is a question which will receive attention in a later chapter.

No other cost factor in originating a mortgage loan can have such an important bearing on the home owner's overall charge for financing his purchase as the matter of the discount. The term is talked of in many quarters and the buyer is generally aware of it. However, to define it, explain how it operates, cite the necessity for it, and cover what has been done about it in the past, is not a simple matter. Other names for this device (employed to circumvent the spirit of the government insurance and guarantee programs) are, "points," "placement fee," or "financing fee."

The terms "discount," and "points" are employed interchangeably by many and the precise difference between their meanings in the business world depends more on the transaction they are associated with than any exact and distinct difference between them at large.

Discount is a term which has been used by lending institutions for a long while and we might say is the "senior partner" of the two. Common practice when making loans was to charge a rate of interest and/or to hold back the full disbursement of the amount being borrowed. The lender would "discount" the loan in advance and not give a full $1,000 on a $1,000 loan. The term "points" is a somewhat newer and oblique reference to the amount of the discount or in place of mentioning a discount.

In regard to FHA or VA home purchases, "points" is a term which has more general applicability. Under these government programs the lender must disburse the full amount of the loan (although many are violating FHA and VA regulations on this point), and does not hold back in advance. The "points" (representing what would be a discount in advance) are paid at escrow closure as a seller charge following a directive statement from the mortgagee. The seller will usually have provided for the offset in an increase in sale price to the home buyer. In other words, the "points" paid for making the loan amount to what the "discount" would have been if made in advance. Actually it is still a discount whether made in advance or not. We might say that the term "points" is typical of expressing what the discount is on a home transaction and also is applied to other transactions in the market.

It should be realized in the beginning that "discount" and "points" have been with the business world for a long time and will undoubtedly be with it for a long time to come. It is a vital necessity in the economy of the capitalistic system. It facilitates the transfer of commercial "paper" and other loans. No one should categorically condemn this "tool" of the business world. It is only when the discount is employed for ulterior purposes that suspicion arises.

It cannot be too strongly stressed that no inference should be drawn from any of the foregoing material to the effect that it even remotely suggests governmental control of the rate of return lenders should obtain from their loans. Our nation was developed under a system of free business enterprise, without governmental regulation, artificial stimulus or control over where, how, by whom, and at what return, vast amounts of capital might be invested toward developing the nation and also protecting it with a tremendous privately-owned manufacturing, distributing, and agricultural system resting on an abundance of natural resources. It would be utter folly to attempt the forcing of funds into selected developments under restrictions as to what return should accrue to those who have wisely chosen to make available their financial resources for development. Such controls smack of socialism and are unalterably in opposition to our national heritage. What will be demonstrated in this chapter is how practical and proven methods of financing have become distorted by governmental regulations which do not properly assess the facts of economic life, and provide for them. Certain basic political forces are at work striving to muffle the voice in the wilderness crying out against the abuses and the inflated costs to the consumer and the purchaser of a home.

The report strongly advises against any forced controls which would restrict profit and legitimate return to investors. The reader of this report should, therefore, divorce from his mind any socialistic implications which might be drawn from material presented in this chapter. Quite the contrary, the report will attempt to identify a solution so the lender and the veteran or home-buyer will be relieved of the fantastic and artificial system with which a large segment of our basic home industry is saddled at the present time. The loss of confidence in this industry by the people of the nation could have serious consequences, and provide the seed bed from which could spring unrest and confusion concerning man's basic social and economic foundation, his castle, his home, his dwelling place, the very hearthstone of democracy and its principals.

If market conditions were absolutely stable, there would possibly be little need for a discount and points system. However, business paper and securities which offer a return to the holder have a value which fluctuates due to the ups and downs of the economy, and in particular, the fluctuations of the security or paper with which it is associated. Bonds may be attractive to some portfolios at certain times, stocks at another, commercial paper at some other time, and commodities and foreign obligations at still another. In this vast complex of business interests and the inter-relationships between ownerships of obligations and their returns, there is the established fact that the bond or the commerical paper (perhaps a short-term contract, note, or mortgage) has a fixed rate of return. The fixed rate may have been established some years ago, or only recently. In any event, since the establishment of the rate market conditions usually will have changed. In cases where the return is now "below market," to transfer or sell such commercial paper it would be necessary to sell at a "discount" or to be charged "points" to equalize and reflect a new situation not obtaining when the "paper" was executed. Equalization is brought about by the "discount or points," which in the case of some older commercial paper, may be a sizeable amount, resulting in far more than a shading of rates of interest between, say 5-1/4% and 5-1/2%.

Therefore, we can establish the need of one party who has offered to buy some commercial paper or loans in a secondary market. In making his purchase, however, he will do so only at a discount. He will take the paper but will charge "points" to the current holder--the points representing the discount. A question might logically be raised in regard to why a seller would accept such charge. Might he not refuse to accept the discount and sell only at the face value of the paper he holds? Yes, he could attempt to, but if he wishes to liquidate and employ his funds in other more attractive investments, he must sell at whatever "market" discount has been established. It should be kept in mind that all institutions and individuals do not invest via a similar pattern. Some initiate loans, some are interested in short-term gains, others in an unearned increment, still others in long-term gains. So we have those who are interested in selling and those who are interested in purchasing. However, when a loan or commerical paper is out of line compared to current "market" on its fixed rate of return, some method must be devised to partially offset such a disparity. Transactions between purchaser and seller may not require any "equalization" when return on paper is close to "market," since one has a strong desire to divest himself of his holdings and the other has an equally strong desire to capture for his portfolio the holdings of the seller. However, when rates of return on commercial paper are too far out of line, then the seller offers some method of bringing the return into closer correlation with the market. The method is to have the purchaser, through a discount or points, pay less than "face" to the seller. On the other hand, if the commercial paper or loan package executed in profitable times has become attractive under depressed conditions, it could demand a premium on the market and obviously be free of discount or points under transactions. In such a case the buyer would pay the seller "over face value" for the paper.

In the illustrations given so far, the discount or points discussion has been limited to a discussion of transfer of commercial paper after it has been executed and a rate of return established. This is a cardinal point. The discount in this case is necessary to provide for circumstances which have changed since a fixed rate of return was agreed upon.

There is another significant area in which a discount (or points) is used. Rates of return expressed as interest usually are identified in 1/4% increments, especially when dealing with mortgage rates. Securities and bond transactions and other rates of return when expressed as interest rates are further broken down to 1/8% or smaller increment. Under conventional and FHA or VA loans for mortgages or deeds of trust, the rate of return is not usually expressed in any other rates than a whole number or a whole number plus a 1/4%, 1/2% or 3/4%. Where competition among lenders exists during a borrowers' market, or where (more commonly) there is competition among borrowers for available lenders' funds, frequently a situation will exist whereby the lenders cannot go up or down a full 1/4% and still remain competitive and realistic. In order to shade such differentials, where a full 1/4% is not necessary, the employment of a small discount or a charge for points accomplishes the purpose. When the discount or points system is used in this manner, it is allowing a greater return to the lender or an inducement to the borrower but is not masking a cost factor any greater than 1/4%, and the rate of interest expressed on the loan is still realistic to within that very small 1/4% and usually within a much smaller percent.

To review then, the discount or points is used to move commercial paper in an "after" market. The discount may be quite large to provide for a practical consideration where considerable disparity will have developed between original "market" and current "market." Discount and points are also employed to shade in between 1/4% on "initiations of loans" made to borrowers in the mortgage market.

Since the advent of the FHA and VA guarantee programs, there has developed a third area for the employment of the discount or points, a situation completely foreign to the purposes for which originally developed and one which carries with it very marked overtones of deception and masking of true costs to the borrower or purchaser of a dwelling. Such discount was born of necessity, was fostered and nourished by artificial governmental regulation, and (with the exception of two short periods in the history of the FHA and VA programs) fully condoned by the government.

CHAPTER XIX

THE DISCOUNT - PRACTICAL APPLICATION

FHA and VA establish a nationwide rate of interest at which they will insure and guarantee home loan mortgages. Currently this is 5-1/4% under both FHA and VA programs. This rate is set on a frozen national basis rather than a regional area approach. In the New England and Middle Atlantic areas, which are close to the money market for not only the nation but much of the financing of foreign enterprises, mortgage loans may be made by some institutions which are at this "par" or not much above the 5-1/4% ceiling placed on the interest rate by the government agencies. However, in the west (Nevada in particular) these loans are closer to 6-1/2%. Institutions are not required to lend at 5-1/4% on mortgage loans, but the government will not guarantee a loan made at a rate any higher than 5-1/4% under the FHA and VA programs.

Economists point out that money is a very fluid factor and can be shifted about the land with very little difficulty from those points where it has accumulated to areas where needed, while buildings, people, equipment and various improvements are hard to shift. Also, money is not as directly affected by climate, and other physical geographic factors which could prove difficult to both people and materials. Governmental factors in an area can act to mitigate an influx of capital through confiscatory policies, taxation and general instability. However, in spite of the very fluid nature of money (or capital) when it moves out of the east and into the south or west it does so at a premium. It is not transportation which levies the charge, it is the indirect manner in which the transfer is accomplished. There are in-between costs, brokerages, finders' fees, "arrangements" and what-not, which result in money costing more on the Pacific coast than it does on the eastern seaborad at the money capital of the world. Investing at a distance does require some minimal survey by the lender through his "agents" to establish that the venture is a safe one. Here in the west FHA and VA loans are most unusual when made at "par" or without a strong discount or charge for points.

A second consideration must be given to the Nevada situation in regard to obtaining mortgage money. In Nevada, we obtain a substantial portion of our mortgage money from a secondary market, namely California. To get the capital up and over the "hill" from San Francisco or across the "desert" into Las Vegas, represents a backflow from the "coast" which has already experienced a charge to that point. The money trade frequently makes reference to the fact that it takes another "point" to get it into Nevada.

The FHA and VA programs fail to provide for the economic "facts of life" illustrated. In the west, and particularly in Nevada, we have generated quite a disparity between the market rate of interest on a mortgage loan and what the government programs will allow to be guaranteed. The disparity is not so critical in the mid-west or in the east but apparently is most severe in parts of the south, southwest, and the far-west. Failure to provide for some regional treatment of guaranteed rates of interest (or some other method designed to recognize market conditions) has led to the big problem of the "discount" as associated with home purchases in Nevada.

The development of the discount (or points or placement fee) as associated with FHA and VA transactions, is a unique one. As pointed out, the discount has been with us a long time and is primarily used to move old commercial paper in the "after" market or employed to shade interest rates between 1/4% of interest.

Since the FHA and VA programs do not allow for a rate of return on investment greater than 5-1/4%, this relative low yield (especially in the far west) is insufficient to attract investors to the area for the purpose of making mortgage money available for home construction and sales. In order to secure the reasonable yield necessary, the discount has been expanded as a charge for points or a placement. This goes way beyond the original provisions for shading an interest rate on originations of loans. It must be remembered that FHA and VA loans are being established as of the moment. It is not a matter of moving some commercial paper in the "after" market several months or many years after an established rate of return has been selected. In order to make the loans, the mortgagee must require a much larger return than 5-1/4%. However, he cannot jump this to 6-1/2% or FHA and VA would not insure the loan. In place of a straightforward known rate of interest charge, the mortgagee is forced by artificial government regulations to invoke the discount or points device. However, he applies covering a full 1-1/2% or more of interest on an initial origination of a loan, not to shade a 1/4% of interest and not associated with a commercial transfer occurring many months after market conditions have changed. Under conventional transactions, the rate of real interest would be stated, plus (if necessary) a shading for discount or points. In truth, the discount or points as employed in FHA and VA transactions, is a device for extracting a necessarily higher yield to the investor far beyond that which a conventional discount is designed to produce in most conventional transactions. The tool is being employed in such a fashion as to deceive by masking the true cost of borrowing money for a home. The subterfuge is aimed directly at the veteran or home-buyer under the red tape and generated complexity of both government programs.

An intelligent person would immediately ask why this deception is practiced by our government agencies. Would it not be possible to come closer to the economic facts of life, even though that might mean adjustments of a periodic nature and possibly the establishment of different regions reflecting market conditions which differ in various sections of the country?

This report can only suggest that perhaps it is not politically wise for any federal administration to move toward lifting the interest rate allowed to be charged to the home-buyers of the nation under FHA and VA programs. This could be so, no matter which party was in control of the federal government. However, it is of tremendous political advantage to lower the interest rate, which is then made a ceiling for the mortgagee and one which he cannot outwardly go above. The average tax-paying citizen lauds the administrative leaders when a lowering of interest rates is announced. He believes that the administration certainly has the interests of the little man at heart and is moved to do battle with the greedy mortgagees, holding them in line and forcing them to retreat into their halls, as the money changers of old. Truly, the government is the guardian of the home-buyer. It is interesting to note since the recent change in administration at the federal level, that the interest rate on FHA guaranteed loans has been lowered twice, from 5-3/4% down to 5-1/2% on February 8, 1961, and down again on May 29, 1961 to only 5-1/4%. In almost all cases where the guaranteed rate of interest has been reduced, there has been a significant matching rise in the discount rate. In the long run, the buyer is paying the same cost for his mortgage but out of the left hand pocket in place of the right. It should not be categorically stated that the lowering of interest had no effect whatever on a precise matching by a points system of discount. The Federal National Mortgage bids did make some modification for a period of time. In some sections of the country and for varying periods, there was a readjustment which was not a precise matching by means of a discount. However, it is believed that far more damage is being done to the people of the nation through falsification of their mortgage costs than can be gained by any small temporary effect on the mortgage market. In actual practice, there is no long-term practical control over the discount in the mortgage market produced by interest rate changes insured or guaranteed by FHA or VA. The true control over the discount rate is largely that established by the Federal National Mortgage Association, dubbed "Fannie Mae," an artificial government acceptance corporation fashioned to pump mortgage money back into the market. Federal National Mortgage Association issues periodic purchasing quotations having a strong effect on discounts and will be discussed in a separate chapter.

What does a discount (or points) amount to in Nevada, talking in terms of dollars and cents? Is it much to be concerned with or is it similar to an origination fee of 1% of the loan granted by the lender? The answer to this question is that this is the most significant cost factor in closing practically all FHA or VA dwelling purchases in Nevada with the exception of the physical structure. On a home costing slightly over $20,000, it can amount to almost $1,000. On homes in the $15,000 and lower class, it can amount to several hundreds of dollars. Clearly, we are not stressing some minor charge, we are dealing with a charge of significant proportions.

Who pays for this discount (or points) which must be given to the lender to enable him to secure enough return to make a loan available to a home-buyer? The builder-seller makes a formal payment of the discount to the mortgagee. This payment of several hundred dollars makes it possible to bring money into Nevada so loans may be made and a market generated for the sale of homes. It is only reasonable that the lender should require the discount. He has faced costs in arranging for it (a mortgage company in most cases) and expects to be in business and stay in business by servicing the loan. The mortgage company in turn must sell the loan in the secondary market, and will have had to meet market conditions in securing the loan funds, which considerations are far away from the 5-1/4% interest rate insured or guaranteed by the FHA and VA programs.

We have indicated that the builder-seller pays the discount to the mortgagee. Yes, but we should not stop our trace of the cost item at this point. From whom has the builder-seller in turn obtained the discount or points? Under FHA and VA regulations, the buyer of the home cannot be charged with this discount, nor may he pay it directly to anyone associated with the transaction. In some special FHA cases the home-buyer may pay the discount where there is no one else in the transaction with the lender to pay for it. However, these situations are not associated with the sales type tract home sale directly from builder-seller to consumer. In most cases, the builder-seller will collect most, if not all, of the discount he had to pay to the mortgagee, from the veteran or home-buyer who is the mortgagor. How can he do this if FHA and VA prohibit such a charge being levied against the mortgagor through closure? The collection is effected by manipulating the sale price of the home. This will be increased to absorb all (or a significant portion) of the builder-seller's discount. It should be quickly pointed out that, again, market conditions will determine how much of this can be passed on to the home-buyer. In certain areas which have experienced depressed conditions, overbuilding, or severe competition among builders (which may have generated a buyers' market of significant proportions) the discount may be entirely absorbed by the builder-seller. In areas where an aggressive builder-seller may wish to make a big showing and rapid expansion or provide for a rapid turnover to reduce interim costs, he may competitively price his wares. The builder-seller may elect to cut into this discount to some extent and the result will be only the partial passage of the discount on to the consumer through the selling price of the home. Such situations are not overly common to the Nevada scene, except under certain conditions, chiefly in the Las Vegas area.

It is interesting to note the remarks made by a State of New York report issued recently, and apparently the only investigation attempted by a state in recent years sweeping enough to cover many of the matters touched upon in this Nevada report. The Report of the Committee on Mortgage and Real Estate to the Assembly of the State of New York (March 15, 1961) Legislative Document (1961) No. 8, does not hesitate to define the problem in that state. It should be remembered that the matter of discounts or a placement fee is not nearly as aggravated a situation in the east for the reasons heretofore mentioned. However, in spite of the modified situation in the east, the report stated as follows:

> The Indirect Cost to the Borrower (pp. 17-18)
>
> The Committee has determined that, in certain locales and in certain types of mortgage transactions, the mortgagor pays far more for his mortgage than is mirrored by these normal and direct charges. As a practical matter, the mortgage seeker may pay large sums of money to acquire his loan without fully realizing that this is the case.
>
> The most obvious manner of circumventing the usury laws of the State of New York is to charge a third party (builder-seller) a fee for granting a loan. It has long been held that, if the mortgage seeker is not charged over 6% interest, directly or indirectly, then the lending institution can charge a third party any amount agreed upon as a condition precedent to granting the loan. Of course, the problem is in determining if the mortgagor does, in fact, directly or indirectly, pay the amount ostensibly charged the third party.
>
> The exacting of a charge from a third party as an inducement to placing the loan is generally known as a "placement fee." The charge is not usually made when the loan is conventional, but is very common in the VA and FHA mortgage market. The amount of the placement fee varies according to market conditions (New York) but ranges to 5% for FHA loans and 6% for VA guaranteed mortgages.
>
> It is the identity of the third party who directly pays this fee that leads the Committee to suspect that, ultimately, the fee is paid by the mortgagor (home-buyer). In the normal transaction, the seller or builder of the home makes the actual payment of this fee to the bank. Thus the mortgage seeker is told that, if the seller will pay a fee of 6%, (discount or points), the bank will grant the mortgage. With this charge being commonly made, it is almost inconceivable that a seller or builder would pay this fee in order that the buyer could qualify for an insured mortgage without getting reimbursed from the buyer, either directly in a private transaction, or indirectly by increasing the cost of the home. Any claim to the contrary based on the argument that the contract price is set before the lender is involved ignores the practicalities of the situation for, in negotiations preliminary to sale, the problem of financing must necessarily be considered and price will be regulated accordingly. (Underscoring and parentheses supplied)

An official FHA bulletin on the subject of discounts, issued July 20, 1961, has this to say relative to the discount:

> FHA prohibits the collection of discounts from home buyers since such charges would circumvent the purpose of interest rate regulations. On the other hand, there is no

prohibition against payment of discounts by builders of new homes, sellers of existing homes, mortgagees, or others having an interest in the transaction. Whether discounts are paid and in what amount are matters for negotiation between lenders and these other parties to the transaction. FHA has no requirements nor assumes any responsibility concerning these negotiations other than to prohibit payment of "points" by the FHA mortgagor or home buyer. (underscoring supplied)

There is apparently some failure on the part of the government to acknowledge and properly deal with what is actually going on in the traffic of home sales as well as in appraisal practices, a matter discussed in a following chapter. Another portion of the bulletin continues:

> To the lender, discounts are a method of increasing the earnings of an investment. To the seller of a house who is asked to pay discounts as a condition to arrangement of FHA financing terms for the buyer of his house, discounts are an expense of selling the house.

This statement is entirely true. However, the statement falls short. Practical elucidation would continue by pointing out that the builder-seller merely adds the discount on to the sale price of the dwelling, and, with or without relatively lax appraisal policies as pointed out in this report, is provided with a method to make a collection from the home-buyer. This indirectly accomplishes precisely that which the FHA has identified as a payment which "would circumvent the purpose of interest rate regulations."

The New York report pin-points who it is that eventually pays for the "placement fee" as they call it. The fee, discount, points, by whatever name, is again clearly identified in the New York report, relative to what it is in a practical sense.

> The purpose of the placement charge fee, of course, is obvious--it increases yield. With the reduction of the maximum interest rates on FHA loans affected by the Kennedy Administration (rates reduced from 5-3/4% to 5-1/2% on February 8, 1961, and again reduced since the New York report to 5-1/4% on May 29, 1961), it is reasonable to assume that "placement fees" will be larger and more common or FHA mortgage money will become unavailable. (material in parenthesis supplied)

We wonder what the New York Committee might have stated after the further reduction made by FHA to 5-1/4%, if reference were being made to the west where the situation on placement or discount is a far more serious practice, at least as far as the amount of discount or points charged is concerned.

At this juncture, we should probably define a situation which will immediately come to the minds of many who are familiar with FHA and VA transactions. Under VA, there is a Certificate of Reasonable Value issued by the Administration, placing in effect a maximum selling price on the home. Any home sold for more than this Certificate of Reasonable Value will not have its mortgage guaranteed by VA. Does not this prevent the builder-seller from padding the price of the home to include a reimbursement to him for the discount he has paid as a third party to the mortgagee? Not necessarily, under two basic escapes. One (which would be used only in very irregular practice) is that identified in the New York report of concluding a private transaction. In other words, some payment to the builder-seller which would not be identified in any contract, or in any charges paid by the veteran through formal closure statements. The other factor is that of a proper appraisal which should reflect the true reasonable value of the VA home without an automatic consideration of what will have to be paid by the veteran for the discount. VA does not permit the inclusion of such a consideration in determining its Certificate of Reasonable Value. However, it is strictly a matter of the efficiency and independence of VA appraisers working in an area.

In 1950 this possibility was of deep concern to the Congress as defined in a FHA memorandum bearing on the history of the discount practice dated September 7, 1956, which reads in part as follows:

> The legislative history of the Housing Act of 1950 discloses the apprehension of Congress that, even though mortgage discounts could not then be collected directly from the veteran by the mortgagee, the builders were being required to pay discounts in many areas and it was reasoned that the VA might be taking into account such expenses of the builder in issuing its Certificate of Reasonable Value and thereby requiring the veteran to absorb the discount in the sales price. (underscoring supplied)

The situation was particularly critical under VA sales and associated appraisals, since the builder-seller could not place a sales price on his home higher than the Certificate of Reasonable Value and have it guaranteed. In order for the builder-seller to collect the discount from the veteran, the Certificate of Reasonable Value would have to be increased enough to accommodate the discount.

Likewise, under FHA, the matter of packing or padding the discount or points into the sales price of the home is a practice. However, under FHA it is a far easier matter. The FHA Valuation does not establish a ceiling for a sale price. It is only a rough guide to the home-buyer that he should possibly not pay too much over the appraisal on sales type tract homes. Remember, FHA will insure the loan made regardless of sale price being well over the appraised value arrived at by FHA. The basis of FHA and VA appraisals differs also. FHA allows the closing costs to be considered as a part of the appriased value. In almost all cases, the buyer pays again for closing costs in addition to a full sale price, even if he purchases at exactly the FHA appraisal figure. He should buy at the appraisal figure minus closing costs if he is to avail himself of the FHA estimate of value. However, if he purchases at above FHA appraisal, which is common, there is considerable latitude under these considerations cited, allowing the builder-seller to include the discount in the sale price of the home to the consumer. In addition, FHA appraisals can also be loose enough to include the full discount. The appraisal problem will be dealt with in a following chapter.

CHAPTER XX

HISTORY OF DISCOUNT CONTROL - BY FHA AND VA

The matter of discounts has plagued the administration of the FHA and VA programs over the years and various attempts have been made to discourage or eliminate the practice. The statement must be made that the FHA and VA administrations have in the past recognized the desirability of eliminating discounts as a direct or indirect charge to the consumer. Under VA, there has been more practical control since homes cannot be sold for more than the Certificate of Reasonable Value. In the event accurate appraisals are made by VA, it is a more difficult matter to circumvent the interest ceiling which VA has established. It might be wondered just why FHA has not moved to require that its FHA Valuation (minus closing costs which have been allowed to enter the appraisal formula) has not likewise been established for controlling sale price.

The following information indicates the history of discount control under FHA and VA, much of which was supplied to the Legislative Counsel Bureau by the FHA Washington office. (Underscoring and parentheses supplied to any direct quotations.)

1934-1950	FHA and VA prohibited the discount to be charged to and paid for by the home purchaser directly. However, there were no controls placed on the builder-seller. The lender could charge the discount to the builder-seller and the seller in turn could collect from the home buyer, either through a separate agreement or in an increased sale price on his home. Discounting was apprently not the problem during some of these years due to a more closely adjusted guaranteed rate of interest to market conditions.
1950-1951	The Housing Act of 1950 established (in Section 504) a directive to both FHA and VA to take action to prohibit discount charges against builders as well as mortgagors. Implementation was as follows: "No loan shall be insured or guaranteed under such Acts (FHA-VA) unless the mortgagee certifies that it has not imposed upon the builder, veteran or other purchaser any charges or fees in connection with the financing of the construction or sale of such housing in excess of the charges or fees permitted. . ." Since FHA and VA made no allowance for discount charges in excess of an origination fee, such certification bound the mortgagee so that he could not make a discount collection from particularly the builder-seller to be passed on as a charge to the veteran or the home-buyer. A House version (H.R. 6080) suggested the same certification. However, the certification would have been limited to those mortgages sold to the Federal National Mortgage Association (Fannie Mae) and the

practical control would have depended upon the strength of Federal National Mortgage Association to make open market purchases from originating mortgagees.

Section 504 of the Senate version adopted, contained a specific provision directed against the practice of lenders requiring excessive charges in consideration for making FHA (insured) and VA guaranteed loans. The mortgagee certification relative to excessive charges not having been made, applied not only to charges in connection with the particular mortgage loans insured or guaranteed by the Government, but also to charges in connection with other loans made for the construction or sale of housing involved.

Following the enactment of Section 504, the FHA took action to prohibit the collection of mortgage discounts from builders as well as the purchasers who became the FHA mortgagors. Similar action was taken by the VA to protect veteran purchasers.

1951-1953

On June 12, 1951, the FHA took further restrictive action in an effort to counter various devices being used to evade the spirit if not the letter of its requirements, by issuing the following letter to the Directors of all FHA field offices:

"The present condition of the secondary market has prompted many originating mortgagees to inquire as to the attitude of this Administration toward various devices involving a charge or collection by the mortgagee of a fee or commission from the builder, sponsor, seller, broker, or someone other than the mortgagor in addition to the maximum fee or commission which it is permitted to charge the mortgagor under the applicable Administrative Rules.

It is the policy of this Administration not to approve or permit the charge or collection by the mortgagee of a fee or commission in excess of the maximum which it is permitted to charge the mortgagor under the applicable Administrative Rules (1% origination fee) regardless of whether such excess fee or commission is paid by the builder, sponsor, broker, seller, or other interested parties, and regardless of whether such excess is paid to the originating mortgagee or directly to the proposed purchaser of the mortgage as an inducement to facilitate its sale.

It is hoped that this letter may be of assistance in answering inquiries relating to this matter."

The effect of the foregoing letter was to prohibit the collection of discounts from any source, and a certificate was required of the mortgagee in each mortgage transaction to the effect that the mortgagee "has not imposed upon or collected from the mortgagor, the builder, sponsor, broker, seller or other interested parties" any interest, fees or charges of any kind other than those expressly provided for in the Administrative Rules and Regulations.

EVASION DEVICES 1950-1953

(1) Some builders made direct overtures to secondary market investors (insurance companies, pension trust funds, etc.) for the purpose of obtaining so-called "take out commitments" which would enable the local lending institution with whom the builder ordinarily did business to dispose of the mortgages at par.

(2) When FHA and VA moved to prohibit builders from paying fees to the secondary market investors, many of them discontinued the direct payment of fees but managed to accomplish the same objective by the indirect method of purchasing securities from the secondary market investors at a price in excess of their actual worth (such as paying par for bonds which were actually selling on the market at 95 and taking an immediate loss on the resale).

(3) Some builders attempted to organize separate corporations which functioned in a manner similar to holding companies. By having the separate corporation or holding company arrange for the "take-out commitments" they were in a position to maintain that neither the builder nor any party interested in the mortgage transaction had in fact paid a discount.

(4) Numerous proposals and plans similar to "holding companies" were presented to the FHA and VA for consideration, and in many instances were actually employed without consultation with the FHA and VA.

At this point, apparently FHA and VA felt they must yield to the insistence of the home building industry and mortgagees that they continue the discount practice. Admittedly there was not much excuse by which FHA and VA could have stood their ground in the face of the unrealistic interest rate for insurance or guarantee. However, enforcement (if that was of real interest to FHA and VA) could certainly have been exercised either under their existing authority or by application to the Congress for assistance and authorization to make major moves such as we have seen develop under anti-trust actions. Anti-monopolistic governmental moves against many segments of industry, and the connections which existed between them, could have and should have been initiated. Suffice it to say, the following did develop as a result of these devices being utilized by many organizations to evade the spirit of FHA and VA regulations, which at times went so far as to be actual outright violations of these regulations:

1953 Congressional Committees received voluminous testimony indicating dissatisfaction both with the provisions of Section 504 of the 1950 Housing Act and the manner in which the same was being administered by the FHA and VA. Evidently FHA and VA were making some attempt to enforce the regulations which Congress had authorized and directed them to promulgate back in 1950.

The mass of testimony established factors elsewhere elaborated upon in this chapter, relative to the low rate at which FHA and VA insured or guaranteed loans, and the matter of fluctuation of mortgage market conditions from one part of the nation to another was clearly defined. We have suggested a regional approach to these obviously cardinal factors which worked to directly destroy discount controls at that time.

The discount was tied in directly to a rate of interest or return to the investor by Congressional committee reports in 1953 as follows:

'It was not intended that the authority authorized by Section 504 be used primarily as an instrument in maintaining a fixed interest rate without regard to current conditons in the mortgage market. Your committee does not now condone the assessment of excessive or unconscionable fees and charges against builders or purchasers of homes under these programs.'

Such was the double talk of the committees at times. The question should have immediately been put as follows: Under the existing low insured or guaranteed interest rates authorized and the further authorization of a one point origination charge (resulting in a return to the mortgagee investor well below that which is necessary to attract his funds into FHA and VA insured or guaranteed mortgages) what other result could have been the outcome under these regulations (if observed) but a fixed rate of interest in many sections of the nation? The discount or points system was the only other safety valve available to the mortgagee. If authorization has been given to FHA and VA to control this discount safety valve, how then can it be argued that "it was not the intent that authorization given under Section 504 would be used in maintaining a fixed interest rate."

Other avenues of escape to the mortgagee who must operate in the environment of the business world, and not in the academic theory of governmental regulations, are minor ones. He could have attempted to pick up an incidental charge here and there at closure, the whole amount of which would have been a very small portion of that needed to equalize the economic conditions existent at the time. Constant regard for the fact that you cannot force investment funds to flow into housing and home mortgages must be maintained. To some extent investment funds are like water. If blocked at one point they will breach a dike at another place to gain a return which is felt necessary. These funds tend to seek their own level, and, if depressed by artificial regulation, will move into other channels to seek a proper return. Government planners are wasting their time in these attempts unless they wish to employ a confiscatory tax basis, and with such returns, operate an entire direct loan program. Further Committee statements in 1953 were as follows:

> In its proposed amendment to Section 504 it is the purpose of your Committee to clarify Section 504 so that it will not be construed as to require regulations which prevent the flow of mortgage money to those areas of the country which must rely upon other areas for a substantial supply of mortgage capital. (underscoring supplied)

The clarification amounted to removal of discount control and, for all practical purposes a return to the former situation, existing from 1934-1950.

In 1953 a congressional committee of conference emphasized that a relaxing of the 504 section (which had given FHA and VA authorization to move against discounts and points) should not affect the VA program. The committee pointed out that under the VA program, the Certificate of Reasonable Value issued by the VA established the maximum selling price. That if this "is in fact a realistic value" (the implication being that it could include the builder-seller discount), any such cost cannot be passed back to the veteran. The committee of conference also suggested that the lender report to the VA the price for which he sold the mortgage in the secondary market as a source of information revealing the extent of and nature of the discount. This will be referred to again under suggestions in this chapter.

The 1953 Act, which made the actual amendment to Section 504 of the Housing Act of 1950, read in part as follows:

1953-1954

> . . . The FHA Commissioner and the Administrator of VA Affairs, respectively are hereby specifically authorized and directed to issue such regulations, applicable uniformly to all classes of mortgagees, as they determine desirable for the purpose of limiting the charges and fees, which shall not be construed to include any loss suffered by an originating lender in the bona fide sale or pledge of or an agreement to sell the mortgage, imposed upon the builder or other seller, or the veteran or other purchaser in connection with the financing of the construction or sale of such housing, whether or not such charges were or are imposed in connection with the financing assisted by the Federal Government. (underscoring supplied)

The effect of the foregoing amendment was to direct the FHA Commissioner and the Administrator of Veterans Affairs to permit the collection of discounts by lenders from mortgagors (home buyers), builders, or any other parties interested in the mortgage transaction, in amounts sufficient to reimburse such lenders for the actual loss sustained by them in the bona fide sale of the mortgages in the secondary market. Both FHA and VA made the required regulatory and procedural changes, which continued in effect until the enactment of the Housing Act of 1954. This amendment was obviously discriminatory against those mortgagees who wished to originate a FHA or VA loan and hold the loan for their own portfolio rather than sell in the after market. This forced many mortgagees to divest themselves of their FHA and VA mortgages to the federal acceptance corporation "Fannie Mae."

1954-1956

In 1954, Congress repealed the provisions of Section 504 of the Housing Act of 1950 as amended. The effect of this action was to restore the situation to that existing prior to enactment of the Housing Act of 1950. Once again only the seller or other interested parties could pay for the discount, and such discount could not be paid by the buyer directly. Adequate authority after repeal of Section 504 was available to both FHA and VA for control over other types of charges and fees paid by purchasers in connection with the initiation of such guaranteed loans and the disbursement of loan proceeds. The Conference Report made prior to the passage of the new Housing Act of 1954 stated as follows: "...It is the intention of the committee of conference that those agencies (FHA and VA) will continue to exercise their authority to protect veterans and other purchasers against excessive fees and charges."

The important aspect of this review of practical procedure relative to FHA and VA attempts to control discounts, is that the problem has been recognized by the government and attempts at controls were made from 1950 to 1953 as well as again in 1957 and 1958. We must, therefore, be projecting a problem already recognized and we are not trafficing in an illusion which should be brushed aside because the problem is unsolvable. Certainly former failures should not indicate that nothing further can be done about the problem. If we are to stop after one or two attempts, and admit that failure is sure to follow any further attempts to curtail the practice, then we must admit that general progress in the nation will be severely curtailed at all levels of government and private enterprise alike.

The regulatory and procedural changes which were adopted in the sales type programs, as a result of the Housing Act of 1954, did not permit the mortgagor to pay a discount unless the same was absorbed in the permissible 1 percent service charge. No restrictions were imposed with respect to the payment of discounts by builders, sellers, or other persons interested in the mortgage transactions. Thus, there was again established the full latitude under which the builder-seller could pass any discount on to the home buyer through either a private transaction or an increase in the sale price of the house, made to reflect whatever discount or portion of the discount the traffic would bear, and associated with certain irregularities in FHA and VA appraisals which frequently worked to allow for inflated sales prices.

1957-1958

The Housing Act of 1957 brought about two important changes in regulations relative to the discount or points collection either directly or indirectly from the home buyer. The first one of these was of minor significance since it changed regulations in regard to a relatively small number of transactions. Under this change the mortgagee was permitted to collect from the mortgagor discounts in accordance with a Schedule of Maximum Charges, Fees and Discounts in effect as of the date of filing of the application for insurance in three specific cases as follows:

(a) When a mortgagor was a builder constructing houses for sale and who executed the mortgage in his own name.

(b) When a mortgagor was constructing a dwelling for his own occupancy.

(c) When a mortgagor was refinancing a prior mortgage covering property owned by the mortgagor.

The Housing Act of 1954 prohibited the mortgagor from paying a discount directly to the mortgagee under any circumstances. However, in the three cases above no person other than the mortgagor appears in the transaction with the lender and, consequently where no person other than the mortgagee is willing to pay the discount, the discount would have to be paid for by the mortgagor or no loan could be made. Hardships were thus created in these limited cases which were typical of FHA cases rather than VA cases, due to procedural or regulatory differentials between the two programs. VA refinancing transactions were extremely limited due to the fact that they were confined to delinquent mortgages where the mortgagee was willing to refinance because of hardship. Also, VA does not issue its guarantee where the loan is closed in the name of an operative builder. However, VA did have a problem in those instances where an individual acquired a lot and had his own home constructed thereon.

Frequent use is now made of this mortgagor discount authorization where a home-owner wishes to sell his property and obtains a new FHA commitment reflecting the increased value of the property. He may then be able to offer his home for sale at a much higher price than he purchased it for. However, he has an attractive new loan to offer a prospective purchaser which will have within the loan most of the unearned increment. In other words, the new buyer will be able to pay a higher price for the home than originally sold for, without having to produce a large down payment. However, to effect this new FHA commitment and the new loan, the mortgagee will charge the current mortgagor the discount. In this case, under these changed regulations FHA will permit the mortgagor to pay for the discount. Originally, it was envisioned that such an authorization would be primarily for refinancing existing mortgagor indebtedness for the purpose of extending the maturity date of an existing loan and thereby reducing the monthly payments to principal and interest. Under this system, the mortgagor would pay more in the long-run but his interest and principal would be spread over a longer period of time, reducing total monthly payments. And, since only the mortgagor and lender were involved in such a new loan, no builder-seller or other party was available to absorb the discount.

The second change in discount control made under the Housing Act of 1957 was of far greater significance since it affected the majority of FHA (insured) and VA guaranteed loans being made.

The new regulations provided that the mortgagee could collect a discount from the mortgagor (home buyer) as long as such discount was not in excess of that established by the Schedule of Maximum

Charges, Fees and Discounts. Application of this authorization was made to both FHA and VA insured and guaranteed mortgages by action of the committee of conference in Congress. The House version had provided for such discount authorization to apply to FHA mortgages only.

In addition to allowing a discount charge based upon a maximum allowed by the schedule, the application for insurance had to be accompanied by a certification executed by the builder, seller, or purchaser of the property, certifying that such person had not paid or obligated himself to pay any discount in excess of that authorized in the schedule. The mortgagee also had to furnish a signed statement to the guaranteeing agency listing all items for which any charge, fee or discount was collected from any person connected with the mortgage transaction, together with the amount of each such charge, fee, or discount.

The Washington office of the FHA was asked to prepare an explanation offering some information on why these discount controls of general application were repealed on April 1, 1958. Those regulations covering the three cases where no person other than the mortgagor appears in the transaction, and the mortgagor could pay the discount, remained in effect. FHA offered the following information on the general discount repeal:

> FHA made every effort to administer the provisions in this Section of the 1957 Housing Act in such a manner as to occasion as little disruption of the normal practices of the home building and financing industries as possible while at the same time preventing any gouging of the public. However, in spite of FHA's efforts this provision created confusion and reluctance on the part of the industry toward using FHA-insured financing. As such, these discount controls worked a hardship against prospective home buyers, particularly in the lower priced housing areas where higher loan value ratio mortgages were most needed. As a result, Section 605 of P. L. 85-104 was revoked April 1, 1958 and our regulations were amended to read substantially the way they do today.

The former action taken by Congress in 1957 was a most commendable step toward some solution to the problem of discounts. From the above information offered by FHA, it is obvious that either the program to control discounts was not engineered properly along with other enabling changes, or that either or both the insuring and guaranteeing agencies and the mortgagee-builder teams may not have bent every effort toward having discount controls work.

Some constructive explanation can be offered at this time, which will be incorporated under suggestions in a following chapter, as to why there may have been difficulty in carrying out the intent of Congress under these regulations.

(1) Both FHA and VA programs very possibly still failed to make sufficient allowance for actual market conditions although the authorization made reference to "geographical factors" and "geographical areas," the variances for "geographical areas" being specifically mentioned in Section 605.

(2) The guaranteed rate of interest was raised from 5% to only 5-1/4% which could make for too great a disparity in many sections of the country to still be covered by an issued schedule. In other words, there remained too vast a discrepancy, creating a discount and providing very possibly for too large a battle ground of "differences" between what the government agency felt to be a proper discount, and what the "market" felt should be made available to them.

Had the geographical consideration which was finally recognized in this 1957 act been made applicable directly to alter the insured or guaranteed rate of interest by regions rather than the indirect attack on the problem through discount authorizations based on regions, very possibly there would be only a slight inaccuracy in matching market conditions, and the discount problem could have been largely eliminated. A following chapter offers suggestions to provide for fluctuations within a given region.

(3) A further explanation is that common to all complex programs which have been in effect for but a short time. There is a reluctance by those being regulated to want to understand and comply with the regulation. The approach to compliance has much in common with actual desire to comply.

(4) The FHA program, as it differs from the VA program, is primarily organized as an insuring agency to the mortgagee. VA has a two fold purpose, with the primary objective that of protecting the veteran as well as guaranteeing his loan. FHA may not have had the full sympathy of the home buyer and national consumer at heart when it attempted to regulate the discount under this machinery. It must be quickly admited that perhaps the machinery was improperly designed and not complete. In any event, the different objectives of FHA and VA should be considered in a practical understanding of the failure. To make a plain statement, the mortgagees and lenders could more easily bring pressure to bear on FHA to abandon the controls than they could on VA. Any significant pressure upon one could remove the controls for both.

(5) Under present home-building conditions and the state of the market, where mortgage companies have entered the field in force in the State of Nevada, it is hard to see how homes could be sold in any great volume without FHA or VA insurance or guarantee on the mortgages. Under both these programs, financing may be either complete or to 97%, and no prudent lender is going to make loans to that amount without FHA or VA insurance or guarantee. In short, if such controls were not placed back into effect, it is strongly suspected that the mortgagees and home-builders would have to cooperate with FHA and VA or houses would be hard to sell without such in-

sured or guaranteed mortgages. Without the insured or guaranteed mortgage, the home buyer would have to resort to conventional financing under which a large down payment would have to be made, something most are not equipped to handle.

It must be realized that the home-buyer has been "traded-up" to the point where he expects and purchases expensive financing. That is to say, he looks for a long term loan to cover all of his purchase if possible. The overall cost is of little concern to him. It is the monthly cost even though that may be for life. Since 1957, this "trading-up" practice has brought us to practically complete financing, and the trend has had definite stimulus from the government itself as a "generator" of the economy.

(6) The general failure of the program as attempted in 1957-1958, should not necessarily offer discouragement toward developing a more logical approach to a situation which has undergone changes, as pointed out. Such suggestions are given in the following chapter.

1958-1960 Since the abandonment of controls over discount in 1958, only one significant change has been made in regulations relative to the paying of discount by the mortgagor.

The change under FHA was an extension to a fourth category of mortgagors in limited cases where no other person enters the transaction with the mortgagee except the home buyer. In this case, there is actually another party in the transaction but that party is prohibited by law from paying the discount. Where the mortgagor is making his purchase from a government agency or municipal corporation, he is allowed to pay the discount. The government agency appears in these cases where it has taken over a property and offered it for resale, but, is prohibited by law from paying any discount.

1960-1962 No significant changes have been made since 1960 relative to discount controls under FHA or VA.

CHAPTER XXI

SUGGESTIONS FOR THE ELIMINATION OR CONTROL OF THE DISCOUNT

SUGGESTIONS:

The repeal of Section 504 of the 1950 Housing Act, and the repeal of provisions for discount control in the 1957 Housing Act, returned the situation to that which had previously existed from 1934 to 1950, in regard to the absence of specific directive to regulate and control the practice of the discount being charged by the mortgagee to the builder-seller or other interested parties. This situation under the law is current today. In this connection, it is of interest to examine a statement made in 1953 by the House Committee on Banking and Currency in defense of repealing the strong controls over the discount made available by Section 504.

> During the hearings on the bill the attention of your committee was directed to the effect that the regulations issued by the Veterans' Administration effective May 18, 1953, with respect to fees and charges permissible in connection with the guaranty of Veterans' home loans was having on the mortgage market for such loans. In its regulations of May 18, the Veterans' Administration set forth the fees and charges that could be paid by the builder and veteran and further provided that discounts could not be paid by builders and originating lenders greater than one point allowed under these regulations (origination fee 1%). The regulation was issued at a time when the mortgage market was tight due to a number of factors, one of which was the anticipated increase in the interest rate on GI loans. It was hoped that the increase from 4 to 4 1/2 percent in the interest rate on GI home loans would provide sufficient incentive to insure a substantial volume of GI home loan construction and mortgage financing. However, when the new interest rate did become effective the mortgage market in many areas remained tight and was further aggravated by the May 18 regulation with the result that GI home loans even with the new interest rate could not be sold in many areas under the allowable fees and charges set forth in the VA May 18 schedule. The difficulty was, and is, specifically applicable to those areas of the country, particularly in the South, Southwest, and West, which must secure a substantial part of mortgage financing from financial centers of the East and Midwest. Builders from these areas have testified that they have been unable to sell or warehouse their mortgages under the May 18 schedule and as a result veterans in their areas have not been able to purchase homes under the program. (underscoring supplied)

This testimony, and the report of the committee, clearly indicates three very great weaknesses which can be corrected and offered as suggestions relative to eliminating this practice of allowing the discount to exist and be passed on to the home-purchaser in direct violation of the spirit and often the letter of the FHA and VA regulations.

(1) Of primary significance was the obvious failure to provide a level of interest return on insured and guaranteed mortgages which would attract investors and bear some practical relationship to market conditions, particularly the 1950 Act. The failure to do so is strongly emphasized in the foregoing committee report. The raise from 4% to 4-1/2% was inadequate and reflected a failure to take into consideration practical money market considerations, especially in the west. Without a discount (prohibited by the existing regulations) few would traffic in such a low return. The blame should be placed directly upon the government rather than the money lenders.

under such an unrealistic approach. But, it may not have been politically wise to have allowed insured or guaranteed interest rates to rise to such a level. The voter might not understand. He could have mis-interpreted such action as a failure to protect his interests. The charge is made that such a political consideration overlooks the far more disastrous consequences to the citizen in having him pay for this higher rate anyway, by masking it and burying it in the form of a discount incorporated into the sale price of his dwelling place. Such misrepresentation to the veteran, citizen, and taxpayer of this nation is such as we would expect only from administrations in totalitarian nations.

In this connection, it should be noted that, under the newly established FHA home improvement loans (which now go up to a maximum of $10,000), the guaranteed rate of interest will be 6% or less plus 1/2% insurance premium. There are two facts worth noting about this change. First, it is a true interest rate, not a discount rate disguising a much higher effective rate. Second the rate is very close to the equivalent of those currently prevailing on first mortgages. In many cases, the improvement loans will be written as second mortgages, but the terms are about as good as those available in many localities on a first mortgage, portions of the west and south excepted.

Without any change in federal law, the FHA Commissioner is now authorized to insure mortgages made at "6 percent per annum, if the Commissioner finds the increased rate necessary to meet the mortgage market," on FHA home loans.

Further in this connection, the recently announced plans to have introduced in Congress legislation which would provide charters to a FHA type insuring program and a National Mortgage Facilities Company to handle the purchase and resale of conventional mortgages (a take-off on the FHA and FNMA combination now operating) envisions permitting the mortgage lender to set any interest rate on the loan that the competition will bear. While such a program would probably provide for only 90% financing under a semi-governmental insurance program, losses to lenders would be paid in 100% cash rather than the marketable debentures now issued by FHA in settlement, which usually result in a loss when traded. Somewhat of an under-statement has been offered prior to introduction in Congress for the reasoning behind such a plan which has been in the formative stages for several years. The statement is as follows:

> Some complaints about FHA also helped spur the new market's planners. Many mortgage lenders disapprove of FHA's legal ceiling on interest rates on the mortgages it insures. (Underscoring supplied)

While the formation of a new program to traffic in insuring and resale of conventional mortgages would not directly affect FNMA or FHA and VA mortgages, there may be an indirect impact, since, through such a new program insuring at the market rate of interest many of the ramifications associated with the discount generated by FHA and VA will not be present.

The urgent suggestion is made by this report that FHA and VA move to immediately provide for insuring or guaranteeing mortgages at market rates of interest and eliminate the discount practice in a practical manner. The implementation of this will be discussed under suggestion number 3. FHA and VA have some authority now to move in this direction and should seek any additional authority needed from the Congress.

(2) From 1950 to 1954, the FHA and VA were directed to end the practice of discounts by action taken in the Housing Act of 1950. FHA and VA from that date forward have been closely associated in all matters relating to discounts on mortgages covering sales-type homes. The difficulties encountered have been pointed out prior to these suggestions as have the devices employed by those associated with building and the money market to circumvent regulations. With a practical approach to mortgage money costs as suggested herein, these devices would hardly have been resorted to by these associates. In any event, lacking such a logical approach, it must be remembered that no system of regulations, however carefully fashioned, can hope to accomplish the end results for which they were designed, unless there is a strong desire on the part of the administering agencies to have the system work. Certainly, as devices were discovered to be in operation, the appropriate commissioner and administrator should have taken immediate steps to prevent such devices, or sought congressional action if necessary to strengthen any existing authority so that administrative regulations could be issued to halt device practices forthwith. It is felt, however, that this suggestion might only have resulted in a drying up of mortgage money without resorting to suggestion number 1 at the same time. In any event, such action would have forced the problem into the open to receive final correction.

The suggestion that administration have strong sympathy with its own regulations is a necessary concomitant to the implementation of its directives. No weaker system can be devised than that which places in charge those who, from the start, have no sympathy with the duty they are chared with performing. This report has not in any way attempted to assess the degree to which such possibility may have led to the abandonment of discount regulations in 1954 and again in 1958. The host of associated political complications and contemporary adjustments of interest rate insurance or guarantee, is also not one to which we would attempt to assign any suggested value. These matters are offered only to point out in a practical vein some suggestion of how we have come upon this massive difficulty, and why it has been allowed to remain as a cancer and continued to develop within the body of our citizens who are making purchases of dwelling places.

This report also strongly suggests that FHA and VA should move to immediately enforce those regulations which it now has at hand and has promulgated under authorization granted by Congress. The enforcement of those provisions (identified as not being properly administered in this report) will do much to protect the veteran and home-buyer. Neither FHA or VA should search for paths upon which to travel to evade the true intent and meaning of their own regulations. In many cases, it is apparent that these government agencies, through action of their regional offices, will make every excuse and seek every possible out for not having to enforce their very own regulations, when such regulations were specifically designed to offer some minimum protection to the consumer. Only when FHA and VA become intent with a strong desire to make their systems work effectively for the like protection of both mortgagee and mortgagor, will any current provisions or suggested changes in their programs engender the complete corrections they are designed to effect.

(3) A third important issue is raised in the Committee Report. Reference is made to differing conditions in the "South, Southwest, and West," and the fact that mortgage funds for these areas is dependent upon "financial centers of the East and Midwest." Does not this suggest and admit that mortgage market conditions are of a regional nature? Why not then establish a guaranteed interest rate regionally? The

Committee Report identifies five regions in its brief remarks, as follows: East, Mid-west, South, Southwest, and West. Government planners and geographers would immediately point out that such vague terminologies suggest no precise boundaries, and that they are not political entities or even generally recognized groupings of states. However, for many other purposes the federal government does set up programs and administration of numbers of regulatory functions by regions. Such "regions" are frequently not only for the purpose of lower-level administration and convenient subdivision, but also to meet varying conditions existing in different parts of the country. Certainly, if agricultural programs and projects can differ from one part of the nation to another (largely due to physiographic and climatic differentials) so also could the rates at which the government will insure or guarantee loans vary from one part of the nation to another to reflect the particular "climate" existing in the particular regional mortgage market.

The Housing Act of 1957 recognized the necessity for some regional approach to provide for fluctuations among different geographical areas. Authorization was given for the preparation of schedules of discount charges which would reflect the variations in the money market from one part of the nation to another. Such a suggestion is not, therefore, a novel one. Rather, it is a matter of what level or at what part of the transaction such geographical differences in the money market are to be recognized. Full admission has been made by the Congress that such a regional problem exists, and an authorization to deal with it was made. As pointed out in the history of the discount, however, the effectiveness of this regional recognition may not have been designed to bring about a direct enough approach to eliminate the bulk of the difficulty.

Under a system of regionally applied insured and guaranteed rates of interest (subject to constant review and necessary change) the FHA and VA administrations, acting either independently or in conjunction with each other, could provide for elimination of the discount deception and violation of the letter and spirit of their existing programs. Insured or guaranteed rates of interest should be kept slightly below market to provide for any suggested or imagined control over actual money conditions that may be exercised by establishment of these rates. To provide for the shading necessary to reflect slight differences between lenders in the region and also within the region itself, it should be kept in mind that there is already provided an origination fee to be charged (under both FHA and VA) to the home-buyer of a full point (1%). Any insured or guaranteed interest rates established should also be expanded to include "most" of this necessary one point. However, a full 1% origination would continue to be authorized and the shading of interest rates could continue to operate (within a full range of one point in a given region), to accommodate those situations where it is felt by the lender they must go beyond the insured or guaranteed rate, and collect further return within this range. The only real control is competition and no artificial government control, unless it be a perpetrated farce against its own people under the present discount system, can even suggest that any control exists. The FNMA secondary controls would continue to be in effect in the secondary market, provided the government chose to continue to make such a system available as an adjunct to the whole insurance and guarantee program.

The authorization to insure and guarantee mortgages at higher interest rates will immediately be pointed out by many as having the net effect of increasing mortgage costs to home-buyers, especially in those cases where a very large tract is being developed under highly efficient building techniques employing prefabrication and component construction associated with corporate interim financing. In such a situation, the builder-seller's cost per unit (or home constructed) may be below that of other builder-sellers who build two or three homes at a time. Such efficiency and lower cost per unit would allow the builder-seller to absorb a portion, if not all, of the discount and he could still price his wares competitively with the smaller builder. However, some small builders have a low managerial and labor overhead and can operate with practically no interim financing cost. These factors are clearly recognized and dealt with again in the chapter on FHA appraisals and VA's Certificate of Reasonable Value.

Before an examination of this introduced element, it should again be understood that in a free enterprise system it is competition that will determine the overall picture. An inference is drawn in the case of an efficient builder that he could save the home-buyer from paying much of the discount anyway without lifting the ceiling on the interest rate. This is just as true as the fact that he could likewise save the home-buyer by lowering the sale price of the house. If he elected to, he could also save the home-buyer by paying for a discount to the lender and obtaining from the lender a more attractive loan at say 1/4% or 1/2% below the authorized ceiling for the suggested region established. No lender is required to establish his mortgage interest rate at the maximum. In short, there is no way to level out the overall cost to builder-sellers so that they all come up with the same "cost package" covering land, development, labor, materials, and financing. Some will be more efficient than others and the size of the operation is not always a controlling factor.

Under the suggestion made in regard to meeting actual market conditions for making a loan, a super-efficient builder would have available to him several alternatives in competing for the veteran or home-buyer's dollar. (1) He could sell at well below the Certificate of Reasonable Value or FHA Valuation; (2) He could pay a discount to the lender (not pass it on to the mortgagor) and secure and advertise a mortgage to the home-buyer at below ceiling interest rates; (3) He could reflect his efficiency by offering extras at no added cost, such as wall-to-wall carpeting, patio equipment, movable appliances, draperies, etc., which would not be included in the FHA Valuation or VA's Certificate of Reasonable Value.

This report does not suggest that interest rates should be allowed to go so high in a given region as to capture the lower efficiency factors of some builders, to eliminate entirely the discount or points. Some fluctuation from the average has been suggested by the latitude in maintaining a 1% origination fee, with the incorporation of most of this fee as it now exists into the base interest rate.

The fear that the home-buyer will pay more in the end is not justified if we are to give any consideration at all to our present competitive economic system. It has been observed that competition is at an all time high in the State of Nevada in both metropolitan areas. The home-builder who wishes to sell homes at larger profits than those of another, cannot be controlled through any device. If he elects to make the results of greater efficiency available to the home-buyer in a better "deal," he is free to do so. Only with a war-time Canadian type of price freeze will the natural effects of supply and demand fail to work. Any apparent concern to the home-buyer resulting from removing an unrealistic interest rate ceiling is unjustified. The builder-seller must not price himself out of the market with expensive financing to be passed on to the home-buyer, any more than he could survive with unrealistic sales prices and inefficient labor and low quality materials. If competition cannot solve the problem under a realistic guaranteed interest rate (which will make clear to the home-owner what his financing is costing him and allow him to deduct such actual costs from his income tax) then we had best adopt a federal system wherein government manages construction, sale, and direct financing.

The veteran and home-owner should be interested in knowing that, if the true rate of interest were allowed to be charged to him on his home mortgage, he would be able to deduct this entire amount on every annual income tax return he prepared. Now it is only possible for him to deduct that portion which is actually identified as interest under the 5-1/4% ceiling. In other words now he is paying for a higher rate of effective interest but not being allowed to deduct it as interest since it is labeled as an origination fee, or hidden into the sale price of the home under a discount charge, points, or placement fee.

Under a regional system of mortgage rate insurance or guarantee, it is realized that more complexity would be built into an already overburdened and frightfully complexed and interrelated governmental system. However, if the government chooses to traffic in such systems, they must be free as it is possible to make them from an unjust and deceiving cost to the taxpaying home-buyer-veteran, and the consumers of the nation at large. Since such deception and masking of costs runs into the many hundreds of dollars per home transaction (over $1,000.00 for many of the medium class homes now being sold under FHA and VA insured or guaranteed mortgages), the extra effort required by FHA and VA to provide for some system of recognition of the economic facts of life should be activated. If 15 different regions are necessary to cope with the full range of the one point or 1% suggested (after the lower end of the market in a region has been reached with an insured or guaranteed interest rate) then 15 would have to be established. However, under the authorization for a one point range, it is not anticipated that more than a half dozen regions, if that many, would be necessary. If there is need of annual adjustments in the insured or guaranteed interest rate, than let's make them annually. The Kennedy administration did not hesitate to offer us two reductions on a nationwide basis within one year, from 5-3/4% to 5-1/2% to 5-1/4%. If economic conditions become so upset that changes would be necessary within regions, we already have a precedent established to make those frequent changes without resort to gross discounting. Within the period of time the FHA program has been in operation, it has been necessary to change the insured interest rate quite frequently and the range has been all the way from 4-1/4% to 5-3/4%.

There should be no argument that regional changes could not be logically effected that would reflect actual market conditions in a geographic area. It is suggested that, if at all possible, FHA and VA should come to an agreement on coextensive regions of as small a number as necessary to accommodate true regional discrepancies.

The FHA and VA programs have recognized differences. However, as indicated in an FHA study of the discount problem, the following excerpt from an official FHA review is presented. This indicates the relationship between the two in regard to the discount:

> Beginning in 1950 the Congress became concerned with the payment of mortgage discounts by builders, its principal concern apparently being in relation to the VA program rather than the FHA program. From that date forward the FHA has been closely identified with the VA in all matters relating to discounts on mortgages covering sales type home ownership properties. (underscoring supplied)

Peculiar spots may exist within a broad geographical region, making it necessary for a small sub-region to be established in a broadly defined area. However, it must be recalled that agricultural programs may fluctuate from one county to another within a state. In the end, there is every justification for establishing some system which will eliminate the discount and approach a logical insured or guaranteed rate of interest. This is offered only as one suggestion in a Nevada report. Those who make a specialty of economic problems over a lifetime, and whole organizations established to study economic conditions, should certainly be able to come forward with additional logical suggestions.

This report is ever mindful of the political repercussions which might result from the establishment of a realistic system controlling the borrowing of mortgage money. An administration that would tear away the mask of deception it will have inherited from former administrations will have to be a bold one in thus meeting its obligations to our citizens. Such action could well mean the rise of insured or guaranteed interest rates to 6-1/2% or higher in some established regions. The political impact would be great. However, that administration should at the same time take the opportunity and be completely free to indicate to our people how the government had been lax in its duty to its citizens and how mortgagees have been collecting such a return anyway. The tremendous impact of confidence in the government by its own people would, in the end, contribute an incalculable advantage to the entire nation in its campaign against world tyranny and injustice being waged on many fronts. How difficult for us to walk upon the lands of the earth and impress our form of government upon others when we ourselves have not fully met our obligations through government to our own people.

We are also mindful that the disclosure of the actual rate of interest or cost of borrowing mortgage money may come as a shock to the prospective home-buyer, which, in some cases, may cause him to hesitate before over-extending himself in such an expensive venture. This, in turn, could act as a retarder rather than a stimulant to the housing industry of the nation. Administrations are overly interested in stimulants to the national economy and certainly would move cautiously concerning any depressant factors. Year after year the government housing programs have made it easier for the home-owner to contract ever-deepening mortgage obligations which are way beyond his ability to properly appreciate, with the associated deceptive practices identified in this report. However, if we must continue to practice such deception in order to preserve our economic system (and provide for an ever-expanding economy of which the home construction industry is a key factor) then our economic system is a questionable one for offering such a form of protection. The government cannot condone such device, deception, and masking of costs to the consumer without in the long run endangering its very own existence as a democratic force strong enough to resist encroachment by by those who would practice such methods in a broad form to all peoples of the earth.

As a final suggestion (and one which concerns the FHA program only) considerable discount control could quite easily be effected at present for FHA insured mortgage loans if FHA would move to provide that the FHA Valuation of the property be made the maximum sale price for the dwelling. In the event the home was sold for above this appraised value, then FHA would refuse to insure the loan. This is not novel in any sense of the word. The VA program has operated under this restriction for years. The Veterans Administration Certificate of Reasonable Value establishes a Maximum Selling Price. The FHA Appraised Value of the property could likewise become a "Maximum Selling Price." Under such a regulation, it would be vastly more difficult to pad the discount into the sale price of the home (provided an accurate appraisal was made by FHA). FHA sales are being made at hundreds of dollars over the appraised value on sales type tract homes, and under FHA regulations the government will still guarantee the loan.

As a further control under FHA, the strong suggestion would be made to FHA that the administration move immediately to eliminate the closing costs as a factor in arriving at the appraised value of the home. Such an inclusion allows the builder-seller to collect several hundred dollars, or a portion of the discount, and still price the property at the FHA appraised value. Thus he will have recouped the entire amount of the discount he paid to the mortgagee. The reason for suggesting the elimination of the closing costs from the appraisal is based on the fact that the home-buyer, as well as anyone else not familiar with the precise technicalities of the transaction, will naturally assume that the appraisal is the value of the house (without a consideration of closing costs) as established by FHA. No one would suspect that a few hundred dollars were thrown into the appraisal formula to provide for closing costs which will be collected in addition to the sale price of the home through most closures. In other words, to arrive at a true sale price for a home (without giving consideration to closing costs) the home-buyer must now subtract closing costs from the FHA appraised value in order to establish a figure for the sale price of the home alone.

The removal of this factor from the FHA appraisal formula would further strengthen a discount control program if such was really the interest of FHA. All would naturally have to perate in an environment of accurate appraisals as heretofore pointed out.

An overhaul of the entire matter of appraisal policy and implementation, under both FHA and VA, would by itself go a long way toward control over discount payments being passed on to the home-buyer. This will be covered in a separate chapter since it is such a serious matter and subjected to obvious abuses.

In the event either agency is interested in following with accuracy the exact discounts being paid by the builder directly, and also what discounts exist when the mortgagee moves the paper into the secondary market, the following should be given serious consideration: The suggestion is one contained in a conference report made in the Congress in 1953 as follows:

> As a further check upon abuses creeping into financing charges the committee on conference, in order that the VA and appropriate committee of Congress may have information as to discounts paid, suggests that the Administrator of Veterans' Affairs require the originating lender of any home mortgage loan guaranteed or insured by him under Title II of the Servicemen's Readjustment Act of 1944, as amended, to report the price for which any such loan was sold, or otherwise disposed of by such lender. (underscoring supplied)

It is suspected that an examination of the volumes of reports and hearings held by congressional committees would disclose numerous other suggestions which would help lead to a solution to the problem. It is also suspected that there have been a number of forces from the industry side that have worked against the adoption of any real policy of discount control. There may have been a number of political reasons why governmental administrations have not attacked the problem with vigor and recognized certain practical implications. The suggestions given in this report are few but strong, and represent only those which appeared to be obvious. Other suggestions are undoubtedly at hand from among those who contribute a lifetime to the specialized study of this particular facet of our economy.

CHAPTER XXII

THE FHA-VA MORTGAGE MARKET AND RELATIONSHIP TO (FNMA)

The Federal National Mortgage Association is closely associated with both FHA and VA mortgage loans, since the FNMA provides an immediate secondary market for institutions and mortgage companies to dispose of these government insured and guaranteed loans. Proposed legislation, made known in the spring of 1962, indicated that the federal government also was contemplating the formation of a somewhat similar structure for the purchase of conventional mortgage loans. However, an important feature of this proposed organization is the contemplated acceptance of mortgages at the full market rate of interest, rather than a ceiling of 5-1/4% currently established for FHA and VA. Since this study has repeatedly pointed out the undesirable features of a frozen and unrealistic rate of interest, it is refreshing to learn that such a control may not be a part of the proposed conventional mortgage acceptance system.

The following material is presented from the Federal Bar Journal issue of Fall 1961, and was contained in an article entitled, "Some Structural Features of U. S. Housing and Home Finance" by Robert C. Colwell, Economic Adviser to the Urban Renewal Administration. This is a factual presentation with a rapid summary of FHA and VA mortgage operation, and an explanation of how these are related to the Federal National Mortgage Association (FNMA). This report does not attempt through the media of this presentation to delve into the degree of control over discounts the FNMA purportedly exercises in the open market through its advertised discount rates at which it will purchase FHA and VA insured and guaranteed loans. This would constitute a study by itself and no doubt should be explored. However, this report can only suggest other areas of examination and would be unnecessarily prolonged and fall short of the main issues should it delve into each and every associated operation which admittedly has an important bearing, directly or indirectly, upon the incidental costs to the purchaser of a dwelling.

B. Federal Housing Administration

In order to encourage the flow of investment funds into residential mortgages and home repair loans, the National Housing Act established the Federal Housing Administration (FHA) to insure investors against loss in the event of default. One of the purposes of the Act is to improve the quality of residential construction through the application of minimum standards for all dwellings eligible for loan insurance. Construction under FHA inspections gives the buyer assurance of conformance with published requirements of structural soundness and proper design. Also, houses constructed under FHA inspection provide market criteria for other builders to match or excel if they seek public acceptance of their product. Another purpose of the FHA plan is to substitute long-term monthly amortized first mortgages, with high loan-to-value ratios, for the short-term unamortized loans coupled with second mortgages that were commonplace in the pre-depression years and which contributed to the collapse of the real estate markets early in the decade of the thirties.

Under FHA procedures, a builder proposing to construct a number of houses to be sold with FHA-insured mortgages requests his lender to submit an application for loan insurance. Detailed plans and specifications accompany the application. If the submission meets technical standards and other requirements, a commitment to insure is issued by FHA. This commitment covering one or a group of houses, gives the builder and the originating lender assurance that the loan will be insured as construction proceeds, in advance of sale to a qualified purchaser. The FHA commitment is thus a form of production credit. As work progresses, FHA makes stage inspections to ascertain that actual construction conforms with plans and specifications. When a sale is arranged, the credit status and income of the buyer is reviewed and verified to determine that credit underwriting requirements are met. The FHA derives its income from an application fee paid by the builder or seller to cover the cost of appraising and inspecting the building, and from a mortgage insurance premium paid by the borrower, equal to 1/2 of 1 percent of the unpaid loan balance.

C. Veterans Administration

Assistance in financing the purchase of homes, farms, and businesses is extended to veterans of World War II and the Korean conflict under the Servicemen's Readjustment Act. Under this law, the Veterans Administration (VA) is authorized to guarantee loans made by private lenders to eligible veterans and to make direct home loans in areas where private loans for mortgages are not available. Every veteran with qualifying military service is entitled to loan guaranty benefits; individual home loans are guaranteed 60 percent, up to a maximum of $7,500. In case of default, the lender is reimbursed in full except in the rare instance where the value of the security property, as appraised at the time of foreclosure sale by VA, does not exceed the unguaranteed portion of the loan. This partial guarantee plan differs from FHA insurance, which applies to 100 percent of the unpaid loan balance.

The VA loan guaranty program allows loans to be as large as 100 percent of the reasonable value of the house, as determined by the agency. This provision of the law has given veterans returning from military service without liquid savings an opportunity to buy a house without a down payment; at the same time it has provided them an assurance that the price of the property was not unreasonably high.

Loan maturities may be as long as 30 years, although some lenders have been reluctant to make loans for that length of time without some initial equity, particularly during periods when the supply of mortgage funds was restricted. The program has generally been popular with both lenders and veterans; since the end of World War II, there has been a larger amount of mortgage debt outstanding on 1-to-4 family houses under the VA program than under FHA insurance. However, in recent years the statutory ceiling on maximum interest rates permitted on VA-guaranteed loans has restricted the supply of funds available from private lenders.

Direct home loans are made by VA to veterans who live in capital shortage areas where guaranteed loans are seldom available. These loans have generally been limited to small towns and rural sections, since lending institutions tend to avoid those places where origination and loan servicing costs are high with a sparse market for any houses that might be acquired as a result of a default in payments. The interest rate and the down payment and maturity terms on direct loans are the same as those permitted on guaranteed loans made by private lenders. The repayment record on direct loans has been about the same as on the loans guaranteed by VA.

Under both the guaranteed and direct loan programs, the Veterans Administration applies minimum property standards to both new and existing houses in determining their eligibility as security. In large measure, the VA standards are similar to those of FHA, and are based on FHA's technical studies. Builders who propose to develop a tract with houses to be sold largely to veterans may apply for a master certificate of reasonable value, based upon construction plans and specifications submitted to the Veterans Administration. Unlike the FHA commitment, however, the VA master certificate does not provide a guaranty of the financing until after individual houses have been sold to qualified veterans.

The administrative cost of the VA program and any losses resulting from guaranty contracts originally were paid out of funds appropriated by Congress, since veterans have not been charged an insurance premium; losses are now paid out of a revolving fund. The direct loan program also operates as a revolving fund, and sizeable reserves have been created out of the difference between the interest charged and the interest paid to the Treasury on funds employed.

D. Federal National Mortgage Association

Under the National Housing Act, the Federal National Mortgage Association (FNMA) was established in its present form to provide a secondary market for FHA-insured and VA-guaranteed loans and to furnish special assistance in supporting the market for various types of FHA and VA home mortgages in which there is a public interest.

The secondary market operations of FNMA are financed by a capital structure created by the sale of preferred stock to the Secretary of the Treasury and by the sale of common stock to lenders who offer mortgages for purchase by the agency. The amount of preferred stock that may be sold is prescribed by law; the amount of common stock is a proportion (currently 1 percent) of the face amount of mortgages offered for purchase. Dividends are paid on both classes of stock. The agency is authorized to sell obligations to the public up to 10 times its outstanding capital stock and surplus. In the event that the conditions and terms prevailing in the private capital markets are not favorable for the sale of its obligations, FNMA may sell them to the Treasury, up to an amount fixed by law. Repayments of principal on outstanding loans and proceeds from the sale of mortgages held are used either to buy new mortgages or to retire outstanding obligations.

The main purpose of FNMA secondary market operations is to provide a degree of liquidity for mortgage investments; accordingly, FNMA is required to establish prices for the loans it buys within the range of current market prices for the particular class of mortgages involved, but it cannot pay more than par. Because the market translates interest rate differentials into common levels of prevailing yields, the prices offered by FNMA differ according to the contract rates on various classes of loans. Geographical differences in the availability of private capital affect prevailing yield requirements, as do length of loan maturity and size of initial equity. All of these elements are reflected in the schedules of FNMA purchase prices. As the general structure of market yield requirements changes from time to time, FNMA prices are adjusted to stay within the market range.

The supply of private funds seeking investment in mortgages varies with the volume of net new liquid savings, the flow of repayments from loans outstanding, and the demands of alternate users of long-term capital. When the supply of private mortgage funds falls short of the demand for home loans, FNMA becomes a purchaser of mortgages. At other times when the supply of funds exceeds the volume of mortgages available, FNMA is apt to become a net seller of loans.

The special assistance functions of FNMA rely entirely on Treasury funds made available through statutory authorizations. Purchases are usually made at or near par rather than at current market prices because of the public interest vested in provision of housing for various special purposes. Special assistance has been extended to urban renewal and relocation loans, to housing for the elderly, to armed service housing and to cooperative projects, among others. As a counter-cyclical aid, FNMA support has been given to low-and medium-priced housing generally during recession and early recovery periods.

From Federal Bar Journal - Vol. 21, No. 4, Fall 1961.

CHAPTER XXIII

APPRAISAL PRACTICES

If any one area were to be identified as that which frequently contributes most heavily (either directly or indirectly) to the home buyer's incidental cost in purchasing a dwelling, it would in most cases surround itself with the FHA or VA appraisal and valuations based upon it. The appraisal value in turn is associated very directly with the discount. As a matter of fact, in many cases it will be the major cause of the discount being passed on to the buyer, with the buyer being almost completely unaware that he is paying such a discount. The appraisal and the resultant FHA or VA valuations are usually the vehicle which allows for the operation of discount costs being paid for by the home-buyer even under a VA closure, the machinery of which is specifically designed to thwart such a possibility. Also, the appraisal frequently operates to allow large discounts to be assessed to the home-buyer under FHA, where sales price ceilings do not exist but where an appraisal figure might serve as a flag of warning to the purchaser especially in sales type tract homes.

An appraisal is made under either FHA or VA insured or guaranteed mortgage loans by appraisers for those agencies, relative to the value of the home to be purchased. In cases of tract area sales type homes already constructed, and having been constructed in substantial conformity to FHA or VA approved plans for some period of time, there will exist a considerable foundation upon which to issue such an appraisal with very close accuracy. In cases where FHA or VA may be appraising an older home which was custom built, the accuracy of the appraisal might logically vary from one appraiser to another. There would be reason for some variance due to location, physical condition of the premises, and inability to compare the structure with like improvements. However, where appraisals are being made of sales type homes in tract areas, very little latitude should be allowed among appraisers in their final figures, since material and labor costs are current, land and development costs of the moment, and basic homes are quite alike in structure and quality with only additional equipment, extras, and increased size in some lots and models to be considered. Furthermore, it is quite likely that in an adjacent tract (or in the same tract) there have been several resales of like properties of recent date. Appraisers working in such an environment have an unusually intelligent basis upon which to issue an accurate appraised value.

It should be noted, that the appraisal which is employed to arrive at the FHA Valuation or Certificate of Reasonable Value under VA, is necessary to the government agencies so that a foundation for a guaranteed or insured loan may be established. Under VA, the Certificate of Reasonable Value (issued after appraisal) constitutes the ceiling for the sale price of the home; likewise establishes the extent of VA responsibility in formulating the guarantee. Under FHA, the appraised value also constitutes the foundation upon which the formula for that portion of the loan FHA will insure under different break points in cost is established. However, differing from VA, the FHA appraisal establishes no control over the sale price of the home. The home-buyer may pay more than the appraised valuation but the FHA insurance will only cover a certain percentage of the FHA Valuation. Any overage the home-buyer pays for in the sale price of the house is in cash, along with that portion of the loan under the FHA Valuation which FHA does not cover (3% up to the first $15,000 and a higher percentage, not covered, on more expensive dwellings).

PRACTICAL APPLICATION:

It is quite apparent that the FHA and VA appraisers may in many cases be taking into consideration, as a part of the appraisal and valuation placed on the home, any discount which the mortgagee may require. In this connection, it is of interest to note that Congress had this concern some years ago as evidenced by the following report of a Congress committee of conference in 1953, which amended Section 504 of the Housing Act of 1950:

> In adopting the language of the House amendment, the committee of conference wishes to make clear that the VA may take reasonable measures to assure that any discounts or warehousing or similar fees which may be absorbed by the builder are not passed back to the veteran purchaser. Any such costs cannot be passed back to the veteran if the CRV, issued by the VA in connection with the sale of the property, is in fact a realistic value...This is the control mechanism to guard against abuses in either financing cost or construction practices. Obviously if the CRV is a realistic figure such abuses cannot exist. (underscoring supplied)

Further in this connection, the legislative history of the Housing Act of 1950 discloses the concern of Congress that:

> Even though mortgage discounts could not then be collected directly from the veteran by the mortgagee (1934-1950), the builders were being required to pay discounts in many areas and it was reasoned that the VA might be taking into account such expenses of the builder in issuing its CRVs and thereby requiring the veteran to absorb the discount in the sales price. (underscoring supplied)

In 1956 again the problem was recognized by the Congress when it established (in connection with multifamily FHA projects) the following provision in an attempt to control the practice of including the discount in the FHA appraisal. Just how such a "slap on the wrist" directive could control this situation is not absolutely clear. FHA's report on the matter reads in part as follows:

> With respect to multifamily projects, a recent change in instructions, adopted in the form of a letter to the Directors of all FHA field offices dated July 6, 1956, the payment of discounts by mortgagors, or any other persons interested in the mortgage transaction, in accordance with the demands of the mortgage market; the only limitation being that the amount of the discount must be approved by the local FHA Director. There is being employed, however, an additional control to assure that the amount of the discount, if any, is not reflected in the FHA valuation cost estimates, or insured mortgage. This is accomplished by an instruction to FHA appraisers and cost estimators that in the processing of multifamily projects, for the purpose of determining the maximum insurable mortgage, THEY WILL MAKE NO ALLOWANCE FOR FINANCING EXPENSES OTHER THAN the 1-1/2% permissible service charge. (Underscoring supplied)

Although this directive was related to multifamily FHA projects, the concern about having discounts included in FHA appraisals and following valuations issued by FHA, was of genuine concern.

It should be realized that a VA Certificate of Reasonable Value and a FHA Valuation on precisely the same property will not necessarily be the same. This is due to one primary difference, other factors being equal. The FHA allows, and directs their appraisers to include in the appraised value of the home, the closing costs as a necessary part of a valuation figure on the market worth of the home. Under VA, their appraisers are not directed to make such an allowance and such cost factors are not allowed to enter the appraisal formula. Other things being equal then, the VA Certificate of Reasonable Value should come out several hundred dollars under the FHA Valuation figure on the same home.

Another important point should be made. It should be realized that appraisals made by FHA and VA do not take into consideration (or should not take into consideration) the unit cost of construction which may vary from one builder to another. Builder "A" may be building his tract homes on an almost assembly line basis, employing prefabrication and/or component methods, and making material purchases in vast quantities at substantial savings. He may also be able to hold together a crew of relatively efficient labor through seasonal fluctuations by having them constantly at work on projects throughout a state, or in parts of two or more states. Builders such as this may be a part of vast corporate enterprises with almost unlimited resources for financing. They purchase to advantage and take the opportunity to employ large scale cost-saving techniques. Builder "B" on the other hand may be a local builder with limited resources. His financing may be difficult and so he cannot always move at the opportune time. Usually his material costs will be higher and his building cost per unit (not being geared to assembly line methods) could, and usually are, relatively higher than Builder "A". His acquisition and development of land for building sites may not be as efficient, also adding to his overall cost.

However, some relatively small builders may gain significant advantages by lower labor overhead and supervision costs and may also operate without interim financing. Size alone does not always determine a unit cost factor with any set ratio of dollar efficiency.

In the face of these varying situations between builders and their relative differences in the cost of producing like homes, how does the appraiser operate? Is he to take into consideration the greater efficiency of many of the mass builders or penalize some of the local higher cost per unit builders? From most observations, it should be reported that the appraiser is more apt to set a valuation in line with "market" and more in line with the small builder. To do otherwise would almost certainly freeze many small builders out of the construction business but likewise gives a price advantage to any efficient mass builder. Possibly the unit cost between large and small builder is not overly great in some areas, and any variations may rest primarily with efficiency factors rather than size. Unit cost differentials are identified to indicate such variance, and not the quantity of it, which would be a separate study by itself. They are also identified to indicate how, in the future, with the adaptation of increased prefabrication and component methods and mass assembly line techniques, the disparity could grow and cause an even greater problem than exists today. A separate chapter is devoted to new building methods which are bringing about a change in both material, labor, and interim financing costs, to both the builder-seller and indirectly to the home-buyer.

The argument will immediately be made that, if the efficient mass builder is to receive the same appraised valuation on his structure as the smaller builder, certainly the big time operator with a lower unit cost will be in a better position to absorb any discount into his selling price. This is true, and again it is purely a matter of competition. Where FHA and VA must place valuations high enough to actually cover inefficient builders (large or small), they are at the same time providing for efficient builders to completely absorb the discount. However, competition will again enter the picture to weed out these inefficient and costly builders since they will be poorly prepared to pass on their discount cost to the home-buyer where accurate appraisals have been made by FHA and VA. They would have to sell under FHA at a higher sale price per home, or take the shock of the discount themselves under the VA ceiling set by the Certificate of Reasonable Value.

Since there is but one basic reason for a difference between a FHA Valuation and a VA Certificate of Reasonable Value on the same home (that of closing costs in the FHA figure), one could argue that they would not be far apart after a consideration of this variable. The fact of the matter is they should be very close, far closer than the closing cost differential itself. This statement is held to since the appraisers FHA and VA employ are assumed to be men of some experience in the matter of making appraisals and having some basic training in value and cost factors. In sales type homes in tract areas, there is no excuse for not knowing very closely just what a fair market price and value would be and the building cost per square foot on a certain quality of structure. The land values are well established, and development costs for streets, sidewalks, water lines, and sewage connections certainly are not in the realm of conjecture. Where appraisers are sent to a unique type of improvement, say a ranch house built many years ago, and where the valuations in the district have not been recently established through either offerings for sale or actual transactions of ownerships, then the appraisers could conceivably come out 15% to 20% apart, and possibly further on a large estate. Where they are dealing with known costs, on almost factory line production, and have resale information on like structures (perhaps in the same block) there is little excuse for finding any degree of disparity between appraisals and established valuations by FHA and VA in the same area. The possibility for accuracy of the appraisal on sales type homes is therefore evident.

In actual practice, the Congress did have foundation for apprehension and concern that the valuations being placed by FHA and VA could be high enough to take into consideration the discount required by the mortgagee. With a sales price in relation to such inflated valuation, then the home-buyer would in effect be paying for the discount properly chargeable to the builder.

In Nevada the indications that the discount is covered by high FHA and VA appraisals is almost universally accepted among those familiar with the sale of tract type homes under FHA and VA. This study does not try to assess the extent of this, though the practice must be common in a majority of cases to say the least. This does not rule out the possibility of large builders passing some of the savings on to home-buyers with sales below the FHA Valuation and VA Certificate of Reasonable Value. This is common with some builders. Small builders will also do this when they wish to move on a sale and "turn around," financially speaking, to start anew.

It is difficult to see how the practice could be as extensive as that commonly known, without being almost universal in Nevada. It would be most undemocratic to operate under a partial allowance for the discount for some builders and not for others. The dictatorial control over builders that could be exercised by a local regional office of FHA or VA, in manipulation of "policy" on issuance of high appraisals and issued valuation for one group and not for another, has obvious overtones which this report does not attempt to assess.

The results of a variable policy on appraisals and how much, if any, allowance is to be given for discount absorption, could have a controlling force over which builders would be able to operate in an area and allowed to survive. It could also provide for an artificial stimulus to other "selected" builders to forge ahead with vastly swollen profits on each and every transaction. Certainly the spector of "politics" could enter as a very strong and controlling force, providing for the establishment of building empires with a very efficient method of protection through exclusion of outside competition and lower valuations issued to competitors.

In this connection, it is well known that a policy of containment has been in operation for many years in the Reno area, discouraging normal development of competition through abnormal difficulties being placed in the path of any expansion policies which might work to the disadvantage of certain established groups and upset the status quo. That such policies could be implemented and guaranteed through the operation of certain appraisal practices conducted by government agencies in Nevada, should not be ruled out. Suffice it to say that such a strong possibility does exist, through manipulation of any loosely administered appraisals associated with government backed mortgage programs.

The obvious impact of these possibilities works to the distinct disadvantage of the veteran and home-buyer. It will, in every case, work toward a higher cost to him for his home. It may be asked why the cost of homes is as high as it is in certain parts of Nevada. This report can only suggest how this could come about, other factors being equal. Possibly there are some strong reasons why the "discount" has continued to be associated with FHA and VA programs through unrealistic insured or guaranteed interest rates, Possibly there has been reason for the continuation of unrealistic guarantee rates so that a discount could be employed for political purposes.

SUGGESTION:

The entire future respect for the FHA and VA programs rests upon their ability to make correct appraisals as foundations closely associated with the value of the dwelling, exclusive of covering for the discount.

To this end, correct appraisals are far more apt to be forthcoming if it is not necessary for them to be covering for a discount which has itself been artifically created by refusal of FHA and VA to guarantee under market conditions. One would almost suspect that they wished to generate a discount system to maneuver with politically for localized control in many areas of the nation.

Doubtless some inaccurate appraisals will continue after the discount is eliminated, for other reasons. However, the large scale evil practices now evident could be eliminated with the end of discounts. It is therefore strongly suggested that FHA, VA, and the Congress, if necessary, move to insure and guarantee mortgage loans as suggested in this study, at close to market conditions on a regional basis, and subject to continual review and correction, if necessary. Under such a system, the inflated appraisal problem would become far less significant and could only be continued to provide for a clear profit to a builder over and beyond his normal return, something which might be far more noticeable than covering for a discount.

CHAPTER XXIV

COMPLETE DISBURSEMENT OF THE LOAN BY THE MORTGAGEE

Both FHA and VA regulations provide that the lender or mortgagee must disburse the full amount of the loan, and in addition must sign a certification to that effect. Under VA, some amounts from the proceeds may be withheld. However, the mortgagee must state what these amounts are and (in his certification) where they are held.

A full disbursement of the loan would be an amount equal to that indicated on the note and the deed of trust executed by the home-buyer; FHA Deed of Trust Note (FHA Form No. 9146) or the VA Deed of Trust Note (VA Form 26-6326a), and FHA Deed of Trust (FHA Form No. 2146m) or the VA Deed of Trust (VA Form 26-6326).

FHA regulations in this regard are clearly established in Section 203.17 entitled "Mortgage provisions," which reads as follows:

> (a) Mortgage form. The mortgage shall be executed upon a form approved by the Commissioner for use in the jurisdiction in which the property covered by the mortgage is situated and shall be a first lien upon property that conforms with property standards prescribed by the Commissioner. The entire principal amount of the mortgage must have been disbursed to the mortgagor or to his creditors for his account and with his consent. (underscoring supplied)

The FHA mortgagee's certification to this fact is contained on the reverse side of FHA Form No. 2007 as one of the numbered certifications the lender makes on the Mortgagee's Certificate, as follows:

> (c) Complete disbursement of the loan has been made to the Mortgagor, or to his creditors for his account and with his consent. (underscoring supplied)

VA provisions relative to the complete disbursement of the loan are also provided for under their regulations. First, and clearly identifying the transaction, is this definition given in VA Section 36.4300 under (n) as follows:

> 'Full disbursement' means payment by a lender of the entire proceeds of a loan for the purpose described in the report of the lender in respect of such loan to the Administrator either (1) by payment to those contracting with the borrower by such purposes, or (2) by payment to the borrower, or (3) by transfer to an account against which he can draw at will, or (4) by transfer to an escrow account, or (5) by transfer to an earmarked account if (i) the amount thereof is not in excess of 10 percent of the loan, or (ii) the loan is one submitted by a lender of the class specified in 38 U.S.C. 1802(d) or 1815(a). (underscoring supplied)

Under VA Section 36.4303, paragraph (d), the following requirement identifies the full disbursement as follows:

> A certificate of commitment shall entitle the holder to the issuance of the evidence of guaranty or insurance upon the ultimate actual payment of the full proceeds of the loan for the purposes described in the original report and upon the submission within 30 days thereafter of a supplemental report showing the fact. . . (underscoring supplied)

Under VA Section 36,4303, paragraph (g), the following reference ties in the regulations with the VA Form No. 26-1876 "Certification of Loan Disbursement":

> Subject to compliance with the regulations concerning guaranty or insurance of loans to veterans, the certificate of guaranty, or the evidence of insurance credit will be issuable within the available entitlement of the veteran on <u>the basis of the loan stated in the final loan report or certification of loan disbursement.</u> (underscoring supplied)

<u>The VA lender certification</u> covering the mortgagee's complete disbursement of the loan is contained on VA Form No. 26-1876 entitled <u>Certification of Loan Disbursement</u>. The completion of this form and certification of it by the lender, <u>submits that he has so made the full disbursement</u>. For cases where some portion is withheld, there is provided in a number (8A) section (on the bottom of the form) a place to insert the amount not disbursed, and under (8B) a section to be completed indicating where such amount has been deposited. The introductory note on this form, and other material contained in the heading of the form, reads as follows:

> Note: This certification of loan disbursement must be executed and submitted to the Administrator by the holder of Certificate of Commitment within 30 days after <u>the ultimate actual payment of the full proceeds of the loan.</u> (underscoring supplied)

> In connection with the loan identified above and referred to in the Certificate of Commitment issued in connection therewith, the undersigned lender, <u>having fully disbursed the loan proceeds,</u> submits the following report: (underscoring supplied)

<u>The foregoing provisions clearly identify that under FHA and VA programs</u> (as established by both regulations and certifications which must be signed on official forms) <u>the full disbursement of whatever loan the lender has made to the home-buyer must be made prior to either agency insuring or guaranteeing the loan.</u>

PRACTICAL APPLICATION:

In spite of these regulations, many mortgagees are disbursing an amount to the credit of the mortgagor, several hundreds of dollars short of the amount of the loan as evidenced by the note executed between the lender and the veteran or home-buyer. Coincidentally the shortage of several hundred dollars is the precise amount of the discount. For example, frequently this is stated in instructions to the escrow officer from the mortgagee as follows:

> This loan will be funded at 95-1/2% of par. The 4-1/2% discount differential must be collected from seller and cannot be paid by buyer.

The veteran or home-buyer is credited at closure with an amount equal to the amount of the loan, since the differential or discount will have been collected through closure from a direct charge to the seller or from the proceeds of the sale due to the builder-seller. <u>Notwithstanding this action, a complete disbursement of the loan has not been made to the mortgagor, his agents, or anyone else, by the lender. This directly violates FHA and VA regulations and apparently the practice is condoned by these agencies.</u>

Furthermore, in the event an incomplete disbursement of a loan has been made, the home-buyer none the less must repay the full amount of the note. In this case a danger can develop which should be considered. Should the builder-seller have financial difficulties, and the transaction falter at a point where the loan has been made, the home completed, and closure impending, the home-buyer could be saddled with a note which must be paid in full although the funds were not made available in full to him. The seller would not be in a position to pay the discount to the mortgagee, but the buyer would be liable for the full amount of the note. In short, he would not have received a credit for the full amount of the note but would have to pay back such an amount (with interest) with an immediate loss of several hundreds of dollars.

The question will logically be raised, why do lenders not disburse the full amount of the note? Apparently the answer is this. To disburse the full amount of the note obviously ties up more funds than holding back a portion of the amount of the note. The lending institution knows that it will receive the discount through closure from the seller, but this may take several days or weeks. Why not discount the note immediately, at disbursement, and not have several hundreds of dollars outstanding on a number of loans while waiting for collections from the builder-seller to be made through closure? Naturally, under such a system the lender can work with a smaller amount of funds. Lenders may try to rationalize their violation of FHA and VA regulations by making a book entry to the credit of the builder-seller anticipating that such an amount will eventually be credited to him when received from the builder-seller through closure. However, in some cases it could constitute an actual builder reserve for other financial manipulations, in effect a fund acknowledged by the mortgagee as a builder-seller asset.

As a result of this device, the home-buyer starts paying principal and interest to the mortgagee (frequently a mortgage company) on a loan several hundreds of dollars more than the lending institution or mortgage company made available to him by any disbursement whatsoever. Also, in the event the mortgagee has failed to disburse the full amount of the loan, the home-buyer will nevertheless be required to carry hazard insurance and pay any FHA mortgage insurance premiums, in an amount necessary to cover the full loan. Technically he will be carrying (and be required to carry) excess amounts of insurance coverage on funds never made available to him by the lender directly. Admission is made that this is a technical point. However, if FHA and VA approve of such incomplete disbursements, it is to be wondered why they don't change their regulations and certifications.

The fact that, in some cases, the mortgagee may have extended a credit to the seller by an offset equal to the discount or differential not disbursed makes no difference whatever. The loan itself has not been disbursed completely to the mortgagor or his agents and there will always exist a several hundred dollar amount never disbursed to the home-buyer by the mortgagee. He will, however, pay back this money to the mortgagee, with interest.

This is clearly a device and scheme which is not properly policed by FHA or VA, and a vicious misrepresentation to the mortgagor. He thinks he is obtaining a 5-1/4% loan when actually the cost to him, depending on how long he keeps the mortgage, will beat a far greater interest rate when consideration is given to this indirect discount payment, origination fees, and the host of incidental fees and charges assessed to him at closure. The true rate of interest, or cost of the money, may approach 8% in many cases.

It is clear that political expediency is at work. The man on the street thinks the federal government is guaranteeing to him and making possible a low rate of interest or cost for his home loan. Every time the government lowers the rate at which they guarantee a loan, he feels more secure. In actual practice, however, each time the guaranteed rate is lowered, the lenders merely "adjust" their discounts by charging additional points and other incidental charges, to provide them with a continuing yield or return on their money.

This deceitful practice should be terminated at the earliest possible moment. The disservice and misrepresentation subscribed to by the federal government and presented to the people of this state and this nation is a disgraceful exhibition of the worst form of socialism. No veteran or home-buyer who enters the market to shop for a loan has half a chance to compare the actual cost of the money offered under such a continuing governmental policy. Such policy is also primarily responsible for the inflated and inaccurate appraisals and valuations being issued by FHA and VA to cover discounts.

Recent action launched by the Kennedy Administration to protect the consumer by guaranteeing that methods may be employed in the future to present to him the actual cost of money on financing is contained in the so called "Truth in Lending Act" S. 1740 of the 87th Congress, 1st Session. The subcommittee of the Senate Banking and Currency Committee has refused to report this bill out by an adverse vote of 5 to 4, preventing further action in 1962.

The current FHA and VA programs, which operate underhandedly against the consumer so that he may never know the actual cost of money and interest rates when he purchases a dwelling, should be a major consideration of any administrative effort to make clear to the consumer the cost of credit. The federal government works at cross purposes. FHA and VA work to obscure consumer credit costs while the "Truth in Lending Act" promulgated by the administration would disclose such information.

The practice of evasion by the lender, of not making a complete disbursement of the loan to the mortgagor or to his creditors, was brought to the attention of FHA officials in Washington by the Counsel Bureau in a letter dated January 12, 1962. The question was directed as follows:

> In our phone conversation of yesterday, I asked if your attorneys could give us any clarification in regard to Section 203.17 of FHA regulations, subsection (2) Mortgage Form. Our interpretation of the last sentence is, that the mortgagee must make a complete disbursement of the entire amount of the mortgage equal to the specified number of dollars as indicated on both the deed of trust and deed of trust note, and he must so indicate to FHA on the mortgagee's certificate prior to FHA's final acceptance of the loan for insurance. Here in Nevada, it is quite common for the mortgagee to disburse a lesser amount and hold back in advance the discount of several hundred dollars. They do not disburse the full amount of the mortgage, although their mortgagee certification to FHA indicates that they have done so.
>
> 11. We would like to have a clarification of this point by your attorneys. May mortgagees, by this device, collect their discount in advance or must they disburse the full amount of the mortgage loan to be made available as a full credit to the mortgagor at time of closure, and receive their discount through escrow at a later date?

The Legislative Counsel Bureau received a reply to this question in a letter sent to us from FHA Washington offices which enclosed a memorandum dated February 2, 1962, prepared by A. M. Prothro, General Counsel for FHA, and forwarded to Monte Ray Niblack, Information Officer and Special Assistant to the (FHA) Commissioner. That portion of the memorandum relative to our question number 11, regarding the complete disbursement of the loan by the mortgagee, reads as follows:

> Question no. 11 is predicated on your statement that it is quite common for the mortgagee in Nevada not to disburse the full amount of the mortgage, although it certifies to the FHA that it has done so. In this connection it is to be observed that Section 203.17 of the Regulations prescribes that the entire principal amount of the mortgage must have been disbursed to the mortgagor or to his creditors for his account and with his consent. In the normal course of handling such a settlement, the mortgagee would make disbursement of the full amount of the loan for the account of the mortgagor purchaser, which of course would likewise involve payment of the purchase price to the seller, either by the mortgagee or the title company or attorney handling the settlement. The purchase price is made up of the proceeds of the loan, plus the cash paid by the purchaser, so that the title company or attorney would have in its hands sufficient funds to satisfy the purchase contract - a part of which would be held for disbursement to the seller, recording costs etc., all for the account of the mortgagor. If in the transaction there is a discount to be paid by the seller the amount of the discount would be deducted from the funds which would otherwise have been paid to the seller. This is essentially a bookkeeping transaction in effecting the payment to the seller of the amount to which he is entitled under his contract and is done upon the order of the seller. Such a procedure would not seem in conflict with the Regulations, as a matter of fact the payment of the discount in this manner is essentially a separate transaction between the mortgagee and the seller. (underscoring supplied)

Regardless of this opinion issued by the FHA counsel, the fact remains that the "entire principal amount of the mortgage" has not been disbursed to the mortgagor or "to his creditors for his account." As a matter of fact, the mortgagee has not disbursed the full amount of the loan to anyone. The lender simply never disbursed the full amount of the loan, regardless of any bookkeeping transactions referred to. Violation of the FHA regulation in this respect is conclusive and cannot be condoned by FHA under any reasonable interpretation of their own regulations. To hold otherwise is to disregard the common meaning of English and the rudiments of law.

If it is the intent of FHA to have the lender discount the loan in advance of closure, and hold back funds which will eventually accrue to the mortgagee, then FHA should forthwith change their regulations to provide for this rather dubious practice being made at least acceptable under their regulations. New regulations to effect such an authorization would not, however, change the position of the home-buyer, who would still be signing a note and deed of trust indicating the receipt of a certain amount of money on a loan without ever having received same either directly or as a credit from the mortgagee.

The matter of the complete disbursement of the loan was also brought to the attention of the VA officials in a letter directed to the VA regional office in San Francisco, California, on January 3, 1962. Their simple reply was as follows:

> The last paragraph of your letter asks whether we require the mortgagee in the case of guaranteed loans to make a complete disbursement of the loan as evidenced by the amount specified by the note. The answer to this question is 'yes.' (underscoring supplied)

In a Counsel Bureau letter of later date (April 26, 1962) the specific practice of some mortgagees holding back a part of the loan (discounting in advance) was more clearly identified to VA, and we again asked how they viewed this form or manipulation. The VA answer came in a letter to our Counsel Bureau, dated June 12, 1962, and read in part as follows:

> We have discussed with officials of our Central Office, Washington, D. C., the question presented in your letter of April 26, 1962, concerning loan disbursement. You requested our views as to whether Veterans Administration Regulations are complied with if a lender withholds from disbursement as a discount part of the stated amount of a loan as reported on VA Form 26-1876; or must the lender actually disburse the full amount and collect from the seller the discount as a separate transaction.
>
> Inasmuch as the end result is the same we are of the opinion that our regulations would not be violated if the discount was withheld from disbursement and the loan was otherwise proper in all respects. (underscoring supplied)

We must conclude from both FHA and VA replies received, in regard to their regulations and certifications which require a complete disbursement of the amount of the loan, that neither agency is overly concerned with compliance with their respective procedures. Apparently, it matters not whether certifications are made falsely, and whether or not there is an adherence to regulations.

It is obvious that FHA and VA concern themselves only with the end results. We are a loss to understand why both FHA and VA should seek justification for the evasion of their clearly worded provisions in place of issuing forthwith strong directives to mortgagees to the effect that FHA and VA will refuse to insure or guarantee loans presented which have associated with them an incomplete disbursal of the full amount of the mortgage loan.

SUGGESTIONS:

The FHA and VA should obviously be memorialized by the Nevada Legislature to enforce their own current regulations, regardless of the rationalization they employ to justify their current position. To allow the mortgagee to make a lesser amount available to the mortgagor for the primary purpose of saving the lender from having to involve himself with less funding monies is again to increase the mortgagee yield indirectly. This works to the specific disbenefit of the veteran and home-buyer in the presentation of the cost of his loan. Also, it fosters numerous other irregularities.

The FHA opinion cited makes reference to the discount as a transaction between the builder-seller and the mortgagee. Very possibly the builder-seller should in no way be connected with the loan made to the home-buyer. Regulations should allow the home-buyer to pay the discount directly, in which event he would feel the full impact of the cost of borrowing money. If the cost to make the loan available to the buyer has to be the equivalent of 7% or more, then it should not be masked over by short-changing him with the discount device as practiced herein, and having the home-buyer sign a note for one amount while receiving from the mortgagee a smaller amount through discounting in advance of disbursement. A quick rebuttal will be made by those who realize that in some areas competition may force the builder-seller to absorb all or part of the discount, in which case, the buyer would be at a disadvantage. This does not necessarily follow, since in such a case, competition would force the builder-seller to lower the sale price of the home with the buyer picking up that portion or all of the discount the seller might have absorbed as a saving to the purchaser. It is strictly a matter of how competition has worked to pass on the savings, either through a direct builder absorption of the discount by not increasing sale price, or by the buyer paying the full discount with a lower sale price to him.

As a very practical control over the full disbursement of the loan, the buyer could be placed in immediate awareness of what amount has actually been disbursed by the following method. The disbursement check from the lender should be made out to both the title (or escrow) company and the home-buyer, as practiced by some mortgagees. By this method, the person executing the note will not only know when the funds were made available (for purposes of preliminary interest collections), but also will know what amount was actually disbursed to him for his account. Thus he will be placed in immediate knowledge of any discrepancy between the amount he is borrowing and that made directly available to him.

In those cases where the mortgagee is closing a transaction directly, (without employment of a title or escrow company) then a disbursement check by such mortgagee should be made out to the mortgagor for his signature, so that he may comply with the certification to be suggested, and for information to the mortgagor as indicated.

FHA and VA should move to make this suggestion a requirement for all disbursement checks issued by any and all mortgagees. Furthermore, FHA and VA should include in their mortgagor's certifications (FHA Form No. 2007, back side) and (VA Form No. 26-1876, reverse side) the additional item of certification, that the mortgagor has properly endorsed the mortgagee's disbursement check, and that such check was made out in the full amount of the loan made to the veteran or home-buyer, as evidenced on the note and deed of trust.

In addition to a certification by the veteran or home-buyer that he has endorsed a disbursement check made out to him by the mortgagee in the full amount of the loan, another strong suggestion is made. This is not a novel one since it is now employed by the VA. The FHA should move immediately to provide, as VA does, a separate and complete "Certification of Loan Disbursement" which will itemize and list each and every separate charge made to the mortgagor for closing the transaction. Thus, the entire itemization of all closing costs to the consumer is readily apparent. Upon this suggested form might be included the suggested certification that the home-buyer has endorsed the mortgagee's check in the full amount of the loan as evidenced on the deed of trust, in addition to where such certification has been suggested on FHA Form No. 2007.

As of the moment, the only way a veteran or home-buyer might be made aware of any partial disbursement of the loan would be in the unlikely event he happened to be furnished with a copy of the mortgagee's statement of charges to the mortgagor to be collected by any title or escrow company. This usually includes a funding statement identifying the discount. Usually only the closing officer has need of this statement and such officers seldom make the information available to the purchaser.

PART IV

LOAN ADMINISTRATION BY THE MORTGAGEE

The chapters in Part IV are concerned with certain problems the mortgagee has in servicing the loan, particularly as these difficulties relate to the veteran or home-buyer.

After endorsement of the loan, both FHA and VA will be in the picture even less as protective agencies looking after the veteran or home-owner interests. Servicing of the loan, or "loan administration" as mortgagees like to have it referred to, will continue through the years that the mortgagor has the loan. He may sell his dwelling to another. However he is still technically responsible in the event of failure of the one to whom the obligation has been assigned. Chances are very remote that the obligation would again be pressed upon him, and even in that event in the interim a significant amount of the principal would have been paid off by the person who purchased from him.

Part IV strongly suggests the elimination of the trust reserve for the reasons given herein. In turn, this would eliminate most of the "loan administration." With this gone, most of the problems, inequities, and complexities associated with servicing (as well as the closing of the sale transaction) would be greatly reduced.

CHAPTER XXV

DOCUMENTS AND PAPERS RECEIVED AFTER CLOSURE

It is not possible to disburse to the veteran or home-buyer at closure all of the documents and papers which should eventually follow through to the mortgagor. Some of these will still be in the process of being recorded or otherwise to be executed and prepared. A following chapter lists these documents and suggests how a transmittal of all closing documents should be employed to identify them, and how FHA and VA would know whether they were eventually properly dispatched to and received by the mortgagor from any title or escrow company, mortgagee, or builder-seller.

PRACTICAL APPLICATION:

Basically the mortgagor will receive, after closure, his copy of the policy of title insurance, original deed to the property recorded after closure, statement of charges and credits made by the mortgagee, escrow or title company, and settlement check for overages collected, if any. These will be sent by the institution closing the transaction some few days after closure. The buyer should also receive his copy of the warranty, and may receive it at this time if not delivered prior to closure.

The statement of charges and credits frequently will not be itemized to indicate each separate charge and credit properly. Such a statement at closure will fail to provide the mortgagor with information to check items he has been charged for to see whether the charges made to him are those which he has agreed to, or that FHA and VA regulations allow him to be charged for. In addition to the mortgagor receiving an itemized closing statement, it is also suggested that he be furnished with a copy of charges and credits made to the seller, so that he can compare both statements to see if contract or escrow instructions were properly followed. Sometimes this is difficult to determine with only a buyer's statement. Conventional dwelling transactions frequently make available to the buyer and seller a copy of both buyer and seller statements of charges and credits.

Some time after the closure, the veteran or home-buyer will receive a letter with enclosures directly from the mortgagee. This may well be his first direct relationship with the lender in those cases where the mortgagee will have been dealing with the home-buyer indirectly through an escrow officer up until this time. The communication from the lender will usually cover such matters as how the buyer is to remit his payments to the lender. In any case this information eventually should be made available to the mortgagor. Usually along with this is sent a payment book, coupon book, or automation processing cards, to be employed in such remittance procedure. The mortgagee should also include at this time information indicating the breakdown of the entire monthly payment into amounts for principal, interest, taxes, insurance, and FHA premium payments, if any. The due date of the first of such payments to the mortgagee and information as to how the lender may be contacted in order to execute such payments should be clearly identified. If the lender is not a local institution, it will usually be necessary to forward payments by mail. Also, the lender should explain the late charge he is allowed to assess after the 15th of any month, when no payment for that month has been received. This is a charge of 2% on FHA loans and 4% on VA loans. The lender should also explain his requirements associated with the fire insurance policy and how he will "service" the loan and make payments for taxes, insurance, and FHA premiums (if any) from the trust reserve account of the mortgagor. At this time, the mortgagee should also include (in FHA cases) a copy of the amortization table. Frequently this is not forwarded to the mortgagor. VA does not provide such a schedule for the veteran. However, it is strongly suggested that they should.

The amortization schedule provided in the case of FHA guaranteed mortgages is FHA Form No. 2037, and based on three variables. One is the amount of the loan; secondly, the rate of interest which will include the FHA premium insurance at 1/2% (but quoted in a separate column); and thirdly the term of the mortgage in years.

With a copy of this amortization schedule, the buyer can check at any time during the term of the loan and have an immediate indication of what he has paid on the principal and the interest to date. The balance still outstanding on his obligation is immediately known by consulting this schedule and applying the appropriate payment number last made to indicate the line on which the correct balance will be shown as still owed. The value of these schedules also is evident when Federal Income Tax is being caluculated. By consulting his amortization table, the mortgagor can quickly total the sum of interest payments made over the last calendar year, which is a deductible item on his tax return, usually a very substantial amount in the earlier years of the obligation.

For tax purposes it is possible that the servicing agency will furnish the home-buyer with an annual statement which will indicate the amount of interest he has paid on his loan. However, it is quite common that the lender will not have included in his computation any preliminary interest paid in advance at closure, or billed separately after closure, an amount not shown on the schedule, which can approach $100 or more. The mortgagor himself will have to be aware of this preliminary interest and add it to the amounts paid for interest as indicated on the amortization schedule, when figuring the amount he actually paid in interest during the first calendar year he has the loan.

Although the mortgagee is supposed to send this amortization schedule to the FHA home-buyer when he forwards the other information regarding loan servicing, it is quite common for mortgagors not to receive the schedule. In this connection it is of interest to note the following, taken from the FHA Mortgagees' Handbook, Section 404, which reads as follows:

> . . . Three copies of an amortization schedule also will be transmitted covering the payment pattern of a mortgage loan in the amount and for the term of the subject mortgage. One copy of the amortization schedule is for the mortgagor. For buyers of new homes, an FHA booklet entitled 'Home Owners Guide' will also be forwarded with the endorsed note. (underscoring supplied)

It is obvious then that the failure to receive this amortization schedule in all probability is due to the failure of the mortgagee to properly forward same to the home-owner, or that FHA has not provided the three copies to the mortgagee.

The FHA "Home Owners Guide" may also be sent to the home-buyer by the mortgagee. This is of a general nature, has to do largely with physical home problems after occupancy and contains an explanation of how the loan is serviced; how taxes and insurance are paid for; and the operation of the FHA mortgage insurance. The guide is nowhere nearly as broad a publication as that suggested in Chapter XXXIV as a FHA home-owners guide. Furthermore, emphasis is placed upon events occurring after closure of the escrow and entirely too late to be of any assistance to the FHA mortgagor in placing him in awareness of the pitfalls associated with origination of his contract to purchase. FHA has even failed to include information in this guide identifying what the home-owner should expect to receive as documents and papers after closure. In any event frequently it is not sent to the mortgagor by the lender in the first place, even though much of it is designed by FHA as information which has beneficial features to the lender through protection of the dwelling offered to the mortgagee to secure the loan. FHA again apparently subscribes to a policy of concern more for the lender than the home-buyer, even though the official FHA publication is ironically labeled, "Home Owners Guide."

The builder-seller will have no formal papers or documents to deliver to the home-owner or veteran after closure, with the exception of a responsibility to see that the mortgagor has been furnished with certain warranties on equipment installed or made a part of the dwelling. These warranties cover such items as appliances installed or built in, roof, furnace, etc. The warranties (as well as the instruction books usually with them) frequently are not available to the home-owner and he sometimes has to contact the sub-contractor who made the installations to obtain them. Actually the builder-seller is responsible for their delivery since he sold the dwelling and has contracted with the sub-contractors and can make direct requests for the mortgagor.

SUGGESTION:

To insure that all such papers and documents identified in this chapter will be received by the veteran or home buyer, Chapter XXXII of this report strongly suggests the application of a transmittal of closing documents form which would have associated with it a listing of items to be received subsequent to closure, as well as prior to closure, and providing for notification to FHA or VA when all of these are received.

In addition, it is strongly suggested that VA provide the veteran with an amortization schedule as now provided by FHA to their cases.

Both FHA and VA should require that detailed and itemized closing statements of both buyer and seller be made available to the veteran or home-buyer.

CHAPTER XXVI

DIRECT BILLING BY THE MORTGAGEE

In those cases where the lender is not closing the transaction directly, the mortgagee will prepare a statement of charges to be collected from the veteran or home-buyer and dispatch same to the title or escrow company who is closing the home purchase transaction. This statement may also contain any charges to be collected from the seller for the discount. Through closure then, all of the mortgagee charges to the veteran or home-buyer will be collected without any direct relationship or billing from the lender to the mortgagor, with one possible exception. Some few lenders, following normal business procedure, will not demand interest in advance as a collection from the buyer at closure. However, in most cases this will be done, and this item is usually called "preliminary interest" to soften the connotation concerning what the collection or charge represents. In most cases this advanced interest payment will be taken from the buyer's impounds at closure, and he will be none the wiser. This onerous interest collection, as thus engineered, should be entered as a credit to the mortgagor on his statement of interest and principal payments issued later by the lender. However, this is seldom done.

PRACTICAL APPLICATION:

In those few cases where the lenders follow the correct practice of collecting this interest when due after closure (a proper business procedure acknowledged and provided for throughout the business world) the mortgagee will bill the veteran or home-buyer for this interest and collect it outside of escrow. This will necessitate only one billing and this should reach the hands of the mortgagor and be due sometime after the first of the month following the escrow closure. The statement for interest owed to the lender will cover for that portion of the previous month during which time the buyer had the use of the lender's funds. The time should be precisely equal to the number of days from closure of the transaction (at which time the mortgagee funded the loan) to the end of the particular month, representing an interest payment for anywhere from 1 to 30 days. No principal payment is involved since the first payment to principal on the obligation will not be made under FHA and VA cases until after a full month, plus any remaining portion of a month following closure.

Such a billing from the mortgagee will not occur thereafter, since the collection for further interest will be taken care of in the buyer's regular monthly payments to the mortgagee for combined principal, interest, taxes, hazard insurance, and, under FHA cases, the FHA insurance premium.

Another procedure where interest is not collected in advance is to bill the buyer for an extra large monthly payment the first time a payment to principal and interest is made. This will represent a principal payment, a normal monthly interest payment, and the odd month interest payment. Under either of these procedures (the former resulting in a smaller than normal monthly payment, the latter in a larger payment) the veteran or home-buyer often is left confused because his next regular payment, and the ones following, will of necessity be different from the first. He has the feeling that an error has been made unless adequate explanation is given with the first billing.

As an escape from this possibility of misunderstanding, some lenders have the veteran or home-buyer authorize a separate billing covering the odd interest, in a form supplied in escrow. Although the mortgagee needs no such authorization, it does place the buyer on notice that such charge will be made to him and will have to be paid out after the first of the month following closure. This odd interest payment will range from a few dollars to almost a hundred dollars depending on size of loan and date of closure.

SUGGESTION:

It is strongly urged that FHA and VA be memorialized to move immediately to expressly prohibit the mortgagee from collecting interest in advance (preliminary interest). THERE IS NO AUTHORIZATION FOR THIS COLLECTION AT THE MOMENT, but evidently FHA and VA look the other way when the charge for the collection appears on the closing statement, or certification of charges and collections made by the mortgagee to the veteran or home-buyer.

Such a suggested prohibitive regulation would have the immediate effect of placing all home-buying transactions under FHA and VA in like categories, whereby this one time direct billing by the mortgagee would be typical of all such closures.

A FHA Circular Letter No. 97, issued from the Reno Regional Office of FHA on April 17, 1962, initiates a move to at least properly identify this advance payment of interest by requesting the mortgagees to show on submitted closing documents the beginning and ending dates of such interest charges. Just why the practice should be tolerated in the first place is not clear.

In lieu of the mortgagee obtaining an authorization from the buyer to make this separate charge (an authorization not necessary anyway) the lender should cover the statement for collection of this odd month interest with a letter of explanation adequately identifying the purpose for which the mortgagee is billing the mortgagor.

CHAPTER XXVII

SERVICING THE LOAN - THE TRUST RESERVE

Many FHA and VA loans are originated through the services of what is known as a mortgage company. Other FHA and VA loans are originated through more conventional lenders who anticipate holding the loan as a part of their portfolio or may also act as mortgage companies in some respects. This is not to imply that conventional lenders do not sell these loans in the secondary market when economic conditions change, or conditions in their own institution dictate such action. On the other hand, the mortgage company's paramount interest is directly associated with divesting itself of the loan as soon as possible. This interest develops since they do not wish to warehouse or hold loans for "packaging" and resale into the secondary market for any length of time longer than absolutely necessary. With the development of the Federal National Mortgage Association, and its authorization and ability to make direct open market purchases of FHA and VA mortgages to stimulate the flow back of mortgage money for home loans, the mortgage companies found an almost immediate secondary market for individual resale of such FHA and VA loans. With FNMA kept well supplied with purchasing funds the mortgage companies can operate at peak efficiency and "turn around" within the space of a couple of weeks or so with relatively little financing.

Immediately the logical question is asked as to why the mortgage companies originate FHA and VA loans if they are obsessed with shedding the loans as soon as possible. The answer lies in the nature of such companies. They do not have large quantities of funds to invest permanently. As a matter of fact, it will be pointed out shortly that some of them depend at times on lines of credit to obtain monies to fund loans in the first place. They function primarily as concerns that are specialists in handling "red tape" associated with FHA and VA loans, and in the very important area of servicing such loans after closure. They are geared to handle these delicate involvements with which the casual investor or even large scale insurance companies do not wish to traffic and are not properly organized to handle. They also may serve to originate loans for certain groups of investors who may not have authority to make direct FHA and VA loans, such as pension trust funds and many insurance funds.

PRACTICAL APPLICATION:

The mortgage company then provides the origination service, processes the FHA and VA loan, and services the loan for the length of time the mortgagor holds the loan. This servicing or "loan administration," as the mortgagees like to call it, continues regardless of who the mortgage company may sell the loan to in the secondary market. Whether sold to FNMA or some insurance company or pension trust, the mortgage company will collect the monthly payments from the mortgagor and disburse for taxes, insurance, and any FHA mortgage insurance as well as the principal and interest payments on the loan itself. This is similar to those situations where banks or savings and loan associations may originate the loans and hold such loans themselves. In the event they later sell their loans they may continue to service the loans for the secondary holder.

This report has tended to emphasize the part of the mortgage company, since in Nevada very few FHA or VA mortgage loans are made by banks or by savings and loan associations. With the vast disparity between cost of money in Nevada, and the FHA and VA insured or guaranteed interest rates, banks and such associations would have to traffic in an unusually high discount to enable them to obtain a reasonable yield on their investment. The mortgage companies also must charge the discount but can operate under a somewhat smaller discount since the secondary markets they traffic with are not located in the high money cost area of Nevada but rather are national in character such as FNMA or eastern or mid-western insurance funds bearing lower discount requirements. Nevada banks and savings and loan associations do make such loans, banks usually only as an accommodation to a substantial depositor, and the savings and loan associations when money has "backed up," or they wish to color their portfolio with diversification. In either case discounts may be substantial.

In servicing the loan, or "loan administration," the mortgage company, bank, or savings association, receives monthly payments from the mortgagor for principal, interest, taxes, insurance, and any FHA premium insurance payments. The mortgagee service further makes proper disbursements (for the mortgagor) for payment of his taxes, hazard insurance, and any FHA premium payments. These last three items represent servicing for payments which are obligations of the mortgagor while the first two (principal and interest) are payments retained by the mortgagee servicing the loan or remitted to the secondary holder of the mortgage loan. Therefore mortgage companies employ the term of "loan administration" when making reference to their service in keeping track of these details and making proper payments and disbursements, reviewing the trust account or impounds of the mortgagor for possible monthly payment increases, and likewise reviewing this reserve account for possible reimbursements to the mortgagor when funds in the trust account become excessive.

The veteran or home-owner has a very direct interest in the servicing of his loan and the obligations associated with it. He should realize that there are two distinct areas represented by his monthly payment. First is that of the payment of a specified amount each month for principal and interest on his mortgage loan. This amount will remain at stability as only the relationship between principal and interest change. The total of the two will be constant as indicated on his copy of the amortization table. Second is that portion of his monthly payment in a reserve or trust account. Sometimes this is called an impound account,but should not be confused with the impounds prior to closure. The funds thus placed in his trust account belong to him, and should he sell his property a portion of them would be returned to him after certain cost prorations to the buyer. The mortgagee servicing the FHA or VA loan will make payments for taxes, hazard insurance, and any FHA premium payments for the buyer out of this trust account.

As well as impressing this forced service upon the veteran or home-buyer (necessitated by FHA and VA regulation) the reserve trust account serves a very important purpose to the mortgagee, especially the mortgage company. Sometimes the home-owner's trust monies are kept in large eastern or mid-western banks where they draw no interest for the mortgagee or mortgagor, or may be placed in local western institutions closely associated with the mortgage company. However, they are extremely important to some mortgagees since the sum total of large numbers of such trust funds (required to be placed in trust deposits) provide significant aggregate funds upon which the mortgagees may obtain short-term loans to cover ware-housing of loan costs and heavy money demands. Furthermore, the interim interest charge to the mortgagees made by institutions where the trust reserves of the veteran or home-buyer are kept are very attractive. In other words, home owner's trust reserves can serve as a "line of credit" for low cost money to the western mortgage companies.

Banks and savings and loan associations likewise have available to them in their own institutions these trust reserve accounts as deposit assets. However, in these cases, the institutions point out that what little benefit is derived from handling home owner's funds is largely lost in their cost of servicing the mortgagor's loan, which is possibly true to some extent. The banks and savings associations in Nevada (not being particularly geared to handling any volume of such transactions) would have a unit cost for servicing well above a mortgage company. Banks may view the obligation to service the loan as somewhat of a nuisance and a costly operation to them. However, savings association activity in FHA and VA loans is increasing in both Las Vegas and Reno.

At this juncture an extremely important point should be raised. Why not have the home-owner pay for his taxes and insurance directly, and with his own budgeted funds? No more important question could possibly be raised by this entire report. Both FHA and VA require that the mortgagee make such trust fund collections from the mortgagor each month. The basis of this theory rests upon some predications as follows, some of which are perhaps basic to the operation of FHA and VA and again succeed in masking the true cost of such mortgage loans.

(a) The mortgagee should be protected by making sure that taxes and insurance are being paid on the property which is security for the loan he made.

(b) The government, likewise, should have this protection since it is insuring or guaranteeing the loans made by the mortgagee under either FHA or VA programs.

(c) Municipalities and hazard insurance companies should be assured that they will receive their funds on time, and will have no concern in those FHA and VA tract areas where a withholding system is impressed upon the home-buyer.

(d) Under FHA, the mortgage insurance premiums would be easily collected from fewer individual servicing agencies than would be the case if every mortgagor was making payment to the FHA on an independent basis.

(e) Seldom mentioned is the basic reason, that of the highly desirable trust moneys which the mortgagee (particularly mortgage companies) has thus created for them, which can be employed as "lines of credit" to make their basic costs of operation less expensive. Make no mistake, the veteran's or homeowner's trust reserve is being employed by the mortgage company in the absence of a more easily recognized interest return.

(f) And finally, we run across the socialistic reasoning that the individual himself should be "protected" by making sure that he has reserved for him (by small monthly payments) sufficient funds so that when his bill comes due there will be moneys with which to make the payments.

Let us examine the first four of these predications relative to making sure that taxes and insurance are paid and funds received by the FHA insuring agency, municipalities, and insurance companies involved, as a protection to the lender. This may sound logical on the surface as a necessary protection, and desirable in the absence of any other normal protection afforded under a conventional system. Such is not the case. Hazard insurance policies contain a lenders' loss payable endorsement required by the mortgagee, and any notification of delinquency in payments (rendering eventual coverage termination) would be received by the mortgagee as well as the mortgagor, who should be making payments directly. The lender would be kept informed as well as the home-owner for back taxes, since actions would run headlong into the holder of a first deed of trust on the property. Any such proceedings against the home-owner to sell for taxes is hard to visualize without the mortgagee being aware of the difficulty, long before such an impasse would have been reached. As for the FHA collecting for its mortgage insurance premium payments directly from the FHA home-owner, this also is only a reversion to a normal situation. If the government cannot execute the collection of such payments then its effectiveness as a collection agency must be placed below the level of a small insurance company, difficult to conceive. Many conventional mortgage loans are handled in the manner suggested.

The matter of any consideration or reference to the municipality or hazard insurance company to the effect that their collections are made easier, is entirely incidental to the mortgage transaction and any insurance or guarantee by the government agencies. These parties should not expect to look to any procedures that make their collections an easier matter, with an additional charge placed upon the home-owner to afford them of this incidental by-product. They should expect to traffic with the veteran or home-owner on a conventional basis, and are in no way deserving of any particular consideration.

It is charged that the foregoing considerations are incidental to the chief and underlying reasons for the impressment of a withholding system upon the FHA and VA home-owners or veterans of this state and nation. The basic reasons are two in number. The first is concerned with the hidden costs of the mortgage loan to the veteran or home-purchaser and the consumer, by engineering a special consideration for the lender, particularly the mortgage companies, who originate most of the FHA and VA loans in Nevada. It should be evident to all that some added cost would be imposed on many mortgagees in the event they did not have these choice trust reserve accounts upon which to sometimes obtain low cost interim funds to assist in originating loans. Without them, the discount would be even larger. The mortgagor will be paying for this larger discount anyway but in a fashion not immediately apparent to him. The mortgagor will have such funds collected from him well in advance of due date, will not have the use of these monies, and will receive no interest payments on the funds so held, some of them for a period of up to three years.

In this connection it is interesting to observe the remarks made in the report issued by the State of New York which calls this trust reserve a "hidden charge." Legislative Document (1961), No. 8, Report of the Committee on Mortgage and Real Estate to the Assembly of the State of New York, issued on March 15, 1961, has this to say, the report having just concluded with a scathing denunciation of the discount practice:

> The second hidden charge paid by the mortgage seeker is born out of the practice of many institutions of requiring prepayment of real estate taxes and insurance with the funds being

placed in an escrow account until disbursed to the municipality or insurance company. These funds are collected monthly by the institution along with interest and amortization (principal) payments and held without interest credit for up to three years in the case of insurance monies and one year in the case of taxes. . . The Committee notes that there is presently before the Assembly a bill which would require savings banks and savings and loan associations to pay to the mortgagee interest on the sum held in his escrow account (Norwicki - A.I. 2476). (underscoring supplied)

This is certainly a recommendation which will be contained herein. However, the New York report should have driven more deeply into the problem of attacking the very basis of such reserve trust accounts in the first place or at least provided that interest paid to the mortgagee on these accounts be made available to the mortgagor. The elimination of the withholding for these accounts does away with the necessity to consider any mortgagee collection for interest on such trust funds to be credited to the mortgagor.

By the employment of trust reserves the true cost of borrowing money is again masked. The veteran or home-owner is making withholding payments to establish reserve accounts to defray an even larger discount which would necessarily develop without the use of the home-owner's reserves by many mortgagees. Here, the government again has engineered against the consumer by preventing him from ever knowing what it is costing him to underwrite artificial governmental programs to stimulate home buying and the overall economy of the nation. This should hardly be a necessary concomitant to our form of democracy and it is high time to survey the situation and make immediate moves to preserve ourselves from such tyrannical activities associated with the democratic system.

The second reason for establishment of this withholding system to build a trust reserve is of greater significance concerning the very survival of this nation. Here we have in operation governmental socialism of the rankest form, and when associated with trust reserves for the lender's benefit has very serious implications. It must be charged that the "protection" of the individual to make sure he will have funds available for making certain payments, is "bottle-feeding" of the citizens of this nation and a direct attack against his structural fiber and ability to do for himself. The government is engaged in a practice which weakens the citizen to the point of surrender to outright socialism and eventually allowing the government to take care of all of his needs through surrender of his income to the government to be doled out as the governing body sees fit, choosing for the individual at what level and in what relative amounts he shall be provided his basic needs for shelter, clothing, food, and for entertainment and related activities not actually necessary for survival.

Immediately the argument is raised that veterans and home-owners by and large may wish to be relieved of this task of providing for a reserve and the bother of making such payments. Such is admitted and fully realized. However, the government should be working in the very opposite direction to emphasize to the citizens of this land that, to preserve our freedom and way of life, burdens and responsibilities must be accepted and sought by the people. This is as necessary to the defense of democracy as those efforts expended in physical conflict with forces which seek to destroy us in time of war. The preservation of democracy and democratic principals is not strengthened by the resignation of its people to a system which relieves the individual of certain basic obligations. The veteran and home-buyer accepting the responsibilities which are associated with home ownership should not expect to be artifically assisted by concern over his payment of taxes or insurance. If he be so irresponsible, certainly he has little right to anticipate owning his dwelling place.

The specific socialistic attack identified in this connection is leveled at the hearthstone of democracy itself, a man's home, his castle, and the land he is so often called upon to physically defend. Any decay fostered and encouraged by governmental regulation which feeds upon this dwelling is the most serious charge of all. The avenue is thus paved for those who would seek an even stronger form of government and relegation of the individual to the status of a mere pawn, existing for the benefit of government rather than government existing for the true benefit of the people.

As pointed out under suggestions, the FHA and VA should take immediate steps to eliminate the forced practice of withholding and building of trust reserves by the mortgagee. It is further realized that this will result in an increased discount which will be indirectly paid by the veteran and home-buyer unless the government moves under other suggestions offered in this report to recognize the cost of money in the market place. Further it should be realized that, in the end the home-owner will pay no more for his dwelling place through financing costs, since he is already paying for any resulting increased discount by the withholding procedure now practiced. The home-owner does not now have the use of the money held in this reserve, nor does he receive any interest upon this account.

SUGGESTIONS:

Both FHA and VA programs should completely eliminate the necessity for any such trust reserve accounts or provide for interest payments to the mortgagor on the trust accounts held. Under abandonment of the trust reserve, the problems cited will evaporate and the complexity of servicing of the loan, such as would be left for the collection of principal and interest payments, would be tremendously lessened. It is realized that the government would have to collect from the individual mortgagor the FHA insurance premiums in FHA cases. As it is now, the government must bill the mortgagee servicing the loans on each individual loan and these massive billings are subjected to considerable reconsideration due to sales of loan, loan payoffs, etc. FHA provides a form for this (No. 3653) "Premium Reconcilement." The home-buyer could be billed directly once a year for this insurance payment, just as is done for any other type of mortgage insurance. No matter what additional burden might be placed upon the government, the benefits of having the mortgagor pay his own insurance have been identified, and are still basic in maintaining his individuality. That the government might have difficulty in making the collection is somewhat doubted in the fact of any necessary action of which the federal government could politely warn the mortgagor.

In addition, the complexity of closure statements by elimination of reserves for taxes, insurance, and FHA premium payments at closure would be significantly reduced, and the closing statement to the mortgagor more readily understood by both the veteran or home-buyer, and incidentally, the government agency reviewing these collections.

CHAPTER XXVIII

SERVICING THE LOAN - MORTGAGOR PROBLEMS IN GENERAL

Apparently most of the servicing problems associated with "loan administration" by the mortgagee have been recognized and provided for under the FHA and VA programs, with the notable exception of some basic ones which are of primary concern to the veteran or home-buyer.

A most detailed analysis has been given by the government agencies to the particular requirements of lenders in general, and regulations provided for mortgagee protection. No one seems to have given much thought to any requirements which might rebound to the benefit of the home-buying mortgagor. No basic handbook in the detail provided to the mortgagee has been produced for the mortgagor, under either FHA or VA. It must be admitted that some suggestions are offered to the mortgagee as to how he should deal with the veteran or home-buyer, but much of this is not in the nature of directives or regulations having the force and effect of law.

It is fully realized that the mortgagee must be given detailed consideration in regulations so that the insurance and guarantee programs may work. Not every mortgagor need have concern about how the entire operation is being carried out. To the mortgagee it is of basic necessity that he be provided with a body of regulations and possibly a handbook for an explanation of regulations to enable him to properly process and service the mortgage loan. This should not be construed to mean that most mortgagors or home-buyers wish to remain in complete ignorance of just what is going on. Many would certainly derive considerable benefit from a handbook published for them, as suggested elsewhere in this report, in order to further their general knowledge of the FHA or VA mortgage insuring and guarantee programs and insure a clear understanding of their own specific transaction. It is unfortunate that the citizens of the nation can only hope to understand their position as a mortgagor by tackling the job in a backward fashion through obtaining an understanding of the lender's position, and then relating themselves to that and basic regulations in general.

PRACTICAL APPLICATION:

Since the government has seen fit to establish the trust reserve account as an "accommodation" to the mortgagee and to eliminate the necessity for the veteran or home-owner to be concerned about his taxes and insurance payments, certain problems develop as they always do under artificial systems.

The most serious overall problem as far as the home-owner is concerned is that he is supplied with very little information regarding the status of his trust reserve. Ask any owner to indicate how much this trust reserve amounts to at the moment and you might as well ask him about a reserve account in association with some program of the United Nations. Only when the home is sold does this seem to be of any concern, and then the veteran or home-owner frequently forgets that he has a trust account in the first place. Closures are not uncommon in which the closing officer has failed properly to provide for the return of any portion of these trust monies due the owner selling his property.

At the close of the year many mortgagees will advise the mortgagor as to the amount of money he has paid for interest and principal, but not necessarily that which has been disbursed for taxes and insurance. The reporting of the interest paid by the owner is of special significance since it is a deductible item on his Federal Income Tax. Frequently, this report by the mortgagee will fail to include the amount of interest paid by the mortgagor, in advance, at closure. Or, if collected and billed for separately by the mortgagee, it may not always show in the first annual notice of interest paid. All too frequently the interest paid, as reported to the home-owner, is only that in association with regular payments of both principal and interest.

Still typical of many small lenders and originations of accounts by some large lenders for the first month or so is the system employing a payment book in which is entered the monthly payment made by the mortgagor. In its most complete form, this payment book will indicate the amount of each monthly payment credited to a reduction of the principal and an amount paid for interest (these figures usually taken from an amortization table by the clerk making the entries). Also, there will be entered the amount of the payment to the trust reserve, and in cases where the complete system is employed, this amount will be properly allocated to either taxes or insurance and to any FHA premium reserve. In addition, whenever the mortgagor presents this payment for monthly servicing (in person or by mail) the servicing agency will enter in the payment book (usually in red ink) the amount and purpose of any disbursements of the trust reserve, then adjust the specific reserve for these disbursements.

Under such a system of payment book processing in its complete form, the veteran or home-owner has a running balance and can tell at an instant, by reference to his payment book, precisely what the outstanding balance is on his mortgage loan, what has been paid in interest each month, and, highly significant, is his ability to see at an instant what funds are held in his reserve trust account and what the balance is for each separate item in this account.

To have this information available is of obvious value to the veteran or home-owner. He has available immediate information upon which to check the "servicing" of the loan for errors in his account which may occur from time to time. Secondly, he is as aware as the mortgagee servicing the loan whether or not there will be sufficient funds in a specific reserve to cover an anticipated tax or insurance bill. He will, therefore, be able to understand the receipt of a notice from the mortgagee that his reserve is insufficient to meet a certain obligation. Thirdly, he is immediately aware of any significant overage of trust fund being held by the mortgagee which is not necessary to cover for anticipated tax or insurance payments. This can easily develop after a veterans exemption is taken out on a property subsequent to established reserve for taxes by the mortgagee, and also when the mortgagee may revise his insurance coverage downward to eliminate for coverage not required by the government or the mortgagee. The home-owner is in a position to question certain notices that his monthly payment to his reserve is to be increased when obviously it is not necessary. Such notices may be in error and applicable to some other account, or may reflect unnecessary mortgagee collections.

Under the system employed by most mortgage companies operating in Nevada at the present time, the veteran or home-owner has practically no such servicing information at hand. In the event that he should desire such information he must make a special request to the mortgagee servicing the loan. The answer received will only be valid for a short period of time and becomes quickly obsolete through following payments and disbursements. Evidence at hand indicates that, in some cases, the mortgagee servicing the loan will become highly indignant and indicate to the mortgagor requesting information on the servicing of his loan that the law does not require the mortgagee to prepare such requested information for the home-owner, and further, that the mortgagee is only making the information available under a request he considers to be outside his requirements either ethically, professionally, or at law.

In this connection it is of interest to note the following statement made in the FHA Mortgagees' Handbook at Section 1402:

> Servicing Responsibility. All approved mortgagees are required to service insured home mortgages in accordance with practices acceptable to prudent lending institutions. Counsel and advise shall be always available to mortgagors regarding the terms of their mortgage obligations, the status of mortgage payments, related mortgage requirements and the application of funds remitted. (underscoring supplied)

This servicing responsibility logically includes requests from the mortgagor for information as to the status of his mortgage and trust fund. While most mortgagees issue a fairly comprehensive year-end statement, the mortgagor may request an accounting of the current status at any time. Likewise, information relative to where his trust monies are held by the servicing mortgagee would be included under "the application of funds remitted." These are trust monies and the mortgagor has a right to know at all times how they are being handled.

The present system employed by the majority of mortgagees and mortgage companies servicing loans is tied in with automatic processing methods. Under these systems, the mortgagor may send in his payment with a printed card punched full of data processing slots or it may be a payment slip from a booklet. He has no payment book to send and receives no acknowledgment of payment received or information setting forth the current status of his account, information always available with a payment book system. The savings to the mortgagee servicing the loan are most obvious. Automation has taken the place of manual entries. However, a blind is pulled over information to the veteran or home-owner, offering him no advantage and covering a complete loss of valuable data.

It is interesting to note the language employed by one mortgage company when it advised the mortgagors that it was changing over to such an automatic system:

> Due to a change in the processing of your monthly loan payments, we will not be on a payment coupon system and will no longer have payment books. When you forward your next loan payment, please forward a payment coupon per the enclosed instructions. Please do not send the payment book in the future.
>
> In January of each year we will mail to you a statement showing the breakdown and distribution of your previous year's payments and disbursements for taxes and insurance, along with a supply of coupons and envelopes for the next twelve months.
>
> We hope this new system will prove convenient for you and result in better service for everyone. We appreciate and thank you for your cooperation. (underscoring supplied)

The reference to better service is certainly a device to twist the mind of the mortgagor to make him believe that he might in some way be receiving "better service." Just how the elimination of a monthly payment book, indicating the precise status of his trust reserve account and status of his mortgage obligation, can be interpreted as "better service," is somewhat obscure. The mortgagee, in this particular case is to be commended in that his annual statement to the mortgagor will include disbursements as well as the previous year's payments. Just how complete such an annual statement would actually be is not indicated in relation to the payment book method of entry and disbursement and complete breakdown of items in the trust reserve account. In short, the change is a serious disservice to the mortgagor and leaves him completely in the dark within the calendar year. The buyer has no facts at hand to review for errors and to make him aware of insufficient reserves or excessive funds held by the mortgagee. Many annual statements also may be of little enlightening value in regard to trust funds, unless properly prepared.

In addition to the elimination of basic information for the mortgagor, the iniation of such a system necessitates that the mortgagor keep his separate and own record of what payments were made, when, and in what amounts. This is not necessary under the payment book system, where each payment is entered in a book available to the mortgagor. To further complicate matters but referred to as "better service" by the mortgagee, is the mailing to the home-owner of a bundle of envelopes and coupon cards for him to keep track of for a full year and remit one at a time to the mortgagee.

If the government and the mortgagee feel that the veteran or home-owner is so inept at paying a tax bill once a year, it should have great concern that he may not be able to find his monthly coupon and accompanying coded envelope twelve times a year to forward to the mortgage company. At least with a payment book there is not the necessity to keep track of 24 envelopes and coupon cards, or data processing cards which may not be folded or bent, all of which are easily misplaced by home-owners, who, by government and mortgagee standards, are not able to make two or three direct payments a year on their own homes.

In the case of transfer to automation by one mortgagee servicing loans in Nevada, the system ran wild to the point where several mortgagors were receiving delinquent loan-payment notices at the transfer. Home-owner payment books were returned with no acknowledgment of the last payment entered, and in the absence of immediate receipt from the bank of the cancelled checks showing they had made such monthly payments, the mortgagors were in a state of utter confusion. The mortgagee later explained that it would have "up set" their system to have made the logical acknowledgment of receipt of payment in the payment book.

It should be noted that some of the mortgagees furnish a form upon which the mortgagor may keep a record of his monthly payments made by check number, amount, and date of payment, all of which was done for him by the mortgagee under the previous system employing the payment book.

The total of all this lack of important information being made available to the home-owner and inconvenience on the part of the mortgagor in keeping track of his own records and the welter of coupons, cards and envelopes, is summed up by the mortgage company servicing the loan as "better service for everyone." It is strongly suspected that the better service is to the mortgagee in particular, with the resulting disservice firmly imposed upon the veteran or home-owner. If the government and the mortgagees are so concerned that the buyer have everything done for him (rather than leave it to his ability to perform) it is wondered why they should manufacture a more complicated system for payment remittal. Perhaps there are some who would wish the buyer to have less information about how his mortgage loan is being serviced.

SUGGESTIONS:

In the event the FHA and the VA administrations shall see fit to continue the trust fund reserve and not abolish same as suggested in the preceding chapter, then these suggestions are made to offer necessary assistance to the home-owner.

(1) A complete return to the payment book system for recording payments made, with a monthly accounting to the veteran or home-owner of the reserve in his trust account and any disbursements made, as well as the status of his loan. Or, if the mortgagees insist on retaining the automation most have established, that such a system be expanded to make a proper month by month reporting to the home-owner without the necessity for him keeping a record himself and sending individual payment coupons or cards. In other words, there should be established what would amount to an automation method of making entries in a payment book for the mortgagor, as heretofore done by hand, making available full, complete, and current information to the mortgagor and eliminating the necessity for him to maintain a record-keeping system. All coupons or cards necessary to automation would be kept by the servicing agency and machine-processed when the automation payment book is sent in each month by the home-owner.

If the government and the mortgagees feel the veteran or home-owner is unable to handle three annual direct payments for taxes, insurance, and FHA premiums (if any) how do they expect him to keep track of and record 12 monthly payments to the lender? It is strongly suspected that veteran or home-owner inability is not identified when it is wished to impress a withholding system for other than the mortgagor's benefit.

CHAPTER XXIX

SERVICING THE LOAN - EXCESS TRUST RESERVE FUNDS

Both FHA and VA make suggestions and give directions to the mortgagee that the trust account reserve made up of remittances in the monthly payment by the veteran or home-owner for taxes, hazard insurance, and any FHA premium payments, should not be allowed to "grow too large." The mortgagee servicing the loan is also cautioned to make a "realistic" estimate for proper collections for these trust reserves lest he have to bill the mortgagor at a later date for deficiencies.

The matter of treatment for any overages which develop in the veteran's or home-owner's trust reserve account is set forth in the deeds of trust under both FHA and VA. These deeds of trust provide as follows:

> FHA Form No. 2146m 'Deed of Trust' at number 3 of a number of agreements incorporated in and as a part of such deed, reads as follows:
>
> 3. If the total of the payments made by the Grantor under (b) of paragraph 2 preceding (trust reserve collections) shall exceed the amount of payments actually made by the Beneficiary for ground rents, taxes or assessments or insurance premiums, as the case may be, such excess shall be credited by the Beneficiary on subsequent payments to be made by the Grantor. (underscoring supplied)
>
> VA Form No. 4-6326 'Deed of Trust' at number 3 of a number of agreements incorporated in and as a part of such deed, reads almost identically as follows:
>
> 3. If the total of the payments made by the grantor under (a) of paragraph 2 preceding (trust reserve collections) shall exceed the amount of payments actually made by the holder for ground rents, taxes or assessments, or insurance premiums, as the case may be, such excess shall be credited on subsequent payments to be made by the grantor for such items. (underscoring supplied)

Further in this connection, under FHA, the matter of the trust reserve has been treated to some extent by FHA regulations. For example, Section 203.23 of FHA Regulations under Mortgagor's payments to include other charges, the following is stated:

> . . . The mortgage must also make provisions for adjustment in case the estimated amount of such taxes, assessments, and insurance premiums shall prove to be more, or less than the actual amount thereof so paid by the mortgagor. (underscoring supplied)

This general FHA regulation does not spell out what an excess in a trust reserve would be, at what point it would be reached, and how the matter should be resolved. However, FHA's Mortgagees' Handbook in Section 702 makes specific reference to excess funds in the trust reserve of the home-owner as follows:

> . . . The mortgagee should take particular note of any escrow account where the funds being held in trust are in excess of the total sum required for the payment of ground rents, premiums, taxes and special assessments. Such excess must be credited by the mortgagee on subsequent payments to be made by the mortgagor, in accordance with the provisions of the credit instruments. (underscoring supplied)

The "provisions of the credit instruments" makes reference to the deed of trust and deed of trust note. These have heretofore been identified at the outset of the chapter and the same terminology is employed, that of crediting the mortgagor for such overage on subsequent payments. The plural form of this term should be remembered.

It is obvious that under the terms of the FHA or VA deeds of trust, there is only one way in which the excess may be returned to the veteran or home-owner, and that is to extend a credit to him by reducing subsequent payments.

The mechanics of how this would be accomplished are identified in VA External Information Bulletin No. 155, issued on November 2, 1956, by the VA Center at Reno, Nevada, a portion of which is reproduced as follows:

> . . . this provision would require a periodic audit of each tax and insurance account and, if the amount estimated previously to be necessary for the payment of taxes and insurance was excessive and a surplus existed in the account, a downward adjustment in the monthly installment allocable to the T and I account would be required. This, of course, could be done by deducting the surplus from the amount estimated to be necessary to pay taxes and insurance for the ensuing period and spreading the balance over the number of payments to be made in such period.

PRACTICAL APPLICATION:

Mortgagees were questioned in regard to how they actually treated such overages and how a credit of the overage was actually made to the veteran or home-owner. Apparently very few cases are handled as the terms of the deed of trust provide for and as explained in the VA Bulletin No. 155. Since such overages could occur after disbursements for taxes and also after payments for insurance, adjustments of subsequent payments by the mortgagor might have to be made in an overlapping manner and the bookkeeping and change necessitated in issuance of new coupons or automation cards could develop into quite a complex problem. In order to eliminate such possible confusion for both the mortgagee and the mortgagor, the lenders usually make the credit available to the home-owner under one of the two following methods: (1) Issues a check to the home-owner in the exact amount of the overage which has developed after complete disbursement of the trust monies for a specific purpose, or (2) Contacts the home-owner and indicates to him that such an overage exists, stating the precise amount, and directing him to forward his next monthly payment in a lesser amount to reflect this deduction for the overage.

As now provided for by most mortgagees under these two methods, the veteran or home-owner receives an immediate adjustment for the overage and the full amount of it is made available to him through a check issued to him or the remittal of a correspondingly lower remittance on his next payment to the mortgagee servicing the loan.

This report suggests that either of these methods are to be preferred over that suggested by the FHA and the VA deeds of trust. Under the deed of trust method, the veteran or home-owner would receive the credit in the long run, but the overage would be made indirectly available to him over the period of a year, or at the least, several months. If an overage does exist it should be squared with the mortgagor at once to prevent any further loss of the use of the money by the home-owner and any use of the excess by the mortgagee to assist with his line of credit.

Unfortunately, although the mortgagee's action in most cases suggests the best method of settling with the mortgagor, this report has serious doubts that such a settlement can legally be made under the existing deeds of trust now employed by both FHA and VA. The more desirable immediate refund could be achieved by revision of both FHA and VA deed of trust forms, and other regulations if necessary, to cover direct settlements of overages.

A release dated November 2, 1956, from the VA Center at Reno, Nevada, as Loan Guaranty Division Memorandum 4B-31-56 (External Information Bulletin No. 155) raises some question as to the method prescribed by the deed of trust forms for credit of trust fund reserve overages to the mortgagor without additional FHA or VA action. The bulletin reads as follows:

> The purpose of this memorandum is to explain VA policy in respect to the disposition of excess balances in Tax and Insurance Accounts on outstanding guaranteed and insured loans.
>
> 1. Under the provisions of the standard form mortgages and deeds of trust approved by the VA for use in making guaranteed and insured loans, the holder of the instrument is required, in effect, to apply any excess balance in a Tax and Insurance Account on subsequent payments to be made by the mortgagor for such items, i.e., taxes or insurance premiums. A literal application of this provision would require a periodic audit of each tax and insurance account, and, if the amount estimated previously to be necessary for the payment of taxes and insurance was excessive and a surplus existed in the account, a downward adjustment in the portion of the monthly installment allocable to the T and I account would be required. This, of course, could be done by deducting the surplus from the amount estimated to be necessary to pay taxes and insurance for the ensuing period and spreading the balance over the number of payments to be made in such period.
>
> 2. In a recent opinion of the General Counsel, Op. G.C. 42-56, it was held that any excess balance in a T and I account constitutes security for the loan and that payment of such sum to the borrower would be a release of security within the meaning of Section 36.4324 of the Regulations. Thus, if VA's prior approval to such release were not obtained, Section 36.4325 (b) (7) of the Regulations would be for application in the event a claim was filed on the guaranty or insurance and it would be necessary to determine the increase, if any, in the Administrator's liability on the guaranty or insurance and make any appropriate adjustment. Application of the surplus in a T and I account to the principal of the indebtedness was held not to adversely effect the guaranty or insurance provided there is an agreement between the holder and all obligors (and the owners of the realty if not also obligors) to apply the surplus in such manner.
>
> 3. In view of the foregoing, blanket prior approval is hereby granted to any holder of guaranteed or insured loans to dispose of any excess balances in the T and I accounts maintained by them by paying the excess to the owner of the property provided (1) the loan is current, (2) the consent of the owners of the property is obtained, and (3) no obligor is released from liability on the indebtedness as a result of such deposition. Such blanket prior approval will apply to any cases in which an excess balance in a T and I account heretofore has been disposed of in the manner set forth above as well as in future cases. If any obligor(s) will be released from liability by disposing of the excess balance in a T and I account in the above manner, the individual case may be submitted to the appropriate VA Regional Office by the holder for prior approval.

The practical application of the foregoing information bulletin by VA to mortgagees resulted in such lenders servicing loans under VA paying directly to the veteran home-owner any excess in his trust reserve for taxes and insurance, with the approval of the home-owner. It also ratified any such previous payments made to veterans. However, there is no language in the bulletin indicating a direction from VA to require the lender to seek approval from the veteran and, under such approval, make such a disbursement of excess trust reserve monies to the home-owner. In the absence of such elective action on the part of the mortgagee or non-consent by the mortgagor, the lender would be bound by the terms of the VA deed of trust which is identified under (1), i.e., to credit the overage on subsequent payments, which is held to require VA approval.

It is suspected from some cases known that the mortgagee may not always request the authorization and consent of the veteran but makes such a disbursement to the home-owner without such necessary consent. Mortgagees seem to elect this method of making an overage adjustment under FHA cases also, rather than apply it to subsequent payments, since the bookkeeping work is thus minimized.

However, a shadow is cast upon the mortgagee when he makes credits to subsequent payments without specific VA approval under the General Counsel Opinion cited, since that opinion held that this would be a release of security and have to be authorized by VA. In VA's blanket authorization issued on November 2, 1956, they only authorized that excess trust funds be handled by one method, that of making a refund directly to the veteran. The authorization was elective on the part of the lender and needed approval by the veteran. It is wondered in what position a refusal on the part of the veteran would place the mortgagee under his general terms in the deed of trust. Obviously VA should move immediately to clarify how excess trust funds may be returned or credited to the veteran under directives which are mandatory and do not hinge on mortgagee incentive to act, or home-owner approval.

Further in this connection, we understand that the Federal National Mortgage Association, to which a large majority of loans made by many mortgage companies are sold in the secondary market, prohibit by their FNMA regulations the cash payment of such an excess in the trust reserve to the mortgagor. This regulation will also need review of FHA and VA move to make direct cash settlements either mandatory or elective.

On April 3, 1957, the same VA Center issued a bulletin supplementing this one of November 2, 1956, which read in part as follows:

> 2. In addition to the blanket authorization approved in our Memorandum 4B-31-56, similar approval is hereby given to disposing of excess balances in a tax and insurance account by crediting such excess to the payment of delinquent installments, provided no obligor is released of liability on the indebtedness as a result of such action.

It should be noted that this was not a requirement and that evidently the lender could hold the account to be in the full amount of delinquency, and not elect to provide for the excess to be applied to defray such delinquency.

Under FHA regulations and FHA deed of trust provisions there are no parallel directives to mortgagees allowing them to make such excess trust reserve payments directly to the home-owner. In most cases then, under FHA or VA loan insurance or guarantee (although it is what this report would suggest be made a possibility) the mortgagees have not been handling these overage payments as provided for in the basic credit instrument between them and the veterans or home-owners. Obviously, if FHA and VA intend to permit such settlements, and subscribe to the methods being employed to make immediate settlements through refund, then their regulations and the basic deed of trust credit instruments should be changed, not only to provide for such settlement of the excess fund but to make such a settlement mandatory and incumbent upon any mortgagee. Also, specific directives should be made requiring the lenders to reduce the monthly collections to reflect any changed conditions, thereby lessening the possibility of future overages in specific trust funds.

Since the terms of the credit instruments are controlling, no current FHA or VA regulation or opinion could legally alter the responsibility of the lender to proceed as required now by the deed of trust. FHA and VA would have to change the terms of such deed if they wished the excess trust reserve funds to be handled in some other manner than that now prescribed by their own deed forms. They should so move if it is their intent that direct settlements be made of these excess funds. The mortgagor would receive an advantage if such a direct settlement was made in place of having the excess spread over a period of payments. The veteran or home-buyer would receive the direct benefit of the excess, and the simplicity of the operation desired by the mortgagees would apparently eliminate cause for concern on the part of both parties. FHA and VA are now permitting what is suggested, but without proper redrafting of their deeds of trust and regulations to reflect this action.

Under FHA an interesting option is made available to the mortgagee to eliminate the necessity for the accrual collection of hazard insurance trust reserve payments from the mortgagor over a period of three years for payment of any three-year policy. Obviously, quite an amount could be collected over a long time and held without interest, and without any justification this withholding would be to the advantage of the lender for an excessive period of time and to the disadvantage of the home-owner as heretofore pointed out. FHA's Mortgagees' Handbook provides that, where a home-buyer has paid for a three-year hazard insurance policy (occurring usually at closure), the mortgagee does not have to begin to collect on a monthly basis for the hazard insurance trust reserve until 13 months prior to expiration of said three-year policy. These funds collected over 13 months would provide for a renewal of a one-year policy at expiration of the original long-term policy without additional collections from the home-owner. This method is permitted by FHA but is not a requirement of the mortgagee. It is wondered just how many home-owners are aware of such an option having been allowed to the lender by FHA, and request the mortgagee to so treat their monthly payments, keeping in mind that the mortgagee would be under no obligation to honor such a mortgagor's request. This is another good reason for the suggested mortgagor's handbook.

In the FHA Mortgagees' Handbook, FHA allows for the mortgagee to make accrual monthly collections to assist the mortgagor in the payment of "Home Owner's" policies, an insurance complication which is definitely outside the requirements of the government or the lender. Possibly in the near future FHA will also condone the accrual collection by the mortgagee to establish a reserve out of which the home-owner will have available funds for his annual life insurance policy payments since these are now being tied in closely with hazard insurance "package coverages." It is suspected that insurance coverage for the home-owner's cars garaged in the mortgaged home will likewise be subjected to such accrual collections and dispensed by the mortgagee servicing the loan. It is entirely possible that this "loan administration" business could very easily be expanded to provide for a host of monthly collections and disbursements for the veteran or home-owner's monthly, annual, or semi-annual needs for funds to meet certain obligations. Perhaps there should be one to provide for an anticipated Federal Income Tax payment not sufficiently provided for under the normal amount available to the home-owner under the present withholding system affecting his pay check. None of these possibilities should be overlooked by the socialistic planners, for they offer a fertile field and are almost without number. Fortunately, FHA at the moment prohibits the mortgagee from the withholding or accrual collections for mortgage life insurance policies selected by the home-buyer, and has had to go so far as to strictly prohibit the forced sale of such policies as a requirement by the mortgagee to make the loan. We offer sympathy to the "loan administrators" who at the moment cannot expand their empires to encompass this item and lift such a burden from the home-owner, who must direct his wits toward the very real problem of having to somehow find funds with which to pay for this himself without the "benevolent" hand of the mortgagee and government to assist him in reserving for the purpose.

This report does not attempt to assess the degree of non-compliance with regulations and deed of trust provisions which require the mortgagee to "adjust" for excess funds in the trust reserve with specific regard to "small" and "minor" overages which will occur from time to time. It has been observed that, usually, any significant overage in the tax or insurance reserve is adjusted by most mortgagees. It has likewise been observed that, where the amounts are but a few dollars (or under a dollar) in many cases no adjustment has been made. It is suspected that the practice may be widespread and only an examination of a large number of cases would disclose the degree of any such evasion of the deed of trust provisions regarding these overages.

Since some cases are known where overages have been allowed to drift for months, any revision of FHA and VA regulations and deed of trust provisions should make it crystal clear that any excess (be it relatively small or large) shall immediately be "adjusted" by the lender and made available to the mortgagor.

SUGGESTIONS:

In the event that the FHA and VA administrations see fit to continue the trust fund reserve, and not abolish same as suggested in the preceding chapters, then these suggestions are made to offer some semblance of help to the veteran and home-owner.

(1) FHA and VA should move immediately to provide adequate coverage in their regulations and deeds of trust for the required payment of any excess in the loan trust fund reserve directly to the mortgagor, in place of the complex payment reduction spread over subsequent months. This will provide immediate relief to the mortgagor.

(2) Strict regulation should be promulgated by both FHA and VA directing that any and all overages occurring in the trust reserve for either taxes, insurance, or FHA premium payments, and which arise upon the payment of any of these accounts, shall immediately be released to the veteran or home-buyer and not allowed to be commingled with other trust reserves.

(3) This report is averse to further complications to programs already at a stage where they are difficult to administer. However, where these programs insist upon the impressment of a withholding based on a monthly accrual for the primary benefit of the mortgagee, then such forced systems must be dealt with on the basis of adequate information and protection to the home-owner and veteran.

CHAPTER XXX

SERVICING THE LOAN - LATE FEE CHARGES AND OTHER COLLECTIONS FROM THE MORTGAGOR

The only additional charge which may be made by the mortgagee, under normal circumstances where a mortgage loan is currently being paid off by the mortgagor, is that of a specified late charge for monthly payments received by the mortgagee after the 15th of the month when due. Regulations provide for methods to be employed for the application of any monthly payments made by the mortgagor which are not for the full amount established by the mortgagee. We are assuming here that a late payment is being made and a full monthly payment has been received by the mortgagee after mid-month. In this case, the mortgagee may assess the mortgagor under FHA regulations, Section 203.25, a late charge as follows:

> Late charge. The mortgage may provide for the collection by the mortgagee of a late charge, not to exceed 2 cents fo each dollar of each payment more than 15 days in arrears, to cover the extra expense involved in handling delinquent payments. Late charges shall be separately charged to and collected from the mortgagor and shall not be deducted from any aggregate monthly payment. (underscoring supplied)

Under VA procedure, a late charge may likewise be made against the mortgagor as follows, quoted from Section 6061 of the VA Lender's handbook:

> A late charge may be collected in an amount not in excess of 4% of any installment received more than 15 days after its due date, provided the loan instruments contain an express provision for such late charge. The delinquent installment must have been paid before the late charge may be made. Also, the late charge may not be based on an amount greater than the past due installment. Lastly, late charges must be collected from the borrower as such, i.e., they may not be deducted from regular installments received. (underscoring supplied)

Under both programs a late charge may be collected but the mortgage document must provide for such a collection. The late charge under VA could amount to double that established as a ceiling for FHA late charges.

PRACTICAL APPLICATION:

Cases are known where excessive late charges were extracted from the veteran or home-owner, particularly the application of a VA maximum to an FHA insured loan. In such cases, the servicing lender could easily point to an error on his part where a clerk made the wrong late fee charge which should only be assessed against VA cases being handled by the mortgagee. It is not known how widespread abuses may be with regard to either excessive collections or collections made for periods of time prior to the 15th of the month.

This report has not been able adequately to survey many service problems which may exist, or those pointed out which may be of unusual significance on a volume basis. With limited personnel and time, it is hoped that recognition of the problems which would be revealed if a survey were executed on a broad basis, is realized. We suggest that, if further interest is present in this area, a following directive to that effect be made to the Legislative Counsel Bureau, at either the next session or through Legislative Commission action.

An additional problem has been observed which is connected with the situation where insufficient funds may develop in the trust reserve account. Under both FHA and VA, the deed of trust provides that the mortgagee shall bill the veteran or home-buyer for such a deficiency. This is quite a common occurrence and the mortgagor should be expected to be billed for an insufficiency of funds if he keeps his mortgage for any period of years. Reasons for these insufficient funds will develop under any of the following situations. Increases in taxes, property assessments not present when mortgage was executed, transfer of a veteran's exemption to other property, increases in cost of hazard insurance, "home-owner" policy complications with increased insurance costs, etc. When the mortgagor has been notified by the mortgagee that such a deficiency in his trust reserve account exists, the home-owner must produce funds for the insufficiency within 30 days of such written notice from the lender, under the terms of either the FHA or VA deed of trust. The mortgagee usually identifies how the deficiency has developed when he requests the remittance of the funds. At the same time, the mortgagee usually adjusts subsequent monthly payments to prevent a recurrence of a similar deficiency due to the identified occurrence.

Many mortgagees operate on the conservative side and start off the veteran or home-owner with payments into the trust reserve somewhat higher veteran or home-owner with payments into the trust reserve somewhat higher than they expect may be necessary. The feeling is that it is better to lower the mortgagor's monthly payments and make an adjustment of credit to him than to have to bill him later for a deficiency. Usually this conservative approach is associated with the first few payments made by the veteran or home-buyer. In the case of sales type homes, there is some justification for this discussed in this report and associated with tract areas. Sufficient evidence may not be at hand on which to base a close estimate of annual taxes. To make sure, they set the accrual payments somewhat higher than expected to develop, to cover for conditions which could alter the tax payment and require a collection for insufficient funds. Where mortgagees make this a practice extra care should be taken to make sure they do finally adjust to prevent the further collection of overage funds to the trust account.

The very opposite situation has developed in some areas and has been recognized by VA and FHA. In this situation an insufficient amount is being collected for trust reserves in order to lower the monthly payment quotation by the salesmen in builder-seller tract areas. This system of "low balling" normally requires the cooperation of an unscrupulous mortgagee to provide for these lesser collections since it is the mortgagee who established the impound collections to the trust reserve. With such a system in operation, the salesmen in tracts practicing such a technique have a strong selling point since they can indicate to the prospective veteran or home-buyer that, with the purchase of their home, the monthly payments will be significantly lower than competitive tract homes. The VA regional office in San Francisco (which services all of Nevada except Clark and Lincoln counties) issued the following release (Information Bulletin No. L-279) on June 20, 1961, which identifies this basic problem.

> 1. The purpose of this Bulletin is to re-emphasize responsibilities of lenders and builders in obtaining accurate tax information and reflecting such information in their computation of payment requirements as well as in their representations to prospective veteran-purchasers.
>
> 2. In issuing its approval of the Application for Home Loan Guaranty (VA Form 26-1802, Rev. Jan. 1960), the Veterans Administration accepts the representations of the lenders

concerning tax estimates and impound requirements. Lenders will be held responsible under Section 36:4312 and Section 36:4331 of the Regulations for care and accuracy in computing and in conveying to veteran-borrowers, before loan closing, accurate information regarding annual taxes.

3. Tax estimates must be based on information obtained on diligent inquiry at a dependable source, such as the Tax Assessor's Office. Item 9, in Part I of VA Form 26-1802 (Rev. Jan. 1960), 'Approximate Annual Real Estate Taxes,' must reflect a full year's normal taxes (without exception) based on current tax rates for the completed improvements. In addition, if the property is being assessed for the first year as unimproved or only partially improved, with a corresponding lower assessed valuation in the tax bill for the first year, this 'Estimated Tax-First Year' should also be noted in Block 9. This will assist this office in its analysis of the credit and impound requirements.

4. The lump-sum amount required to be prepaid to the Tax and Insurance Account by the veteran at loan closing must, when added to the monthly accruals established for the Tax and Insurance Account, equal the amount of the tax bill.

5. Lenders have a continuing responsibility to conduct periodic review of tax and insurance accounts to insure that necessary adjustments are made in the borrowers' monthly payments to allow for any tax or insurance increases.

6. Veterans should be warned at the outset of the danger of losing their tax exemption if they fail to make application therefor during the period prescribed by law. They should also be cautioned that personal property taxes will be included in future tax bills on the real estate according to State laws.

7. The failure of lenders to fully discharge their responsibilities in this regard will be treated as a demonstration of their inability to service loans adequately and as 'wilfully or negligently' engaging 'in practices otherwise detrimental to the interests of veterans or of the Government' within the purview of Section 36:4331 of the Regulations.

8. The failure of builders to obtain reliable estimates of the taxes and the accompanying requirements therefor in connection with lump-sum payments and monthly payments to the Tax and Insurance Account and to convey that information completely and unequivocably to prospective veteran-purchasers in all advertising material and sales discussions will be treated under Section 36:4361 of the Regulations as the use 'of methods or practices in marketing. . . of a type which are unduly prejudicial to the veteran concerned.' Such a finding may lead to the refusal of this office to accept further requests for appraisal from such builders.

9. County tax officials have indicated their readiness to cooperate fully in projecting estimates of future taxes on proposed subdivisions. This office, accordingly, will hold lenders and builders fully accountable for the avoidance of future complaints arising from this source.

10. Attention is also called to the fact that some cities assess and collect their taxes independently of the County Governments and their tax payment dates are also sometimes established independently. This information should be carefully developed by both builders and lenders in order that their lump-sum and monthly payment estimates are properly computed and the veterans are fully informed.

The 1961 release by VA from San Francisco was obviously directed toward this practice of "low-balling" prospective buyer under a VA guaranteed home sale. This practice when selling homes makes a quotation of a monthly payment to interest, principal, taxes, and insurance, of an amount well below what will actually be necessary, and quoted low in order to close a sale. This can be done by a manipulation of that portion of the monthly payment represented by the trust reserve. Since taxes are the substantial portion of the trust reserve, the builder-seller may provide to the buyer and also include in the information to VA, an unrealistic figure for monthly collections to take care of the annual taxes. He could easily cut this figure in half, and employ as a foundation for his estimate the tax rate on the property from the previous year when the property may have been only partially improved or perhaps raw unimproved and undeveloped real estate.

Under such tactics, the prospective veteran or home-buyer, in making comparisons with other possible offerings in the area, may feel he is obtaining more for his money where the salesman is "low-balling." The prospective mortgagor will not realize that, a month or so before the mortgagee (who has seen fit to play along with this game) pays the home owner's taxes, he (as the veteran or home-owner) will receive a notice that his trust reserve for taxes is well below that necessary for such payment; that the mortgagee must make a separate and immediate collection from his for perhaps as much as $100 to $200 for taxes. Subsequently, the mortgagee will make an immediate adjustment in the monthly payments to cover for this initial deception, and thereafter the veteran or home-owner will remit to the mortgagee a monthly payment increased by some $10 to $20 or more to prevent the deficiency from recurring. However, the damage has been done for the home has been sold to a buyer who thought he was obtaining a low cost per month home. As indicated, <u>VA has issued rather direct information to eliminate the practice and warns that it will not guarantee loans originating from those who traffic in the practice</u>. This however, is the direct opposite of the problem of the overage, but has been introduced at this point to identify problems in general with trust reserves and their collection. The "low-balling" technique can also be extended to picking up an unrealistic and small impound collection from the prospective home-buyer which will prove to be insufficient even with a correctly quoted and collected monthly cost payment to trust reserve to cover for following tax bills. Employment of the tactic at this point cuts down the necessary closing costs to the buyer and makes for a more attractive transaction. <u>VA has warned builder-sellers and mortgagees</u> against this practice also.

SUGGESTIONS:

<u>The elimination of the trust reserve</u> as a requirement of FHA and VA <u>would simplify the entire mortgage loan guarantee transaction</u> to the point where such abuses as the "low-balling" technique would not exist. Likewise, <u>the elimination of this trust reserve</u> (as suggested in previous chapters) <u>would do away with the necessity for the mortgagee to make collections from the home-owner for insufficient funds to bolster the trust reserve</u>. It is recognized that the elimination of the trust reserve would do away with much of the necessity for "loan administration" and likewise with the establishment of accounts made from these trust reserves upon which the mortgagee or mortgage company may depend for lines of credit, the aspects of which have heretofore been discussed.

In the absence of FHA and VA refusal to eliminate this tidy bundle needed by the lenders, all that can be suggested is for the home-owner to be aware of when he can be charged a late fee and in what amount, as identified in his deed of trust form.

Such advise should be emphasized in the suggested complete handbook for the mortgagor, along with warnings about "low-balling" tactics. This handbook would be a comprehensive manual provided for the mortgagor by FHA and VA, such as these agencies provide now for the mortgagee. These publications will be discussed in a following chapter.

CHAPTER XXXI

SERVICING THE LOAN - DELINQUENCIES AND ASSOCIATED LAXITY IN CREDIT REPORTING

Mortgagee problems in servicing loans must be numerous, and, in the absence of the elimination of the trust reserve account of the mortgagor (strongly suggested herein), may be increased by the adoption of any necessary mortgagor protective features outlined in this report.

Delinquencies are dealt with in FHA and VA regulations as well as methods of handling them, thus enabling mortgagees holding insured or guaranteed loans to proceed to liquidate and foreclose in an appropriate manner. Optional methods are suggested, as well as many requirements which the mortgagee must meet in dealing with delinquencies and resultant foreclosures.

This report has not attempted to assess (in any particular way) the difficulties of the mortgagee, since the directive for the study indicated the desire for knowledge in regard to the mortgagor's position as the purchaser of a dwelling and incidental charges associated therewith.

PRACTICAL APPLICATION:

It has come to our attention in the last year or so that an increasing number of foreclosures concerning FHA and VA insured or guaranteed loan properties may have a direct relationship to the laxity with which credit reports are issued by some organizations who specialize in such a service for the mortgagee. It should be remembered that the credit report ordered by the mortgagee also serves as that which the FHA and VA examine in conjunction with the acceptance or rejection of the prospective mortgagor. Any incomplete coverage of background on the individual applying for the mortgagee is also a lack of complete information for FHA and VA in considering loan insurance or guarantee.

With the development of mortgage companies as originators for loans to be sold in the secondary market (large numbers of these to the federal acceptance corporation, "Federal National Mortgage Association") the practice of issuance of credit reports which are not as exhaustive as they might be has increased. Usually the mortgagee, if a mortgage company, will not be as interested in the economic soundness of the prospective mortgagor as will a mortgagee who is originating a loan for its own portfolio.

While the statements made to this point regarding the credit report problem may be generalizations, nevertheless they are tied-in with a developing situation which has serious proportions. Such tendency was identified in an article appearing in the April 2, 1962, edition of the Wall Street Journal which quoted FHA's director, Mr. Billy Wilcox, area director in Southern Florida, as follows:

> Government men say they've been fed misleading information on lots of their Florida credit risks. FHA director Wilcox, after ordering thorough re-checking of applications channeled through his office by 'particular suspect operators,' found four or five out of every hundred

contained false claims. 'Builders, real estate people or mortgage lenders would tell people how to falsify applications,' he says 'or even worse these poor people signed blank applications, and someone else filled them in.'

Under the FHA program, the mortgagor pays an additional 1/2% on his loan to cover for FHA Mortgage Insurance Premium payments. These funds are held by FHA and employed to underwrite the losses sustained by the FHA insurance program through failure of some FHA mortgagors to continue with their mortgage payments. Any significant delinquency and foreclosure rate increases can work against this reserve fund built from home-owners' FHA insurance premium payments. The reserve in this fund is relatively high but possibly not excessive when consideration is given to any long-term depression which might develop and skyrocket foreclosures under FHA. Concern is registered by this report for the unusually high rate of increase in the past year or so, not directly tied-in with any long-term depression, and identified by the following figures from the Wall Street Journal and a UPI release in October, 1962.

> Federal Home Loan Bank Board statistics show non-farm home foreclosures jumped to 35,499 during the 1961 first half, up 50% from the 1960 period and the highest for the period since. 1940. VA insured mortgages are proving the chanciest, followed by FHA backed loans. (Wall Street Journal)
>
> FHA officials have acknowledged that even within the limits of the liberal credits requirements there has been some slipshod approval of loan insurance applications. A follow-up survey of 1,800 recent foreclosures of FHA loans showed that about 25 per cent should not have been insured by FHA in the first place. (U.P.I.)

Should such trends continue, the balance in the Mutual Mortgage Insurance Fund, which was $603,000,000 on December 31, 1960, could be reduced to the point where a recession of any length, or further laxity in credit reports resulting in issuance of shaky guarantees, could work toward an exhaustion of this balance. The natural result, lacking action toward a tightening of credit reporting, would be an increase to every home-owner in a higher precentage payment for his FHA Mortgage Insurance Premium

VA, it will be remembered, has no mortgage insurance program and holds the veteran himself directly responsible. However, VA seldom proceeds against veterans, under authorization to cite delinquent cases as hardships.

In this connection, the following VA release, Bulletin No. L-200, issued May 17, 1962, from the San Francisco office (which covers most of Nevada) is of special interest:

> 1. In 1961 the Veterans Administration experienced a substantial increase in the number of foreclosures on VA guaranteed home loans. The total* number of guaranty claims paid on home loans during the year was 16,060 compared to 11,052 in 1960, or an increase of 45 percent.
>
> *Erata sheet correction.
>
> 2. During 1961 Veterans Administration offices intensified their post audits of credit reports and employment and income data on borrowers obtained by lenders originating GI home loans on the prior approval basis. Credit reports were obtained by VA from different credit reporting agencies from those which furnished the credit reports to the lenders. Employment and income verification was requested directly from the borrower's employer. <u>A disturbing incidence of serious discrepancies was noted between the credit data submitted by lenders and that developed in the course of these audits.</u>

3. Due to the increase in foreclosures and the incidence of discrepancies in reported credit data, we consider it essential that we broaden our credit data spot check activity to include home loans originated by supervised lenders under the automatic guaranty procedure.

4. In requesting guaranty on any home loan made under the automatic procedure on and after May 15, 1962, all supervised lenders will forward with the VA Form 26-1820 (Report of Home Loan Processed on Automatic Basis), a copy of the loan application (showing income, assets, and obligations) which the lender requires the borrower to execute when applying for the loan, a copy of the employment and income verification obtained from the borrower's employer, and a copy of the credit report on the borrower. VA field stations will increase their spot checks of credit underwriting on loans of this type.

5. The foregoing requirement in no way affects a supervised lender's right to issuance of a Certificate of Guaranty upon disbursement of a loan on the automatic basis in accordance with the law and regulations. The evidence of guaranty will continue to be issued immediately upon receipt and review of VA Form 26-1820. Thus, there will be no delays in the issuance of the guaranty because of any subsequent review of credit underwriting that may be made by VA. (underscoring supplied)

SUGGESTION:

To afford some remedy for already existing abuses associated with the issuance of the credit report, which are working to bring hardship to both the home-owners and lenders, this report has no other alternative but to suggest governmental intervention once again. The suggestion would be to have FHA and VA issue an "approved" list of credit reporting agencies eligible for FHA or VA work. This is now done for mortgagees, and FHA has issued a list of approved mortgagees which it will traffic with in Nevada, numbering some 85 institutions in this and adjoining states.

In lieu of establishing such a list of approved Credit Bureaus, FHA and VA would have no alternative but to tighten up on their loan processing in order to further check on the credit rating of the prospective mortgagors and re-check work already supposed to be done by the bureaus, the service for which either the buyer or seller has paid. In spite of assurance as given in the VA release of May 17, 1962, this could eventually result in delays in FHA and VA processing to decide whether to accept or reject an application. FHA and VA may have to move to more elaborate procedures and the resultant costly delays would work against builder-seller profits and harass mortgagee processing also. Possibly if FHA and VA were to adopt strict and extensive audits associated with the credit report the mortgagees and builder-sellers would insist that credit bureaus sharpen up their efficiency and would traffic only with those bureaus who could produce an accurate credit report. Certainly such strategy would work to quickly eliminate any tie-in deals with mortgagees, builder-sellers, and credit rating bureaus who purposely fabricate a report so FHA or VA will be encouraged to accept the prospective veteran or home-buyer.

This report strongly suggests that both FHA and VA institute extensive audit of all credit reports and delete the names of any credit bureaus from the suggested list of approved bureaus when evidence shows them to be making either false or incomplete reporting.

PART V

MORTGAGOR'S DOCUMENTS

The research work associated with this study has brought to light a serious situation regarding the veteran or home-buyer. In the majority of cases where FHA or VA insured or guaranteed mortgage loans have been closed and are being serviced, the mortgagor has not received adequate information regarding his case and does not have at hand those papers and documents which are rightfully his. Some of this failure to have secured the proper documents may be due to his own neglect. However, far more often they are missing because the builder-seller, mortgagee, the FHA or VA, has not provided the veteran or home-owner with copies which are specifically his under the processing of FHA and VA cases. Certainly FHA and VA insured or guaranteed mortgage loans (and the accompanying closure and servicing of same) are complicated enough without adding further confusion to the uninitiated through failure to supply him with his copies of vertain portions of the transaction to provide the mortgagor with minimal information from which to understand the ramifications.

All parties seem to have adopted a policy of having the mortgagor's interests last in mind when it comes to making available his copies of the transactions. This policy seems to permeate most of the balance of such insured and guaranteed programs, their execution being an example thereof. Whether FHA and VA are aware of the lack of proper guarantee to the mortgagor in regard to his receipt of his papers (as well as other abuses of their programs) is not entirely certain. Suffice it to say, this study does make such identifications quite clear.

To the end that the veteran and home-buyer will have some basic security and guarantee in the matter of having in his possession his documents associated with the mortgage loan transaction, the study strongly recommends in this Part V, that FHA and VA immediately provide through strict regulations a "transmittal of closing documents" for the mortgagor. Also, to render the other abuses of the programs less likely to occur and place the veteran and home-buyer in awareness, the study strongly recommends that both FHA and VA move immediately to produce and make available to mortgagors a basic and complete handbook. This should direct specific emphasis toward identifying pitfalls associated with the FHA and VA transactions (much as this study has done) and focus such coverage on factors which will have to be recognized <u>prior to contract execution, during process of closing transaction of purchase, at closure of transaction, and in servicing of the loan</u>. Most materials made available by FHA and VA to the veteran or home-buyer are concerned with how to take care of the home <u>after it is too late</u> to rectify the costly financing errors which have developed prior to and during the closure of the purchase transaction. Some financial information is given by both FHA and VA in generalized publications available to the veteran and home-owner as pointed out in this Part V. However, there is nothing as complete as the materials made available to the lending mortgagee by FHA and VA, stating in layman's language the mortgagor's rights, suggested methods to protect those rights, and how to thread through the intricate procedures. The veteran and home-buying mortgagor certainly needs more assistance from FHA and VA on these points than the lending mortgagee, who is trafficing in such regulations as a full time business and has available to him attorneys and specialists by the score.

CHAPTER XXXII

DOCUMENTS THE BUYER SHOULD RECEIVE AND SUGGESTED "TRANSMITTAL OF CLOSING DOCUMENTS" TO MORTGAGOR

It has been suggested that a transmittal form be prepared by both FHA and VA which would list the many documents the mortgagor should have in his possession at closure and indicate those to be received. The mortgagee issues such instructions covering what is to be transmitted to him or to any closing officer handling the transaction. Likewise FHA and VA, as insurers or guarantors of the mortgage, require such transmittal forms and associated papers to be completed by the mortgagee before they will insure or guarantee a loan. <u>However, neither FHA or VA have provided for such transmittal to the mortgagor or any other method that will guarantee that the mortgagor will receive his particular papers and documents</u>. Of all parties who are associated in the the transaction, the mortgagor veteran or home-buyer is in greater need of such information and transmittal for purposes of enlightenment, than either the mortgagee or the federal agency. Usually he is unfamiliar with the transaction, while the others are working with it constantly as a specialty.

In addition to other documentary requirements FHA demands that after the origination of the insured loan and prior to endorsement for insurance, the mortgagee (lender) complete FHA Form No. 3642, entitled "Transmittal of Closing Documents," listing the many documents FHA must have. VA regulations also identify what must be transmitted to them along with VA Form No. 26-1876, before they can process the guarantee.

PRACTICAL APPLICATION:

In most cases the veteran or home-owner will be missing one or more documents which he should have received either prior to closure, at closure, or after closure. Since there is no form identifying just what it is that he should receive, and no handbook is available to him including such a listing; further, since usually he is unfamiliar with such transactions, the mortgagor making the purchase is unaware of his position. Perhaps FHA and VA feel this is unimportant to the veteran or home-buyer and, if he does realize that he is missing his copies, either the closing officer, title company, or the mortgagee, will make copies available to him.

Investigation reveals that it is common for the veteran or home-buyer not to receive his copies of a number of papers or documents which should have been given to him either by the closing officer, the mortgagee, or the builder-seller.

The mortgagor is not aware of what he should have in his possession at closing, and naturally so since the highly complex FHA and VA insurance and guarantee programs require the execution and preparation of a goodly number of papers not common to a conventional mortgage transaction. The buyer, even though he may be experienced concerning ordinary mortgages, usually would be at a loss to realize what he should receive as a mortgagor under FHA and VA transactions. Obviously, such mortgagor could prepare himself if he were to thoroughly digest FHA or VA regulations and also become familiar with FHA or VA forms associated with these requirements. This we would hardly expect the usual FHA or VA mortgagor to do. Regulations are so difficult that the mortgagees themselves, working constantly in the area as a part of their business, have had prepared for them by FHA and VA mortgagee handbooks for their assistance.

SUGGESTION:

FHA and VA should immediately move to establish a "transmittal at closing form to the mortgagor," which will clearly identify what papers and documents the home-owner or veteran should have. These would be identified under three categories as follows:

(a) Documents which mortgagor should have received prior to closure.
(b) Documents which mortgagor is being supplied at closure.
(c) Documents which the mortgagor will receive after closure.

The transmittal form would list such papers and documents under these three classifications and provide the necessary identification of what form or document is referred to by form number and title or by proper explanation of what the paper is in terms which are both technical and of practical value to the veteran or home-buyer. A column would be provided in association with the lists in which the mortgagor would initial each item as having been received for the first two categories.

At least three copies of the transmittal form would be made available - two to the mortgagor and one to either FHA or VA. Of the two the mortgagor received, one would be for him to keep and the other to send to either FHA or VA after receipt of the last document to be received after closure. He would complete this second form for the federal agency after properly initialing in the proper column that he had received the last and final paper.

The transmittal form would also contain four certifications, three of which would be executed and certified to prior to closure. The three executed certifications would be made by the builder-seller, mortgagee, and any closing officer, relative to certifications from these parties that they have delivered to or are hereby delivering with the transmittal form those papers and documents which they are responsible for delivery to the mortgagor either prior to or at closure. Their respective certifications would list those items for which they are responsible for delivering to the home-buyer or veteran.

In addition to the items to be delivered prior to or at closure, the certifications (where applicable) would also list those documents and papers to be delivered to the mortgagor after closure by the party responsible for their delivery. For example: The mortgagee's certification would have to include the statement that they agree to make available to the home-buyer a copy of the amortization table after closure, which FHA provides them with and which seldom find its way back to the home-buyer, for whom a copy is intended and provided for by the insuring agency.

FHA or VA would have knowledge of any final deliveries when the mortgagor sent in his last copy of the transmittal, or could follow up when not received in a reasonable time by asking the mortgagor if it had been received.

<u>This report is loath to suggest that any further ramifications and "red tape" be attached to already complex FHA and VA transactions</u>. <u>However, since the government has elected to fabricate programs which are inherently fraught with complexity, and has entered the area of mortgage insuring and guaranteeing, and is a party to the dwelling-purchase transaction along with the home-buyer, we have no alternative but to strongly suggest this transmittal form</u>.

Were both FHA and VA programs operating correctly, with an absence of the large weight of evidence at hand indicating serious evasion of responsibility to the mortgagor, such suggestions would not be necessary. However, where mortgagees loaning the funds, officers closing the transactions, and builder-sellers selling the homes are consistently failing to recognize their responsibility toward providing the veteran and home-buyer with his papers and documents as required by both FHA and VA, then it is suggested that they have brought this necessary further complicated control upon themselves. Certainly this would be out of place and hardly necessary if the other parties to the dwelling-purchase transaction would traffic with the mortgagor in a correct fashion as provided for under much of the existing FHA and VA regulations.

An example of some items which should be listed as papers and documents to be received by the mortgagor under the three headings would be as follows: As a further suggestion, stamping "borrower's copy" in large block letters in red on appropriate mortgagor's copies by the FHA or VA, the mortgagee, or the escrow officer would certainly help in assuring proper delivery to the home-buyer. <u>The following lists are not necessarily complete and serve as examples of obvious items which would fall into the three classifications</u>.

<u>Documents and papers received prior to closure by the mortgagor:</u>

1. FHA Statement of Appraised Value (Form No. 2562) or VA Certificate of Reasonable Value, as suggested in Report.
2. Receipt for earnest money deposit.
3. Receipt for any credit report paid for outside of escrow.
4. Copy of purchase contract, agreement, or deposit receipt.
5. Contract covering any changes in existing structure.
6. Rental agreement pending closure, if any.
7. Copy of escrow instructions if not incorporated in a deposit receipt.
8. Copy of FHA or VA Handbooks as suggested in this Report.
9. Preliminary Report from title company.
10. Guarantees on all installed equipment, and instruction booklets (if occupancy prior to closure).

11. Copy of authorization to mortgagee for collection of preliminary interest payment after first of month following closing.

<u>Documents and papers transmitted at closure to the mortgagor</u>:

12. Purchaser's copy of statement of mortgagor's charges made by the mortgagee or to title or escrow company by the mortgagee, as suggested in this report.

13. Policy of title insurance, if available at this time.

14. Copy of fire insurance policy if being provided through escrow.

15. Copy of closing statement including charges and credits made to buyer.

16. Copy of closing statement including charges and credits made to seller.

17. Copy of attachment to check disbursement made by mortgagee when funding loan as suggested in this report.

18. Copy of agreement between mortgagee and mortgagor providing for billing after closure for odd interest due to mortgagee from funding to 1st of month.

19. Copy of the deed of trust.

20. Copy of the deed of trust note.

21. Copy of the warranty on the house.

22. Guarantees on all installed equipment, and instruction booklets.

<u>Documents to be received after closure from the mortgagee</u>:

23. Original deed to property properly recorded.

24. Statement (annual or otherwise) indicating principal, interest, and trust funds received, and when trust funds were disbursed by category, or monthly pass book (automated or manual) indicating this situation on a monthly basis. Strongly suggested in this report.

25. Instructions from the mortgagee as to how the mortgagor is to remit payments.

26. Amortization schedule FHA Form No. 2037, and VA schedule as suggested in report.

27. Policy of title insurance, if not delivered at closure.

28. Statement from mortgagee on breakdown for each item comprising monthly payment.

29. All warranties on roof, furnace, appliances, etc. from the builder, or directly from manufacturers.

30. FHA Home Owners' guide now available through FHA.

31. New FHA Form No. 2344A from FHA directly to the mortgagor for his information and possible future use, with proper covering explanatory letter.

Each document listed should also have an indication as to whether the veteran's or home-owner's is an original (0) or copy (C).

CHAPTER XXXIII

SUGGESTED MORTGAGOR'S FHA AND VA HANDBOOKS

This report has made frequent reference to the desirability of having available for the veteran or home-buyer a handbook such as now available to the mortgagee under Both FHA and VA insured or guaranteed mortgage programs.

It is fully realized, as heretofore stated, that, while the mortgagee has basic requirements for such a publication since he is continually processing FHA or VA insured or guaranteed loans, there is no reason to suspect that most of the mortgagors wish to remain in ignorance of what should be executed properly in connection with their once-in-a-lifetime transaction under a complex FHA or VA program.

Rather, we suspect that mortgagor interest may sometimes be discouraged by lack of such a handbook, leaving the veteran or home-buyer with the feeling that the entire processing (and transactions associated with it) are of such complexity that he could not possibly understand what was taking place anyhow. With no tools at hand, any slight interest he might exhibit is frustrated in place of being stimulated by some available explanatory and well-organized handbook developed <u>with the mortgagor's interests in mind</u>. Also it is recognized that the FHA program in particular is designed principally to assist mortgagees and make funds available by the FHA insurance on home loans, with protection of the mortgagor a secondary purpose. The VA program, to some extent, holds primary concern for the veteran as well as encouragement and assistance to the mortgagee in funding the guranteed VA loan.

This is not to suggest that the respective federal agencies have not published information bulletins for the mortgagor explaining elementary matters associated with either program. However, the nature of these has been rather general, not specific enough and not well enough organized as to provide the mortgagor with a firm foundation for understanding his financial position. Lacking from both FHA and VA mortgagor publications are such fundamentals as indication of what documents the mortgagor should receive and at what state of the transaction he should receive them.

Such bulletins as have been issued for mortgagor elucidation and assistance, are exemplified by the following:

(a) <u>The FHA Story in Summary (1934-1959)</u>, FHA No. 375, 1959.

(b) <u>Estimating Ability to Pay for a Home</u>, FHA No. 201, March, 1961.

(c) <u>Fact Sheet on FHA Home Mortgage Insurance</u>, FHA Form No. 208.

(d) <u>FHA Facts for Home Buyers</u>, 141595-P 6/61.

(e) <u>How to Apply for an FHA-Insured Mortgage on Your Home</u>, 173727-P 7/31/61

(f) <u>Mortgage Payments to Principal and Interest</u>, FHA No. 202.

(g) <u>This is FHA</u>, FHA Form No. 2650, 1956.

(h) FHA Home Owner's Guide, FHA 100, Revised February, 1961.

(i) VA Fact Sheet, IS-1, January, 1961, (containing information on home loans.)

(j) Pointers for the Veteran Homeowner, VA Pamphlet 26-5, November, 1959.

(k) Question & Answers on Guaranteed and Direct Loans for Veterans, VA Pamphlet 26-4, Revised, September, 1961.

Three of the above publications are of particular value to the home-owner as general guides and the FHA and VA administrations are to be commended for their issuance and making available such general information to the mortgagor. These are VA Pamphlets 26-4, 26-5, and FHA 100, listed previously. However, all publications issued for the mortgagor by either FHA or VA are broadly generalized. Some of them do carry excellent coverage of how to apply for such a loan and how the veteran or home-owner may qualify for insured or guaranteed loan. In some, statistics are presented which are designed to assist in estimating the cost of carrying such a purchase obligation, and two of those cited give detailed information on how physically to care for the home after occupancy.

PRACTICAL APPLICATION:

In spite of several such publications issued by FHA and VA, none provides the veteran or home-purchaser with particular advice that will put him in possession of information relative to cautions to be observed in carrying out the purchase transaction, the critical matters that pre-date closure and follow his decision to make the purchase. In other words, what he should be sure is covered in the purchase agreement, how should the Certificate of Reasonable Value or FHA Valuation be employed to protect him on sale price; what kinds of closing costs and impounds may he be confronted with; what they are for and how they may be misrepresented; what papers and documents should he have or have seen prior to execution of sales agreement; what should he require and ask for in any escrow; what should he be in possession of by way of documents and papers at closure; and what items will follow? In short, the mortgagor is not advised relative to certain dubious practices and outright violations of FHA and VA regulations and procedure.

FHA and VA do advise mortgagees and attempt to control some practices by "asking" mortgagees if they will please desist. FHA and VA go further in their handbooks for the mortgagees and point out how the lender should protect himself in certain cases when dealing with the veteran or home-owner. It is to be wondered just why the FHA and VA have not seen fit to issue similar handbooks to the mortgagors, indicating where they should exercise caution and protect themselves. It should be realized that a mortgagee is in a lot better position to protect himself since he is constantly transacting loans and is a specialist in this area. However, the mortgagor has nowhere near equivalent experience and there is far more reason for FHA and VA to make sure that the veteran or home-buyer is protected.

Again, it should be emphasized that these federal programs have been artifically manufactured and have many necessary features which are not common to conventional transactions. There is a responsibility on the part of the government to give protection to the mortgagor equal at least to that afforded the mortgagee, this through the dissemination of adequate information which will place the veteran or home-buyer in awareness of questionable and outright illegal practices, as well as information for him relative to documents he should have as a part of his file on the most ethical of transactions. FHA and VA make some provisions to the effect that the mortgagor have a copy of several documents, <u>but make no provision that guarantees that he will be given these copies by way of an executed transmittal, as suggested in the preceding chapter</u>. These agencies likewise fail to assist the veteran or home-buyer by identifying illegal practices which are common to these transactions and those where the mortgagor may have an option or may make a request to the mortgagee that matters be handled in a certain way. <u>In the absence of a well-rounded handbook for the mortgagor by FHA and VA, we are led to believe that these government agencies, inadvertently perhaps, pit the inexperienced veteran or home-buyer against the lender who has been through the mill many times, and furthermore indirectly fortify the lender's position with a variety of assistance none the less of which is a laxity in enforcing their own FHA and VA regulations designed to protect the mortgagor</u>.

SUGGESTIONS:

This report strongly suggests that both FHA and VA move immediately to compile a protective mortgagor's handbook which will incorporate at least the provisions identified in this chapter in order to place the veteran or prospective home-owner in awareness of his financial position and protect him from the host of abuses identified in the entire report.

In the absence of FHA or VA action to provide this form of handbook for the mortgagor, it is suggested that the State of Nevada issue one for the use of the veteran and home-buyer. The Real Estate Commission or Planning Board should be familiar with such transactions and might be logical agencies to prepare such a publication for our veterans or prospective home-owners.

PART VI

PHYSICAL PROBLEMS CONCERNING THE DWELLING

The financial aspects associated with FHA and VA insured or guranteed mortgage loans have been covered in some detail in this report in the first five parts, and the report will return to such considerations in Part VII. However, Part VI primarily will be concerned with the mortgagor's problems relative to physical aspects regarding the dwelling he has purchased and occupied.

In addition to this coverage, a separate chapter has been included in Part VI which will identify certain construction methods relatively new to Nevada which may in the future work toward a better physical structure as well as financial savings to both the builder-seller and the veteran or home-buyer under certain conditions.

CHAPTER XXXIV

MORTGAGOR'S PHYSICAL PROBLEMS WITH HIS DWELLING AFTER OCCUPANCY

Along with the sale of the dwelling to the veteran or home-owner under FHA and VA insured or guaranteed loans, the mortgagor should receive the FHA or VA warranty. Under FHA, this will be Form No. 2544, and under VA Form No. V26-1859. The forms are identical in every respect and employed interchangeably. The complete title of the form is Warranty of Completion of Construction in Substantial Conformity With Approved Plans and Specifications. Usually the copy to the home-owner is made available to him by the mortgagee or any escrow officer closing the transaction.

This warranty is the basic document the home-owner has at hand to employ for the purpose of notification to the builder-seller within the period of one year from date of sale or date of occupancy (which ever first occurs) relative to any faulty construction or construction not in conformity with plans approved by either FHA or VA.

FHA specifically requires that the builder-seller deliver such warranty to the home-buyer at the time of sale. The builder-seller signs such an agreement with FHA on FHA Form No. 2004, entitled Mortgagee's Application for Commitment (at the bottom of the front page) which reads as follows:

> The undersigned agrees that upon any sale or conveyance of title within one-year from date of initial occupancy, he will deliver to a purchaser at the time of such sale or conveyance a warranty, FHA Form 2544, warranting that the dwelling is constructed in substantial conformity with the plans and specifications (including any changes approved in writing) and on which the Commissioner has based his valuation of the dwelling and he will furnish the Commissioner with a conformed copy of the warranty establishing by the purchaser's receipt thereon that the original warranty has been delivered to the purchaser. (underscoring supplied)

VA is likewise covered on this point under Chapter 37, Title 38, U.S.C., Section 1805, entitled "Warranties," as follows:

> (a) The Administrator (VA) shall require that in connection with any property upon which there is located a dwelling designed principally for not more than a four-family residence and which is approved for guaranty or insurance before the beginning of construction the seller or builder, and such other person as may be required by the Administrator to become warrantor, shall deliver to the purchaser or owner of such property a warranty that the dwelling is constructed in substantial conformity with the plans and specifications (including any amendments thereof, or chages and variations therein, which have been approved in writing by the Administrator) on which the Administrator based his valuation of the dwelling. (underscoring supplied)

The above is a directive to the VA Administrator that he shall require such delivery by the builder-seller. Under VA Section 3 of the VA Lender's Handbook entitled "Processing Procedures" at Section 3024, the VA makes the following requirement of the mortgagee:

> The documents to be submitted to VA by lenders processing loans for VA guaranty or insurance are listed below:
> b. (5) If the loan relates to a newly constructed dwelling:
> (a) Warranty of completion, VA Form 26-1859. (underscoring supplied)

This form is identical to and employed interchangeably with FHA Form No. 2544. In addition to this directive, the VA in Nevada stamps all VA Forms Nos. VB 4-1843 and VB 4-18432 (which are the Certificate of Reasonable Value and Master Certificate of Reasonable Value) with the following red-inked words as a directive to the interested parties, as follows:

> This certificate is issued on the expressed condition that the parties in interest designated by the Administrator will execute and deliver the warranty required under Section 36.4362 of the VA loan guaranty regulations. The warrantor will be ________________________.

The VA regulation referred to in this notification stamp reads as follows:

> Sec. 36.4362 Requirement of construction warranty. Each certificate of reasonable value issued by the Administrator relating to a proposed or newly constructed dwelling unit shall be subject to the express doncition that the builder, seller, or the real party in interest in the transaction <u>shall deliver to the veteran constructing or purchasing such dwelling</u> with the aid of a guaranteed or insured loan a <u>warranty</u>, in the form prescribed by the Administrator, that the property has been completed in substantial conformity with the plans and specifications upon which the Administrator based his valuation of the property, including any modifications thereof, or changes or variations therein, approved in writing by the Administrator, and no certificate of guaranty or insurance credit shall be issued unless a copy of such warranty duly receipted by the purchaser is submitted with the loan papers. (underscoring supplied)

VA does not require a prior certification from the builder-seller that he will deliver the warranty to the veteran. However, the U.S.C. Section and VA regulations quoted do place the responsibility directly upon the builder-seller. In practical effect VA holds the lender responsible and will not process the loan without the warranty, a copy of which must be delivered to VA which will have indicated thereon that the veteran also received a copy at the time of executing the other copies. This VA and FHA combination form executed by the veteran or home-owner has at the bottom and immediately above his signature the following wording:

> Receipt of this warranty is acknowledged this _____ day of ______________, 196__.

PRACTICAL APPLICATION:

A common difficulty observed in connection with this one-year warranty on the house is the non-availability of the warranty paper to the home-purchaser. He may have signed a number of copies on the warranty document when these papers were in the hands of the mortgagee or escrow officer. They are later distributed to interested parties and invariably the <u>buyer of the house is the last one considered in regard to receiving a copy of the warranty</u>.

In spite of these regulations, the FHA certification from the builder-seller that he will so deliver the warranty to the buyer, a large number of veterans and home-buyers end up with no warranty paper at all. How this develops is simple. Actually the mortgagee or escrow officer processing the loan will have the veteran or home-buyer sign a number of papers in advance. Usually these papers are copies of the FHA or VA deed of trust, note, etc., and among them will be several copies of the warranty. Many times these FHA and VA forms will not be filled in anywhere. The mortgagee or escrow officer indicates that the procedure is a normal one and that the veteran or home-buyer should sign them and the blanks will be filled in later. He may sign three or four copies of the warranty and thereby indicate that he has received a copy of said warranty. However, all copies will be taken from him for further processing and he will be told he will have his back eventually. Many times he never receives his copy although he will have acknowledged by this action that he has. The practice is so widespread as to be an accepted practice, and obviously works to destroy any built-in protection to the veteran or home-owner. In the event the prospective mortgagor balks at signing blank FHA and VA forms, he is told that without his cooperation in this fashion they won't be able to process his loan. The transmittal of closing documents form suggested in Chapter XXXII should go far toward covering this gap for the mortgagor.

The title of the warranty should serve notice to the veteran or home-owner that, at the outset, a considerable area is established and leeway granted to the warrantor (builder-seller) under its terms, by employment of the term "substantial conformity." Further, in the body of the warranty the identification is made of instances of substantial non-conformity. Thus, it is quickly realized that, basically, the warranty does not offer the protection to the veteran or home-owner that many believe is secured to them when they receive the document.

From a highly practical standpoint, it must clearly be understood and this report must emphasize that the reputation and policies of the builder-seller, relative to making corrections and so-called "pick-up" work to rectify poor workmanship performed by contractors and sub-contractors, is far more important than any FHA or VA warranty in almost all cases.

The warranty is not of much value to the home-owner if the builder-seller elects to sit tight and not make obvious corrections for poor workmanship and/or material. Fortunately, most builder-sellers will require their sub-contractors to make good on faulty workmanship and materials which may prove to be items requested by the mortgagor to have corrected. Usually this practical control over sub-contractors is maintained by builder-sellers since frequently they are in a position to withhold payment for work performed on other dwellings until they make good on the veteran or home-buyer's finished dwelling. The matter obviously becomes more difficult when the sub-contractor or basic contractor may no longer have contracts on the builder-seller's project. Such contractor may have been paid in full for work performed or may have been replaced by different contractors performing the work later in the same project and hardly responsible for the mistakes and errors of the former. Regardless of this, the builder-seller still is obligated to rectify any faulty construction, no matter what sub-contractor is currently engaged on such work.

In short, the veteran or home-buyer should depend on the builder-seller, his reputation and policy with regard to difficulties arising after occupancy of the physical property, rather than lean on the strength of the warranty. It is true that the warranty could be brought into action in those cases of "substantial" non-conformity to building plans.

The home-owner should go over his purchase with a fine tooth comb upon occupancy and make note of any equipment, workmanship, or materials which are apparently in need of attention or replacement by the builder-seller. Such an inspection should continue throughout the first year since some defects will not become apparent until the house is "lived in" for a while. If occupancy is made in the late spring it is natural to expect that the home-owner may not be aware of defects in a heating plant until several months later. If occupancy occurs in mid-winter he may not be aware of the failure of proper operation of sliding doors and windows designed to be opened frequently in summer months. Parts of the country subject to wet and dry periods will likewise develop different environmental situations which may bring to light defects at different times of the year. Likewise, areas subject to great changes in annual temperatures will bring out defects not immediately apparent to the home-owner on his day of occupancy.

A considerable area of disagreement can develop between the builder-seller and the veteran or home-buyer in regard to the quality of material or workmanship and whether or not certain items should or should not be corrected. Such situations commonly will develop in connection with painting and finish work which the buyer will feel are well below standard. The builder-seller must take the position that the work is average in quality and refuse to force the painter to repaint. Tile and floor work may have obvious indications of very poor workmanship and yet the degree of low quality of performance may be subjected to a wide range of subjective definition between builder-seller and veteran or home-buyer. Matters which may be identified more readily as builder-seller obligations are faulty plumbing and fixtures, electrical work, installation of any appliances and furnace equipment not done correctly, although even here there may be area for disagreement. Materials or equipment which are cracked, bent, broken, or otherwise damaged prior to, during, or after installation, by installers or other workmen obviously should be replaced for the mortgagor. However, even in these types of damage, there may be a difference of opinion as to how necessary it is to replace the equipment. Where a bath tub may be chipped or slightly cracked, the replacing may necessitate partial removal of the basic structure of the house. Such situations make fertile ground for disputes between the builder-seller and the veteran or home-buyer and certainly do not come under the category of "non-conformity" to house plans approved by either FHA or VA.

In addition to the warranty on the house, there are a number of other guaranties normally available to the home-purchaser, many of them not fully appreciated or even realized. The home-owner may or may not be aware of the existence of his rights and the manufacturers' warranties relative to materials and equipment installations. Again frequently this is associated with the willingness of the seller and sub-contractors to make such warranties, guaranties, and bonds information available. Far too often the papers which explain to the new owner these manufacturers' liabilities and the operation of equipment placed in the home, and provided by the manufacturer, are not passed on to him. <u>Warranties, guaranties, maintenance instructions, and installation papers and documents all filter down to the purchaser of the dwelling with a questionable degree of reliability.</u> The purchaser may not be aware of their existence, the sub-contractor has little regard for their careful delivery to the buyer, or to the seller for his proper forwarding. The net result is a host of misunderstandings, again with the veteran or home-owner being unaware of the variety of protections engineered by the manufacturer to provide <u>him</u> with recourse in the event the equipment or material fails to perform as designed.

Unfortunately, sometimes those who do the installation work are not overly concerned that the veteran or home-owner receive the warranties, guarantees, and/or instruction books which go along with the item being installed. They may deliver these papers at a later date or upon home-owner occupancy. More frequently they are left in or near the equipment installed and other laborers working on entirely different work may not realize their significance or have regard for them. Eventually they become misplaced or lost. Usually they are not easily replaced. All of which adds to the woes of the veteran or home-owner confronted with equipment which may be completely foreign to him.

Specific reference is made to papers the owner should have covering such items as his furnace or air conditioning plant; contractor-installed built-in ranges, ovens, broilers, refrigerators, exhaust fans, and other special equipment; the very roof of his dwelling; washing machine and dryer which may have been included in the sale of the new home; food waste disposal unit and dishwasher equipment; automatic garage door equipment; communication systems and other audio devices. The list is varied and dependent to a large extent on the cost of the home and what items may have been requested by the buyer or made available as standard equipment in the sale price of the house. When the consumer obtains these pieces of equipment and extras independently of a house transaction and one at a time, he will invariably receive the necessary papers with the item being obtained, or will request them. Where he acquires in toto, already installed as in a new home, he may or may not think to have provided for him the necessary protective and instructional documents.

Many home-buyers suspect that a one-year unconditional guaranty, and the statement made by the sub-contractor that the installation has "automatically" been registered at the factory as a protection to him, ends his protective span of time. To the contrary, most manufacturers provide an additional period of time, 5, 8, 10, or more years, during which period there may be a warranty in existence as an unconditional coverage of some important components of the installed item, or may provide that during a certain period of time the entire item may be replaced on a pro-rata basis, or that a specified obligation of the manufacturer exists in regard to factors other than time, percentages, or pro-rational factors. The warranties usually spell out what the manufacturer is liable for, whether or not he assumes labor and transportation costs and other provisions important for the consumer. This does not imply that all manufacturers and fabricators employ the same degree of clarity when writing their guaranty and warranty papers. <u>In any event, whatever may be made available by the manufacturer should likewise be made available to the home-buyer through the builder-seller as a foundation for some understanding as to his coverage in the event difficulties develop with some particular installation.</u>

Warranties and guarantees covering such equipment are highly significant to the home-owner. Usually the item being covered must be registered with the factory responsible for the guarantee and frequently the registry card will be attached to or associated with the guarantee papers. Usually, contractors register some types of appliances and units with the factory but may neglect to do so. Sometimes the registration requested by the manufacturer is for the primary purpose of assisting the company in knowing what kind of market is absorbing its wares and in what parts of the nation, with the basic registration taken care of by the sub-contractors. <u>To be on the safe side, all requested registrations asked for by the manufacturer should be immediately complied with and it would not be unreasonable to suggest that they be dispatched to the manufacturer by registered or certified mail with a return receipt to the veteran or home-owner.</u> The few cents thus expended may save hundreds of dollars at a later date. Manufacturers are prone to keep to the letter of the guarantee particularly where time elements enter the warranty.

Again, the sub-contractor's reputation and policy may be more valuable than the guarantee on such equipment since he may go farther than specifically required by the factory (which usually is remote to deal with) in order to generate good will. Local suppliers may have a vital interest in the community and wish to preserve and further develop a good name. It should be realized that the manufacturer's guarantee may be vague, generalized, and proration factors may work toward a costly replacement at best, since necessary labor and shipment of the defective equipment for their inspection, and any new equipment shipped to the mortgagor, may all be at the veteran or home-owner's expense. It is in this area that the sub-contractor may elect to assist the home-owner by providing some labor and may actually replace the unit and never bother to ship it to the factory or attempt to obtain a settlement from the manufacturer. Usually sub-contractors are under no obligation to so assist the mortgagor but many times will do so where they value their reputation. Contract bidding usually allows for some amount of this work which the sub-contractor expects will develop in his supplying and working on a large number of homes.

The basic cause of so much difficulty developing between the builder-seller and the purchaser of the home lies in the area of trying to come to agreement about what degree of workmanship or quality of material constitutes grounds for correction and what amount and degree of damage may reasonably call for replacement. Obviously, the veteran or home-owner who moves into his dwelling place (which may be the first he has ever owned) will look for perfection. Under the manufacturing techniques employed in this nation he has a right to expect close to that. Also, he will be looking for a high degree of workmanship which he likewise has a right to expect in line with current wages being paid in most sections of our country. Unfortunately, under the mass production techniques usually typical of sales type home areas, the craftsmanship of former days is lost, and it is also not unusual to have installed second grade materials. On the other hand, the builder-seller has set his sights upon a lower basis to determine whether or not the quality of workmanship, material, and equipment is "standard." The differential which will develop between the two parties is quite natural and must be recognized. This report does not attempt to set any limits as to how far either party should go. The report does attempt to indicate the reason for the disparity, the wide variations to be expected, indicating how the veteran and home-owner's problems will be handled, and the unrealistic approach of leaning too heavily upon an FHA or VA warranty, expecting it to exercise control over too great an area of problems, (minor and major) which will arise in the occupancy of almost any home built by man in this day and age.

SUGGESTIONS:

(1) Warranties and guarantees covering any equipment and materials should be requested by the mortgagor unless made available to him, and he should forthwith execute and dispatch to the manufacturer any requested registration of same.

(2) The basic FHA or VA warranty should be requested if not made available to the home-owner at escrow closure.

(3) Immediately upon occupancy the veteran or home-owner should take steps to thoroughly inspect his dwelling and report in writing to the builder-seller those matters which need attention.

(4) A contingency fund could be established by FHA and VA which the builder-seller would deposit with these agencies, out of which monies would be available to cover work needing attention. However, this report does not subscribe to such a fund, sometimes established when commercial buildings are being erected and for a somewhat different purpose, because FHA or VA, the builder-seller, and the home-buyer, would all become involved in matters heretofore pointed out to be highly unconducive to objective opinions. It is believed that competition, if provided to operate effectively by rectifying several existing FHA and VA regulations suggested in these chapters, will in the end be most effective.

(5) Since the veteran or home-owner quite often <u>does not receive his copy of the FHA-VA warranty, it is suggested that this document be included as one of the papers necessary for transmittal to the mortgagor at closure, in line with the transmittal document which is suggested in Chapter XXXII</u> to cover for many documents which either the mortgagee or escrow officers fail to deliver to the veteran or home-owner.

(6) The builder-seller, in the case of new sales type homes in tract areas, should be required, and could be required under an FHA or VA insured or guaranteed mortgage, to provide directly to the veteran or home-buyer at closure or date of occupancy (whichever should occur first) all guaranty and warranty bonds, certificates, and instructional papers associated with any materials or installations made in or on the home being purchased. Exceptions would be made for those very few cases where a company sends such warranty or guaranty directly to the consumer, in which case the builder-seller would certify which documents from what companies would be sent at a later date. <u>It should be understood that time is of the essence in the case of these papers, especially instructional materials</u>. Warranties and guarantees should be executed and dispatched by the home-owner as soon as possible after purchase or occupancy to properly cover his interests. Obviously instructional materials and handbooks are of immediate need to the veteran or home-owner and he should have them as soon as possible before possible damage to equipment by faulty operation warned against in such handbooks. <u>Proper adjustments and protective provisions should be information made available to the mortgagor at the earliest possible moment</u>. In the absence of this information, he might easily operate equipment in a fashion which would void the manufacturer's agreement and he would have no recourse covering repairs or replacements.

<u>Therefore, this report suggests that the transmittal form to the mortgagor suggested in Chapter XXXII include the provision that the builder-seller transmit to the veteran or home-buyer on date of occupancy or date of escrow closure (whichever shall occur first) all guaranty or warranty papers and all instruction books covering equipment separately warranted or guaranteed by the manufacturer, which has been installed in or attached to or supplied with the house, and which is covered in the sale price of the dwelling.</u>

CHAPTER XXXV

CONSTRUCTION METHODS DESIGNED TO REDUCE COSTS TO HOME BUYERS

Costs to the home-buyer which are truly hidden and do not contribute in any way toward the cost of developing the land, and labor and materials employed for building the dwelling place, are identified in this chapter particularly as they relate to interim financing costs to some builder-sellers. The cost of interim financing naturally must be passed along to the mortgagor who purchases the home since the builder-seller must receive a reasonable profit from the transaction. Such interim financing costs cannot be expected to be absorbed by the seller.

It must be emphasized that the employment of the building techniques identified in this chapter will not necessarily reflect a savings to all builders. Any advantages cited herein will depend entirely upon the nature of the current financing methods and labor efficiency of the builder and should not be taken as a cure-all for the home construction industry.

PRACTICAL APPLICATION:

The builder-seller, as pointed out in earlier chapters of this report, frequently does not employ his own funds in a significant quantity in the development of tract sales type home developments. Thus, we have the entry of interim financing for the builder-seller from banks, savings and loan associations and other lenders on a short-term basis. These lenders usually traffic in short term interim loans to the builder-seller on a cost factor which is higher than long-term mortgage loans. The interest cost of interim funds will run in the neighborhood of 7% here in Nevada which is a significant cost factor to the builder. The longer he has to have the use of these funds, the more costly the project and the higher the sales price of the house must be in order to recoup this high cost of interim financing. It is obvious then, if the time period can be reduced and the dwelling constructed in a shorter time, that the indirect interim cost to the veteran or home-buyer can be significantly reduced.

In this connection, it is of interest to make available to the readers of this report new building techniques which are very common in some sections of our nation but seldom employed in Nevada. For many years in the mid-west and east, the manufactured home has been increasingly employed by builder-sellers to eliminate this interim cost factor. In some sections of states like Indians, Ohio, New York, and parts of the New England states, the manufactured home predominates over the conventional building-in-the-field method. <u>The manufactured home is not to be confused with the prefabricated home of pre-war and World War II days, which was frequently made of cheap materials, poorly fitted, and thrown together by inexperienced workmen with time factors most significant</u>. Likewise, the manufactured home is not to be associated with a pre-cut home, or with the shell type home common now in the south. The term "pre-cut" merely relates to the lumber being cut in advance to exact size, all of which, <u>without any fabricated portions</u>, is shipped to a builder. The shell-type home is one which has the <u>basic structure assembled</u> but other finished portions such as wallboard, painting, and most of the electrical wiring, plumbing and kitchen equipment, <u>yet to be installed</u>. The shell-type home is rapidly encompassing such a large number of extras in most parts of the country where it is sold in volume that it amounts to almost a finished home, which may or may not have developed from pre-cut or partially prefabricated sections.

The true manufactured home is built in assembly line fashion in a factory designed for such construction, similar to an automobile plant. The materials employed are usually of the highest quality since it is not economical to employ second grade materials where allowed by FHA or VA, necessitating inventory of that material. Usually pre-cut pieces are fabricated by highly specialized machines with a minimum of waste of material and man hours of labor. The resultant fabricated sections are composed of high quality materials, precision cut and nailed or joined by machine techniques, the same materials being used and the same assembly methods for a $15,000 model as for a $50,000 model. In short, through savings in labor and waste material, high quality dwellings result and these may not be quite as costly as those produced conventionally. However, these obvious advantages, along with a builder not having to fight weather conditions for long periods of time in the open, are only a part of the argument for precision-manufactured home acceptance in many sections of the nation. The basic reason is that of savings to the builder of his interim expenses for financing as identified in this letter of information sent to the Legislative Counsel Bureau from the Home Manufacturers' Association:

> It is true that a builder often can obtain a house package and complete the house at a price somewhat cheaper than a conventional house. But we point out that the primary saving is the increase in cyclical rate. If a conventional builder can erect 10 houses a year, he can erect 30 manufactured houses in the same time and with the same labor force. So the real savings is in interim financing, on-site labor, overhead and so forth. In addition, as a part of the house package, most home manufacturers provide services free in the areas of land planning, merchandising, financing and landscaping. There is only one bill for the complete house package instead of hundreds which a conventional builder must pay and keep track of. In merchandising, for example, many home manufacturers will provide from their own budget advertising 'tie-ins' for builder-dealers. For every dollar the builder-dealer might spend in advertising, another two dollars might be added by the home manufacturer. Complete how-to-do-it and when-to-do-it kits are provided for advertising and public relations. In other words, home manufacturers now provide costly services which most local builders could not afford themselves.

The on-site labor referred to in this letter would be a saving to the builder but obviously a significant portion of this saving would have to be expended in the purchase price of the fabricated package from the manufacturer, since that cost would represent factory labor expended. There can be no argument, however, that such labor expense would have been expended under optimum factory assembly line conditions and would result in direct savings to many builder-sellers and indirect savings to the veteran or home-purchaser.

The reference to "only one bill to pay in place of hundreds" when a builder is erecting manufactured homes, strikes at a large overhead which many builders have and which has been somewhat accommodated for under the "builder control" method. In such cases, either a lending institution or title company, or a builder control specialty company working through either of the former, handles the disbursement of all funds from the interim lender as discussed in an early chapter.

Since the home manufacturer is as desirous of having the homes sold as is the builder, he may expend considerable amounts for advertising, thus eliminating some of the overhead costs now absorbed by a local builder-seller and providing mass-media advertising which can further reduce costs for him. Home manufacturers equipped to assist the local builder along these lines are vast and well known organizations but general knowledge of their frequent contributions to lower building costs for Nevada is not widely recognized, although a few of these companies are well known even in Nevada, such as Harnischfeger, National Homes Corporation (the "General Motors" of the industry), and United States Steel. Three companies now have plant locations close to Nevada and one plant is located in the State. These are National Homes Corporation with a plant at Newark, California; Muttart Homes, a Canadian-based operation with a plant at San Jose, California; Intermountain Precision-Bilt Homes, Inc., at Ogden, Utah; and Castle Homes located in Reno, Nevada.

House packages moving from manufactured home plans are frequently transported to the building site in huge moving van type vehicles. One such low slung model is equipped to move an entire house package. For larger models selling at $25,000 and higher, two or more such vehicles might be necessary, since manufactured homes sell at prices ranging upward to $65,000.

Two of the nation's major manufacturers of homes are now engaged in delivery of homes in but two sections. This can be done only with smaller homes at the moment. The home is entirely prefabricated in a manufacturing plant and moved to the site on two large trailers in two separate sections. At the site, the two sections are locked together. How far home manufacturers may be able to go depends largely upon the restrictions placed upon how large a section can be transported by highway or rail from the factory to the field.

Some are quick to point out that, with the manufactured home there is too much restriction placed upon variety. This is somewhat hard to accept as major restriction to their eventual wider acceptance, since most manufacturers allow for modification to some dozen or more basic models. And it should be kept in mind that home manufacturers have been building and selling certain models for a long time. If there were any major faults in the house plan it would have developed and been corrected. In this connection, the manufactured home absorbs builder-seller architectural fees in the cost of the house package and manufacturers can employ the best architectural talents available for their mass production, much as the automobile makers can afford the most extensive overhead for design work. It is wondered just how much the average American motor car might cost if it were produced piecemeal and on a semi-custom basis, as are most of the homes in the nation. Henry Ford cut the cost of the automobile for America, but as yet in Nevada we have not eliminated high-cost housing on any significant scale.

A relatively new innovation in the manufactured home has developed recently, called "component construction." This should set aside any criticism of lack of diversity for the manufactured home. Under this method, several different plants and manufacturers produce component parts of a house and the home builder may make his selection from several different manufacturers in assembling portions of a single house. Some advantage is lost, however, since by dealing with several companies he will lose some of his development, advertising, and other overhead costs, which are assured to him when one corporation is furnishing the entire house package. However, the component method prevents monopolistic practices whereby through the franchise system one builder in an area is the sole outlet for a nearby fabricator of manufactured homes. Component manufacturers make available prefabrication techniques to all builders without franchise restrictions.

The question is logically raised, if all these techniques are such an advantage (with better quality, better workmanship, and less expense to all involved) why has it not spread like wildfire? Why is such production limited on any large scale to the mid-west, south, and the east? There are some answers for this and they are as follows:

(1) In many sections of the country there are antiquated codes which work against any improvement whatever, whether it be for conventional homes, manufactured homes, or employment of component units. Obviously, if these prevent certain innovations from being built into a manufactured home, the manufacturer cannot afford to make models and units for certain specific towns or areas on any wide scale. Frequently the antiquated building codes are designed to protect certain vested labor interests and/or certain manufacturers of equipment. In either event, they work against a less costly home.

(2) Penetration of manufactured homes into the deep "south" was slowed by the fact that damp conditions, along with termite situations, had dictated the employment of large amounts of block, concrete and brick construction in modern homes. Naturally there was little saving to be gained by sending but a small package with most of the building material of heavy weight and low cost to be supplied locally. New techniques of construction have allowed for major portions of new construction to be made of fabricated wood or aluminum.

(3) It was often thought that lenders shied away from the manufactured home. However, where the manufactured home is erected in volume most of them are far more apt to lend on such a home than a conventionally built one, since actual costs are easier to establish on a manufactured product and valuations as far as the mortgagee is concerned are better known.

(4) The chief detterent as far as Nevada is concerned has been the logistics of distance. Until comparatively recently, all manufacturing plants were located at a great distance from Nevada. A quotation from a letter received from the Home Manufacturers' Association, emphasizes this distance factor as follows:

> One of the primary problems in developing acceptance of manufactured homes in some of the Western and Southwestern states apparently is the distance between sales outlets. For example, it generally is difficult for home manufacturers to ship house packages more than about 400 miles and still make a profit. Therefore, it is necessary in such states as Nevada to build a large volume of sales in commercial centers such as Reno and Carson City.

(5) Another problem was that associated with labor in erecting the manufactured home. The local labor unions had a feeling that they were being deprived of work which had been done in a manufacturing plant. However, this attitude usually was quickly dispelled when it was demonstrated that they would have the same hours of work and the same pay but it would be spread over more houses being erected by the builder through more efficient methods. For example, in place of spending all their labor time on a few conventional homes they will have spent the same amount of time in work still necessary on a large number of homes. Since manufacturers of homes employ union labor in the manufacturing plants, this specter of work lost to local labor has largely evaporated. As a matter of fact, in many cases they may end up working for a more substantial employer, who may be in a position to offer a better contract since he has placed himself in a better competitive position.

(6) A more realistic labor problem is that associated with the home-builder obtaining skilled help experienced in erecting a manufactured home. The labor craftsman is not one who can be turned about swiftly and made efficient at an entirely new way of building a home without some difficulty. He may resent the modern techniques and even go so far as to work to prevent a smooth assembly operation. Most large home manufacturers will insist that their factory men be on the spot for the first few units erected, and also to iron out any difficulties which may arise among inexperienced workmen. Builders may expect to find Nevada labor familiar with these new methods since manufactured homes have been erected on a limited scale in Reno and adjacent towns in western Nevada as well as recently on a fairly large scale in Las Vegas.

The major obstacles to be overcome before any advantages of the manufactured or component construction type of home can be made available to Nevada, are distance and trained labor. The first of these has been greatly modified in recent years by location of manufacturing plants west of the Rocky Mountains and in states adjoining Nevada, as listed previously. Secondly, the problem of trained labor is one which will be eliminated in time as some of the pioneer builders tackle these problems which eventually will result in an available equipped labor supply for the state.

This chapter does not attempt to assess in any way the results which might be experienced in Nevada relative to a shift in the composition of necessary labor for the construction of dwellings brought about by an increased employment of component units and manufactured home techniques in the home building industry. Likewise, no attempt has been made to identify the volume of any advantage which might develop to those builders who used the techniques set forth herein and what effect, if any, the increase in their cyclical rate of construction would have upon other builders employing more conventional methods. This report has merely identified recently developed building methods as having a strong connection with the directive of the legislature which identified the quest for information on incidental costs to the purchasers of dwellings. As pointed out in other chapters of this report, financing and other costs, whether they be direct costs to the veteran or home-buyer, or indirect costs to the builder-seller, mortgagee, title company, or others, has the net effect of an increase in incidental costs to the buyer not chargeable to material and labor expended on tangible and physical property he purchases with his dwelling.

SUGGESTION:

No specific suggestions can be made at this point except to suggest to any builder-sellers who may read this report, and are experiencing high cost interim funds and physical building problems, that they might examine the manufactured home and/or component techniques with a view to reducing their interim financing costs and assembly problems, as well as offsetting weather problems in northern Nevada. Any strengthening of these Nevada builder-sellers obviously will have by-product results to veterans or home-buyers through reduced costs and in many cases higher quality of both materials and workmanship.

PART VII

FINANCIAL ASPECTS SUBSEQUENT TO DWELLING OWNERSHIP

This part of the report has been presented in the interests of following through to determine if any further surveillance is required by the veteran or home-owner, associated with his FHA or VA insured or guaranteed mortgage when he may relinquish the loan.

The mortgagor should not relax his interest at this point since investigation has disclosed that some questionable practices will continue to haunt his relationship with either the FHA or VA programs even to the point of final release of his obligation, or assignment of it to another individual.

The situations which develop are more critical with the FHA program. There is the involvement with the FHA mortgage insurance system which has necessary complexities.

The termination of further payments on the obligation will occur in most cases through three common situations which may develop:

(a) Sale of his home to a new buyer who accepts his FHA or VA insured or guaranteed mortgage. The new buyer assumes the obligation which is assigned to him. The original home-owner could be held liable in case of default on the part of the new buyer.

(b) Sale of his home to a new buyer who becomes mortgagor to an entirely new FHA or VA guaranteed loan. Such situations develop when the equity in the house, plus the unearned increment, has worked to require too large a down payment, and the veteran or home-owner selling is not interested in taking back a second mortgage. The new owner will take on a new FHA mortgage, the discount on which will be paid for by the seller directly. This will cost the original home-owner several hundred dollars in discount, but he will receive cash from the sale for the increased value of the building, plus his equity, minus the discount and minus the balance of his obligation on his FHA loan. Usually he will place the sale price of the dwelling high enough to cover for the discount, much the same way the original builder-seller provided for it in the initial sale.

(c) The FHA or VA home-owner may wish to pay off his obligation at an accelerated rate to escape heavy interest which will be due over a long period of time. Under FHA, if this acceleration is carried out over a period of seven years, he can accomplish his purpose without premium adjustment charges. In any event the mortgagor may elect to pay off much sooner than this and relieve himself of any further obligation.

The necessity for concern when a home-buyer is selling his home or paying off his mortgage, is associated with charges and collections which will be made to him through closure of the transaction. Also, of equal importance are the correct credits which should be made to him at this time.

These charges may represent items which are not provided for under FHA or VA regulations. The home-seller should also receive proper credits for the amount of principal and interest he has paid on the mortgage and should have proper prorations made from his trust funds, the balance of which should be returned to the mortgagor when selling his home.

A review of some of these closures has disclosed certain practices of which the veteran or home-owner should be made aware. To have a complete picture of charges, fees and collections incidental to the FHA and VA insured or guaranteed mortgage, it is felt necessary to carry this study through to the conclusion of the mortgagor's relationship to the FHA and VA insured or guaranteed mortgage obligation.

CHAPTER XXXVI

FHA PREPAYMENT CHARGE FOR ADJUSTED PREMIUM ON MORTGAGE PAYOFF

There are certain charges and rebates which will affect the home-buyer under the operation of the FHA program in those cases where the mortgagor may sell his home or otherwise dispose of, or prepay, the mortgage.

Since FHA home-buyers may sell their homes well within the first ten years when they are subject to such a full charge, this report has felt it advisable to include information which will identify this charge and the FHA provisions which will control such a charge. The prepayment situation will also develop in those cases where the mortgagor may elect to pay off his mortgage within the first ten year period.

Due to the general lack of knowledge on the part of the mortgagor relative to his obligations to pay such a charge, and due to the non-automatic provisions for the possibility of a return of such charge (frequently made in error and usually amounting to well over $100), special emphasis on this charge, which can occur several years after occupancy, is warranted.

Under the FHA insured mortgage program, the home-owner will be subject to a prepayment charge of 1% of the original principal amount of the FHA insured mortgage if he voluntarily terminates his obligation at any time during the first ten years of his obligation, and lesser amounts thereafter. This prepayment should not be confused with the typical prepayment penalty frequently provided for under the terms of a conventional mortgage to be collected and held by the mortgagee. The prepayment identified in this chapter is strictly a collection required by FHA called an "adjusted premium," and associated with the FHA mortgage insurance premium payments. The collection will be effected through closure by the mortgagee servicing the loan or by directions from the mortgagee to the escrow or title company. The collection is turned over to the FHA and is deposited in the FHA Mutual Mortgage Insurance Fund.

The prepayment or adjusted premium will not be owed to FHA in the event the new home-owner (who is purchasing the dwelling from the first owner) either takes over the existing FHA insured mortgage or takes on a new mortgage also insured by FHA. In either event, the first of which is not a termination of the original mortgage but an acceptance of it by the new owner, the FHA prepayment collection should not be charged to the original mortgagor.

Provisions for these termination charges and exceptions are set forth in FHA Regulations, Section 203.285, "Computation of adjusted premium," as follows:

> Where the principal obligation of any mortgage accepted for insurance is paid in full before the due date of the 120th scheduled monthly payment, without taking into account delinquent payments or prepayments, <u>the mortgagee shall pay to the Commissioner an adjusted premium of 1 percent of the prepaid mortgage</u>. (underscoring supplied)

By the terms of this section the <u>mortgagee</u> pays the adjusted premium charge. However, as will be seen shortly, the mortgagor actually reimburses the mortgagee for such a charge under the terms of the FHA deed of trust. An important exception is made to the FHA prepayment collection under FHA Regulations, Section 203.287, "Prepayments excepted from adjusted premium charge," as follows:

> No adjusted premium charge shall be due or payable to the Commissioner in the following instances: (a). New Insured Mortgage. Where the insured loan is paid in full with or from the proceeds of a new loan on the same property which is insured by the Commissioner. (underscoring supplied)

The practical effect of the foregoing is to release the original mortgagor from the necessity to reimburse the mortgagee for the prepayment charge in those cases where he is terminating his FHA insured mortgage loan through proceeds received from a FHA insured loan made to the person who is purchasing the property from him.

The mortgagor may also repay his FHA mortgage at an accelerated rate of payment without being charged with an adjusted (prepayment) premium by paying off at the rate of not more than 15% a year. This would allow him to pay his obligation in the seventh year and exempt him from the necessity to reimburse the mortgagee for the FHA adjusted (prepayment) premium charges. Usually the method is referred to as retiring the loan through the use of "idle funds." FHA Regulations covering this point are in Section 203.287, and read as follows:

> (b) Accelerated by partial prepayment. Where the final maturity specified in the mortgage is accelerated solely by reason of partial prepayments made by the mortgagor which do not exceed in any one calendar year 15 percent of the original face amount of the mortgage, plus 15 percent of the original face amount of any open-end advances.

Likewise, no adjusted prepayment premium charge will be due in the event the acceleration of payment has been caused by payments to principal to compensate for damage to the mortgaged property; for release of a part of the insured property approved by the Commissioner, as required by the Commissioner pursuant to an approved escrow; associated with condemnation proceedings; or when payment in full is made of a delinquent mortgage under foreclosure.

PRACTICAL APPLICATION:

Danger to the FHA home-owner lies in the area of the collection of this charge as a reimbursement to the mortgagee whether or not it may be required by FHA regulations. Frequently, the mortgagee may collect or may direct that the reimbursement payment be collected through escrow from the mortgagor by the title or escrow company, in cases where the same home is being immediately covered by a FHA insured mortgage to the person purchasing from the first FHA mortgagor. FHA Regulations, Section 203.287, specifically exempt the mortgagee from the necessity to pay an adjusted premium charge in such cases, and the mortgagee should not seek to have himself reimbursed for this charge by collecting from the mortgagor.

In extremely few cases will the FHA home-owner realize that he does not have to pay this reimbursement to the mortgagee. To further cause concern, FHA does not provide any automatic refunding of collections made from the mortgagor by the mortgagee and forwarding to FHA, when collected without any necessity. Were such collections (usually amounting to over $100), eventually returned to the mortgagor, there would still be concern, but to a far lesser degree. Recently FHA has set up a new form reporting payoff, discussed at the end of this chapter, which may prove to be a better protection to the mortgagor. However, this new procedure has not been operative long enough to properly assess its effectiveness in this area.

The question might logically be asked as to why the mortgagee would make such a charge when he would be turning these funds over to FHA and not have them for his own use. This report hesitates to suggest, but must point out the very real possibility of the charge being made where not required by FHA, and, since it does not have to be turned into FHA, it could be kept by the mortgagee as an added rate of return to him or kept by the mortgage company servicing the loan. Such an irregularity could easily be covered by reporting the new FHA case number on the prepayment report to FHA, Form No. 2344, which case, if finally approved, would not require the mortgagee to remit the prepayment charge collected from the mortgagor. The mortgagee could return the prepayment to the mortgagor. However, this report fails to see where there is any guaranty to the home-owner that such would be done.

The situation which develops when a FHA insured mortgage is being prepaid and followed by a new FHA insured mortgage on the same dwelling is a difficult one, and undoubtedly has led to irregularities in this area. All would be fine, and a mortgagee could be expected to know what the situation was, if both mortgages happened to be ones that he was prepaying and originating. This could easily be the case, but often is not. One mortgagee may be handling the prepayment of an FHA insured mortgage, and another mortgagee may be placing the new FHA insured loan on the same property. The mortgagees, or any escrow officers handling the transaction, would likely be in a position to realize what was going on since they must handle the prepayment of the first mortgage with the proceeds of the newly originated loan. They would obviously know if a prepayment on a FHA insured mortgage was in fact being followed by a new FHA insured loan. However, any escrow officer following instructions from the mortgagee is not charged with figuring out what the home-owner selling his property is supposed to reimburse to the mortgagee. The home-owner himself will rarely know all the technicalities of such a complex payoff of his loan. FHA does place this responsibility directly in the hands of the mortgagee as indicated in the official FHA Mortgagees' Handbook, Chapter IX, Section 910, which reads as follows:

> . . . It is the responsibility of the mortgagee to the mortgagor to determine all of the circumstances which resulted in prepayment prior to maturity and to report them fully to the Commissioner so that when terminating the contract of insurance the Commissioner may properly determine if the adjusted (prepayment) premium is due. (underscoring supplied)

This firm and completely clear language identifies beyond a doubt that the mortgagee is charged by FHA with knowledge of why the mortgage is being paid off and whether or not it is being followed by another mortgage which could very well be insured by FHA. This would have to be known or searched out by the mortgagee by information from the mortgagor, escrow officer, or other parties, to comply with "all the circumstances which resulted in prepayment." Certainly the sale of the house, and employment of the proceeds of a new FHA insured mortgage loan to provide funds for the payoff, would constitute a "circumstance" resulting in prepayment. One would suspect that the mortgagees would exercise some caution and at least establish what type of mortgage, if any, was following.

In another section of the FHA Mortgagees' Handbook, the FHA goes to some length to warn the mortgagee to look out for his own interests. However, there is no such notice to the FHA home-owner on this point to protect his interests, which again illustrates the policy of FHA throughout its program. In a following section from the handbook, Section 911, (c), the mortgagee is advised as follows:

> In a case where an application has been filed with the FHA for the insurance of a new mortgage on the same property securing the prepaid mortgage, the mortgagee should enter the FHA case number of the new application in Item 2 (Item 9 on new forms Rev. 9/61) of the report of prepayment. A remittance in payment of the 1% adjusted (prepayment) premium need not be submitted with the report of prepayment in any such case, but the mortgagee should collect this sum from the mortgagor and retain it in the premium escrow account.
>
> This procedure is recommended for the mortgagee's own protection in the event the application for insurance of the new mortgage does not result in an insured loan, thereby causing the adjusted (prepayment) premium to become payable to the FHA before the insurance contract can be terminated. (underscoring supplied)

Apparently the federal FHA system is concerned primarily with protecting the mortgage companies and money lenders at this point. Just what protection there is for the home-owner to guarantee that such funds held by the mortgagee would be released to the mortgagor, if and when the FHA insured mortgage was approved, is not very clear.

A further section from the FHA Mortgagees' Handbook is of interest on this same point. The section is Number 912, which reads as follows:

> If the space limitations of FHA Form 2344, Report of Prepayment of Insured Mortgage, do not permit the mortgagee to submit all pertinent circumstances involved in the prepayment, the report should be submitted with an accompanying letter from the mortgagee outlining the circumstances in full. If the mortgagee is in doubt as to whether or not the adjusted (prepayment) premium is due in a particular case, it will expedite termination if the mortgagee will forward its remittance payable to the FHA for the 1% adjusted (prepayment) premium with the Report of Prepayment of Insured Mortgage. When it is determined whether the 1% adjusted premium is due, and the premium account for the loan has been reviewed, any excess amount remitted will be refunded. (underscoring supplied)

By this section the mortgagee is instructed to remit the prepayment charge if there is any doubt so that the termination of insurance can be processed by FHA. Due to the FHA suggestion, and the practical press for termination in the interests of FHA processing (which cannot be completed unless the prepayment charge is remitted by the mortgagee or a clear explanation is made by reference to FHA case number for not remitting) evidently many cases are closed with the prepayment charge made by the mortgagee, or collected through escrow closure, as a reimbursement from the mortgagor. Obviously the mortgagor's interests in the matter are not properly protected and apparently he is the last one to receive consideration.

The mortgagor will be aware of the non-necessity for him to have made the prepayment charge to the mortgagee in only one case out of hundreds? This report fails to find where FHA has provided for any protective controls over the practice of mortgagee either wilfully or by error making such a collection and not thereafter refunding same to the home-owner in those cases where such a refund is due. Apparently inadequate machinery is set up at the FHA level to check to see whether the FHA home-owner's prepayment charge was necessary and, if it was not, any automatic refunding by FHA to the mortgagor.

FHA by Section 910 of the Mortgagees' Handbook (quoted from previously) places the responsibility on the mortgagee for knowledge of how the paid-off mortgage is being followed and if the prepayment charge is necessary, but continues to needle the mortgagee to send in the prepayment collection anyway. This is evidenced by another section, 913, from the same publication, which reads as follows:

> The FHA is anxious to complete the termination review of all cases as promptly as possible, so that the contract of insurance may be terminated and any premium escrow held by the mortgagee released to the mortgagor. Where reports of prepayment and requests for termination of insurance contracts are received without the required pro rata earned premium, or the 1% adjusted (prepayment) premium, however, the termination review of the case cannot be completed. This necessitates correspondence with the mortgagee or its agent, and FHA's review of the case must be delayed until all required sums are collected. (underscoring supplied)

The net result of all these FHA directives and suggestions to the mortgagee is that very frequently, no matter where the proceeds of the new mortgage employed to pay off the original mortgage have originated (FHA or non-FHA insured loan) the mortgagee will usually collect through escrow from the mortgagor the 1% adjusted prepayment premium. The mortgagee may or may not hold same in an escrow account to await FHA determination, as FHA suggests. However, when the payoff is executed through closure, and it is an FHA insured mortgage (the proceeds of which are making possible the payoff) the final approval of the loan by FHA is only a technical matter since no mortgagee would fund the loan at closure unless he was 100% sure all his papers were in order to guarantee to him that the final processing and last official approval of FHA would be forthcoming by their endorsement.

Of more practical concern to the mortgagor will be the matter of how he might be able to obtain such a refund of a prepayment collection made by the mortgagee. Such collection might be made in error, collected for and held by wilful violation of regulations by the mortgagee, or collected through the mortgagee with FHA acceptance of the prepayment premium charge, a move easily made through inadequate controls (FHA themselves not being aware that the collection is not necessary). The ramifications associated with such an attempted refund on the part of the home-owner usually go much farther than the casual language employed in the last sentence of Section 912 cited, "any excess amount remitted will be refunded."

Where the home-owner attempts to obtain a refund of the prepayment unnecessarily collected, usually he starts with the escrow officer or mortgagee who handled the transaction since he will question why he was charged with this collection on his statement. In the one out of hundreds of cases where the mortgagor will even recognize such a charge being made in error, any escrow officer is obviously not at fault since he only followed directions from the mortgagee. Any escrow or title company may elect to assist the mortgagor by contacting the mortgagee and requesting the return of the collection as an agent of the mortgagor. However, in such case where an escrow officer closed the transaction, it would be best for the mortgagor to go directly to the mortgagee to avoid complications and indirect action. If the mortgagee has not transmitted the collection to FHA, the issue can usually be settled in a short time. If it has been transmitted to FHA, and FHA has processed the collection but has not indicated that such a collection is not properly due FHA upon its initial review of the case, then it will take little short of an act of congress to obtain return of mortgagor funds collected in error and held by FHA. It is not unusual for the necessary time to exceed a year. Oddly enough the money is refunded without interest, although when a government agency makes a collection from a citizen representing money owed to the government for a period of time, a substantial interest is collected.

This report has not attempted to determine how widespread this practice may be. The FHA machinery for closing out a loan obviously is cumbersome and is designed in such a fashion that it offers practically no protection to the FHA mortgagor on this issue. However, every protective feature is afforded and emphasized to the mortgagee. The lender is directly advised as to how he should work the system to protect himself. It is wondered why FHA has not moved to likewise protect the small mortgagor and home-owner. Evidently the home-owners' interests are very much of a secondary consideration in the FHA program in spite of the layman's feeling that, if the government is in the transaction with him certainly he must be receiving at least minimum protection.

SUGGESTION:

This report must make the strong recommendation that FHA move to immediately revamp its machinery and regulations relative to terminating the FHA insurance when FHA insured mortgages are paid off, in the primary interest of affording the necessary protection to the mortgagor, now lacking. It is realized that the mortgagee feels he must make the collection at closure or he might not be able to collect such a sum directly from the home-owner at a later date. However, this is no excuse for the fact that an absolute guarantee to the mortgagor cannot be made available and provide for the immediate refund of such a collection as soon as it is determined that he does not have to reimburse the mortgagee for such an FHA prepayment premium collection. Apparently, neither FHA nor the mortgagee are overly concerned whether or not either of them receive and hold such a collection when such a collection is not necessary. It is doubted that the home-owner feels likewise.

Subsequent to the preparation of this chapter, and most of the Legislative Counsel Bureau report in general, FHA moved to attempt an alleviation of the onerous practice identified. The following material, identified only as (62-6) is presented directly as released by the FHA Administration in Washington to all approved mortgagees, on March 30, 1962:

> Attached is a copy of FHA Form No. 2344A, Superseding Loan Certificate. This form has been developed for the use of mortgagees and mortgagors to expedite the reporting of information to FHA concerning superseding mortgage loan transactions when the original loan is reported paid in full before the due date of the 120th scheduled monthly.
>
> This improved system, which is effective immediately, will enable FHA to provide faster service to mortgagees in effecting termination of contracts of insurance when FHA superseding loans are involved. In addition, the submission to FHA of a properly executed Form 2344A will relieve the mortgagee of its responsibility to collect the adjusted prepayment premium in connection with mortgages prepaid in full from the proceeds of superseding mortgages to be insured by FHA. Because no adjusted (prepayment) premium need be collected from the mortgagor in such cases, improved public relations will result.
>
> Careful observance by mortgagees and their servicing agents of the requirements of this new system, which is explained in the attachment, will result in considerable savings of

time and effort in closing their records for prepaid loans. The FHA will also benefit from this revised system, since it will obtain information regarding superseding loan transactions at a much earlier date. This will enable FHA to reduce by at least fifty percent the processing time on these superseding loan transactions.

Supplies of FHA Form No. 2344A may be obtained from your local FHA Insuring Office.

Facts Concerning the Need for and Use
of FHA Form No. 2344A
(Superseding Loan Certificate)

As you know, when an FHA insured mortgage is paid in full with or from the proceeds of a new loan insured by FHA, no adjusted (prepayment) premium is due FHA in connection with the prepaid mortgage. Also, no adjusted (prepayment) premium is due FHA when the mortgage is paid in full after the due date of the 120th scheduled monthly payment, regardless of whether a superseding FHA-insured loan is involved. Therefore, these instructions are applicable only to superseding loans to be insured by FHA when the proceeds are used to prepay FHA-insured mortgages less than ten years old.

In numerous cases, under the former system, especially where prepayments in full were the result of sales transactions and the purchaser arranged for financing with a mortgagee other than the holder of the seller's FHA-insured loan, the mortgagee reporting payment in full of the seller's loan was not aware that an application for a new insured mortgage on the property had been filed. As a result, the FHA number for the new loan was not entered in Item 9 of the Prepayment Report, FHA Form No. 2344.

In such cases, the adjusted (prepayment) premium was either remitted to FHA, or because of doubtful circumstances was retained by the mortgagee until subsequent information developed the fact that a superseding FHA insured loan resulted. Thus, the return to the mortgagee of its acknowledged copy of FHA Form 2344 became excessively delayed and mortgagees were prevented from releasing to mortgagors sums held in their mortgage insurance premium escrow accounts.

Because FHA Form 2344A, Superseding Loan Certificate, will be executed at settlement (closing) of the new loan the proceeds of which will be used to pay off the previously FHA-insured loan, and this form will be forwarded to the holder of the paid in full mortgage for transmittal to FHA along with FHA Form No. 2344, the FHA Assistant Commissioner-Comptroller will, in all instances, be immediately notified that a superseding loan to be insured by FHA is involved in the transaction.

To assist in the implementation of this revised procedure, it is suggested that all mortgagees make these requirements known to the various title companies and offices used by them to settle mortgages to be insured by FHA. The importance of having these offices transmit the original and one copy of executed FHA Form 2344A to your office for submission with FHA Form 2344 should be stressed.

To make this new system work effectively, it is very important in property sale or refinancing transactions that the seller or refinancing mortgagor be furnished with his FHA case number for entry on FHA Form 2344A. It is further suggested that the mortgagee indicate the FHA case number of the loan being prepaid in full and furnish the title company or closing office with two copies of FHA Form 2344A, when pay-off figures are supplied. Therefore the mortgagee for the prepaid loan will be in a position to expect an adjusted (prepayment) premium or an executed FHA Form 2344A for all mortgages paid in full before the due date of the 120th scheduled monthly payment.

Mortgagees and servicing agents should be certain to attach the original of the executed FHA Form 2344A to the Prepayment Report. The copy should be retained by the mortgagee or servicing agent.

It is possible that the constant contact this Counsel Bureau has maintained with FHA officials (both regionally and in Washington for several months) frequently pointing out violations of FHA regulations and weak processing under current FHA regulations, may have stimulated FHA to cover this point. It is hoped that further releases of new directives by FHA and VA will work toward making additional abuses identified in this report obsolete. The release of May 17, 1962, from the VA office (presented in Chapter XXXI) is a start in the direction of that agency controlling the problem identified in this report in regard to the laxity existing in executing many credit reports which has had a direct contribution to sharply rising delinquency rates and resultant foreclosures.

The material placed in this report at this point, which FHA has engineered to offer a better control for the mortgagee in the matter of the adjusted prepayment penalty payment to FHA, cannot be evaluated completely as to its effectiveness except in very general terms, since the new processing has not been operative for a long enough time to have made its effects evident.

In general, the form and accompanying instructions issued March 30, 1962, by FHA to protect against a prepayment collection from the home-owner is a laudable move on the part of FHA. It is hoped that mortgagees and any escrow or title companies will make immediate use of the form. <u>However, this report does not see where there is any guarantee the form will be employed in all cases. In other words, FHA has made such a processing possible, and a diligent mortgagee will not have to forward the prepayment or hold it in escrow where the proceeds of a loan upon which FHA has issued a commitment to insure are being employed to retire or pay off an existent insured FHA mortgage loan.</u>

<u>It continues to be somewhat of a question as to just what machinery FHA may have developed at Washington to cross-reference all paid off FHA mortgage insurance cases to guarantee that the home-owner will be refunded his adjusted prepayment penalty in those cases where the mortgagee has collected this payment and forwarded same to the FHA through error and/or lack of knowledge. Since such collections have been made in error for some time by many mortgagees, this report must suggest that a similar latitude will continue to exist as no direct FHA regulations have actually been changed. The form devised by FHA, and the instructions with it, are almost of the nature of an optional service which the mortgagee may employ to relieve him of the necessity of making the mortgagor collection and forwarding to FHA, thus guaranteeing to the mortgagee that the termination of the FHA insurance will not be held up.</u>

In the absence of any precise control at the other end in Washington, not identified in the FHA material at hand, our concern still exists for those cases where the mortgagee will make the collection and forward it to FHA in error. Without adequate FHA cross-reference processing controls at Washington, it will not be known by FHA that the collection is not due to them, in the failure to employ the new Form No. 2344A by some mortgagees.

This report is loath to suggest, but nevertheless must point out the possibility that a mortgagee could make the adjusted premium collection from the home-owner under the terms of the FHA deed of trust Form No. 2146m, <u>and then not remit such collection to FHA in those cases where such a collection was not necessary.</u> Such a disreputable mortgagee could easily have the home-owner (seller) sign the new FHA Form No. 2344A. They would have no hesitancy in signing the statement on this form since it is a true one. However, the mortgagor selling would not know the significance of the statement he is signing <u>since his portion of the form does not identify the intent of the document.</u> The mortgagee could then collect a prepayment penalty (adjusted prepayment premium) from the mortgagor selling his dwelling, keep such collection, and merely send to FHA the new form, which relieves him of the requirement to remit such collection to FHA.

This report strongly suggests two modifications which FHA should move to immediately incorporate to place the mortgagor on notice in regard to this adjusted prepayment premium. These additional changes are necessary to give proper impact to the new FHA Form No. 2344A in addition to adequate notification in the suggested handbook for the mortgagor discussed in Chapter XXXIII.

(1) The new form should indicate in bold type, immediately below the seller's signature that, <u>by his execution of this form he is relieved of any mortgagee collection for the FHA adjusted prepayment premium of 1% of the face of the original principal amount of the FHA insured mortgage loan made to him by the mortgagee.</u> In the absence of such specific notice to the mortgagor home-buyer, he will not realize the significance of the statement he is signing, which to him may have no special meaning other than that which anyone might obtain from the simple statement signed. In order to obtain the seller's signature, the mortgagee would not have to be concerned about the FHA warning at the base of the form in regard to a $5,000.00 fine, since he would not have to make any false statements to mortgagors to obtain their signatures to a statement which is so simple.

(2) FHA should immediately move to revise its official FHA deed of trust Form No. 2146m to indicate on the reverse side of this form (unnumbered page 2) at mortgagor's agreement number one, <u>that the 1% adjusted premium charge will not be due for collection from the holder of the note (mortgagee) in those cases where</u> (a) the home is being sold by the mortgagor and the mortgage is being paid from the proceeds of a new mortgage for which FHA has issued a commitment to insure, or (b) where the mortgagor home-owner is refinancing the indebtedness by a new mortgage which FHA has also issued a commitment to insure.

To many, this report may appear to be over-sensitive on the subject of notices and emphasized statements to be incorporated into FHA and VA forms and procedures. However, due to the host of abuses identified in this report the outright violations of FHA and VA regulations, and inadequate FHA and VA processing controls now in existence, there is no other course to pursue than to make such strong suggestions. Otherwise this report would be derelict in its duty to the Nevada Legislature.

It is noted that, with the employment of this new FHA Form No. 2344A, once again everyone concerned obtains a copy except the home-owner mortgagor. FHA has not even directed on the form that a copy be prepared for the mortgagor as they have done for other interested parties. If the mortgagor was supplied with a copy, eventually he might be curious enough to read the instructional paragraph at the top for the mortgagee, and would be placed in possession of information as to the significance of the portion of the form he executed. These instructions incorporate in the final two lines the information that the home-owner is, by the execution and employment of the form, relieved of paying the 1% prepayment adjustment to FHA. Naturally, this would afford some measure of protection to a curious mortgagor who might read the mortgagee's instructions on the form. FHA has, however, failed to give even this small measure of assistance to the home-owner, and again obviously feels that all parties concerned but the mortgagor should have copies of documents associated with his transaction. It is this policy that has made possible so many of the abuses identified in this report. Even where FHA regulations provide that the home-owner be supplied with a copy of some document of paper, FHA has exhibited little concern that he be guaranteed such delivery. The "transmittal of closing documents to the mortgagor," as suggested by this report, should go a long way toward rectifying such inadequate home-buyer protection.

The particular new form which FHA has devised (and which has been discussed) would be listed in such a transmittal form as suggested, since such a situation usually will develop even some years after closing of the initial mortgage transaction. Without execution, FHA could easily attach a note of explanation as to when the form would be employed. The mortgagor would keep this form with his note, deed of trust, and other dwelling papers. At least he would know that there was such a form and such an opportunity to keep him clear of a collection charge usually amounting to well over $100.00.

CHAPTER XXXVII

OTHER CHARGES AND CREDITS TO MORTGAGOR WHEN SELLING

In addition to the numerous charges and credits already identified in this report, which will be typical when either purchasing or selling under a FHA or VA insured or guaranteed mortgage loan, there are some which are peculiar to transactions when the original home-buyer sells to a new home-owner. These are in addition to the prepayment for adjusted premium charge identified in the previous chapter. Most of these will be credits due to the mortgagor under FHA cases and frequently overlooked. They will also be hard to identify as to exact amounts which should be received as credits, since a thorough knowledge of what amounts have been paid into and disbursed from trust reserves will be necessary, as well as a realization of the present status of the mortgage obligation.

PRACTICAL APPLICATION:

The mortgagor selling his home, with a FHA or VA insured or guaranteed mortgage, first should determine when certain obligations have terminated and when others have assumed them. Usually assumption or termination of the mortgage will be at the same date as when prorations for taxes, insurance, etc., are to adjusted between the buyer and seller. This may be a date identical to the execution of any escrow agreement (not usual); some later date specifically identified which could be prior to closure; after closure; or the actual closure date not known in advance (most typical). After the date has been determined, which the FHA or VA mortgagor selling the home should have been well aware of and determined or agreed to prior to execution of the sales contract, then a computation can be made as to what should be credited to the veteran or home-owner selling. The usual FHA-VA selling transaction will be involved with these credits as follows:

(a) Credit for the full amount of principal paid on the mortgage by the mortgagor directly and also that paid through escrow, if any.

(b) Credit for the amount of interest paid on the mortgage, if such interest payments extended past the obligation date of the mortgagor selling, which have been made with payments to principal and interest.

(c) A proration credit for any hazard insurance policy covering the property, which policy is being accepted and reassigned to the new home-owner. If the policy is being cancelled, the mortgagor selling should request an adjustment from the insurance company.

(d) An adjustment in the case of a FHA insured mortgage for any FHA mortgage insurance premium payments which have been made with payments to principal and interest extending past the obligation date of the mortgagor selling the home.

(e) A credit for any funds left in the trust account of the mortgagor which have not been disbursed and for which there is no obligation for tax proration. That which is a tax obligation will be a charge against the mortgagor selling the property, covering that portion of time for which he is responsbile for taxes, and credited to the new home-owner to be employed in paying for the next tax bill.

Under (a) (credit for the full amount of the principal), the mortgagor selling his home will have to employ unusual care to determine just what the outstanding obligation is on the date he relinquishes his obligation to pay further principal payments.

Such mortgagor should use the amortization tables supplied with his loan (under FHA) and determine the status of the obligation after he will have made his last payment to principal. Then he will also have to consider any payments made through escrow by the escrow or title company, decreasing this principal amount. This situation will develop when the mortgagor selling his dwelling has, at the request of the title or escrow company, sent them all his payment books, coupons, or machine tabulation payment cards and will not himself have made any payments directly. These payments will have been handled by the closing officer during the term of the escrow, which could be two or three months or more. Such payments will show as charges on the closing statement. They should, at the same time, reflect, along with whatever the mortgagor paid directly, as credits toward reducing the outstanding principal. The charge at closure to the selling mortgagor for his mortgage obligation should balance with and not be in excess of that amount of the original mortgage minus all mortgagor's payments he made directly, and any further reduction effected through escrow as explained. Any inadvertant or wilful error which does not properly consider mortgage payments made indirectly through escrow for the mortgagor selling his house, can have a significant effect on the amount the mortgagor receives as a credit from the proceeds of the sale.

In checking to see that a correct principal amount left as an obligation, and indicated on a closing statement as a charge to the mortgagor selling his home, there is a factor that should be recognized. Employment of the standard amortization schedule issued by FHA, other agencies, and private companies, will not always agree exactly with that figure which may be obtained through automatic processing equipment employed by the mortgagee when he reports the balance to any closing officer. Such automation may result in carrying fractions of a cent which differ from the calculations used on the standard amortization schedules. This will lead to the possibility of a several cents difference between the balance indicated on the amortization schedule and that indicated by the mortgagee. This should be recognized as a calculation error. However, it is difficult to understand why this should exist if the amortization tables were produced with the availability of precise calculation and data processing machinery. If such calculations are obsolete, these FHA amortization schedules should be immediately revised and made accurate or FHA should insist upon employment of their amortization tables. The mortgagor has no other alternative than to suspect that the mortgagee or the closing officer has made an error when he checks and finds a difference in the figures, no matter how small the differential may be.

Under (b) (Credit for the amount of interest paid on the mortgage), a significant situation can develop when most of the monthly payments are in early stages of reducing the mortgage and will reflect large payments to interest. The mortgagor selling the home may not be liable for the obligation past the date of execution of the sales contract, not too common but occurring from time to time. A lack of proper credit to the original owner can result if the interest on the obligation is charged to the new buyer only from the date of closure of the transaction. Such interest collections not properly credited back to the original owner will be a part of payments either paid directly by the mortgagor selling (or through escrow) and should show up as credits to him at closure. Such credit will usually be in excess of $100 if one payment has been made since contract execution, and considerably higher if more payments have been made, and the mortgage has only run a few years. It is common for this matter to have been overlooked where the closing officer has not exercised care in closing, and the mortgagor selling is likewise unaware of the complications.

Under (c) a proration of insurance policy costs should be refunded to the mortgagor selling and show as a credit to him at closure, where, in fact, the new buyer is assuming the existing policy and having it reassigned to him. Frequently the new buyer will not even be aware that such a reassignment is taking place. In any event, where such a policy is not being terminated and is being reassigned, the mortgagor selling should receive a proration credit representing that portion of the policy yet to run. He will have paid for the policy out of his trust reserve (and may have done so recently) thus resulting in a significant credit at closure. This may be handled correctly or may be complicated by the fact that either the mortgagor or the mortgagee has not made such a policy available to the escrow or title company closing. In this case, the closing officer should make a special effort to ascertain what policy is covering the FHA and VA property in question, since under both programs it must be covered by hazard insurance.

In those cases where the new buyer is having a new hazard insurance policy issued to cover the property he is purchasing, the mortgagor selling his home will have to, on his own initiative, deliver notice to and make application to the insurance company who issued the policy for a refund of any unearned premium. Unfortunately, there is no automatic cancellation procedure made available to the mortgagor selling. In some cases the insurance company will not cancel until actual receipt of the insurance policy copy from the mortgagor, which under the agency system could cause some delay. Other companies will cancel as of the date of the mortgagor's actual notice to them that he is (or was) no longer in need of coverage, regardless of the date of receipt of this notification either verbally or in writing. Insurance agents and company policy vary from the most lenient procedure to the most binding.

Under (d) (an adjustment of the FHA insurance premium payment) we have one of the most complex of all situations. Fortunately it involves only a small amount of funds. However, the execution of the principal involved causes most closing officers considerable difficulty if they are diligent in the application of proration factors. The mortgagor selling may have made a payment, or the escrow officer may have made a payment for him in escrow, which payment(s) will incorporate an amount which represents the FHA monthly premium payment. If there have been credits for interest made available to the mortgagor selling, as explained under (b) there will likewise be some amount of FHA premium paid which should revert to the seller and appear as a credit to him at closure.

Under (e) (the amount remaining in the trust reserve of the mortgagor selling) this should naturally revert to him as these are his trust funds. However, the escrow officer closing will have to charge against these impounds for any amounts therein which must be prorated as a credit to the new purchaser for the payment of taxes. If the mortgagor selling has not had a disbursement for taxes from his trust reserve account for some time, he is still obligated for the payment of taxes for that period of time up to whatever has been agreed to in the sales contract. This will have to be deducted, and any balance remaining in trust will be credited to the seller. The balance in the case of an FHA trust reserve may be composed of some amounts for taxes, FHA premium payments, and hazard insurance. If no disbursements have been made through escrow from this trust fund for these prorations, the mortgagor selling may receive the total balance in his trust funds, but will have charges for the proration items made against him at closure.

In actual practice, the escrow officer, if any, will normally request information from the mortgagee servicing the loan being closed out or reassigned, relative to the balance remaining in the mortgagor's trust reserve. He will enter such a trust reserve as a credit to the mortgagor selling his home and enter charges for prorations from this trust reserve as charges on the closing statement. For any balance remaining in the trust reserve and belonging to the mortgagor, the escrow officer merely deducts such an amount from the amount due to the mortgagee from the proceeds of the payoff of the mortgage. In other words, the mortgagor selling his home has his trust reserve account taken into consideration as well as any charges properly made to it for prorations, and the balance flows to him along with the proceeds of the sale of the home. Usually he will not receive the balance of this trust reserve in a separate payment.

The procedure outlined above is not mandatory but usually is an optional method used by many closing officers. Another method employed, which has less guarantee to the mortgagor, is that whereby any escrow officer closing merely makes certain charges against the selling mortgagor for tax and insurance prorations and does not credit the mortgagor with any trust reserve. After closure, the selling mortgagor receives from the mortgagee the full amount of any trust reserves left to his account. He will receive these funds in full but will have already paid for prorations from the trust reserve indirectly through charges in escrow. Cases are known where the selling mortgagor has to make a specific request to the mortgagee for a return of these trust reserves. Realizing that many mortgagors selling their homes may not even be aware of their funds so held in trust, this system leaves much to be desired. The mortgagor selling may be moving some distance, and it is possible that the mortgagee attempting to disburse his trust reserve would experience difficulty in locating the seller when such mortgagor had not taken direct action. This report strongly suggests the employment of the first method indicated, where the trust reserve is made a credit to the mortgagor through escrow, and would suggest that FHA and VA move to make such method mandatory.

SUGGESTION:

Complete trust reserve balance be credited to mortgagor through escrow as a mandatory provision of both FHA and VA to mortgagees when payoff or reassignment of mortgage occurs, with proration charges to be collected through closure.

CHAPTER XXXVIII

MUTUAL MORTGAGE INSURANCE DISTRIBUTIVE SHARES TO BE RECEIVED FROM FHA

Under the FHA Mutual Mortgage Insurance Program, the fund is divided into two accounts--a General Surplus Account and a Participating Reserve Account. From this latter account, a Participating Reserve Refund may be made to the FHA home-owner subsequent to the termination of insurance through prepayment, at maturity, or through voluntary termination approved by the Commissioner. FHA reviews such cases and determines what amount shall be distributed to the legal owner at the time of termination. Such payments are not fully understood by the home-owner, much less is he apt to be aware they may be due him. Experienced realtors likewise are not very well informed on the point and frequently are not able to explain these refunds which may come to the mortgagor many weeks or months after termination of his FHA Mortgage Insurance through payoff on a sale of his home. This refund should not be confused with a refund of any FHA prepayment charge which was collected from the mortgagor when he sold his home, and subsequently returned by FHA through the mortgagee to the home-owner in cases where a following mortgage is insured by FHA.

The following material is presented in this closing chapter to identify the nature of this Participating Reserve Refund and under what circumstances the home-owner should expect to receive such refund.

From FHA Mortgagees' Handbook - Chapter XIII:

Section 1304: FEATURES OF BASIC INSURANCE PROGRAM: Testimony at the hearings in Congress indicates that one of the chief concerns of the framers of the original National Housing Act was to provide a system of mortgage insurance which would be self-sustaining in a field in which little if any criteria were available as to the cost of operations and the losses which could be anticipated.

This led to the drafting of authority to establish premium charges under conditions which would eliminate any hesitancy to fix them at levels considered adequate under the circumstances by providing for the return of any unused portion in the form of participating shares. This resulted in the mutuality provision under Section 203 which is essentially a device to return to the mortgagors that part of the premium charges found to be in excess of the need.

Section 1305: INCOME FOR BASIC INSURANCE PROGRAM: In addition to initial fees paid in connection with insuring a mortgage, under all of the FHA's mortgage insurance programs the borrower is required to deposit monthly with the lender an amount of money which will put the lender in funds for the purpose of paying to the FHA the annual mortgage insurance premium when due. This premium is calculated on the basis of one-half of 1 percent of the average outstanding principal obligation for the 12-month period preceding the date on which the premium becomes payable, without taking into account delinquent payments or prepayments.

Out of these fees and premiums the FHA pays all of its operating expenses and losses. The FHA has also repaid all the funds originally advanced to it by the Treasury Department to commence operations. It has also established reserves for losses in an amount estimated to be sufficient to meet possible losses on outstanding contracts of insurance in force.

Section 1306: LOSSES SUSTAINED BY BASIC INSURANCE PROGRAM: In most systems of mutuality the participants are liable for losses sustained as well as profits. In establishing the FHA mutual mortgage insurance program, however, the Congress, in recognition of the fact that there was no experience on which such a system of mutuality could be founded, provided that no mortgagee or mortgagor should have any vested right in any credit balance in the Participating Reserve Account or be subject to any liability rising out of the mutuality of the Fund.

Section 205 of the Act which governs the mutuality provisions of the Fund has been amended from time to time. The pertinent parts of Section 205, as amended by the Housing Act Amendments of 1954, are quoted as follows:

'(a) The Commissioner shall establish as of July 1, 1954, in the Mutual Mortgage Insurance Fund a General Surplus Account and a Participating Reserve Account***.

'(b) The aggregate net income thereafter received or any net loss thereafter sustained by the Mutual Mortgage Insurance Fund in any semi-annual period shall be credited or charged to the General Surplus Account and/or the Participating Reserve Account in such manner and amounts as the Commissioner may determine to be in accord with sound actuarial and accounting practice.

'(c) Upon termination of the insurance obligation of the Mutual Mortgage Insurance Fund by payment of any mortgage insured thereunder, the Commissioner is authorized to distribute to the mortgagor a share of the Participating Reserve Account in such manner and amount as the Commissioner shall determine to be equitable and in accordance with sound actuarial and accounting practice: Provided, that, in no event, shall any distributable share exceed the aggregate scheduled annual premiums of the mortgagor to the year of termination of the insurance.

'(d) No mortgagor or mortgagee of any mortgage insured under Section 203 shall have any vested right in a credit balance in any such account or be subject to any liability rising out of the mutuality of the Fund and the determination of the Commissioner as to the amount to be paid by him to any mortgagor shall be final and conclusive.'

Section 1307: PARTICIPATION AND RESERVE ACCOUNTS: The Mutual Mortgage Insurance Fund, under the above quoted provisions of the Act, is divided into two accounts, the General Surplus Account and the Participating Reserve Account. The first of these accounts is credited semiannually with that part of the aggregate net income received which is determined by sound actuarial and accounting practices to be necessary as a reserve for future losses and to protect the general solvency of the fund. The remainder is credited to the Participating Reserve Account. It is out of this latter account that distributions, if any, are made to the legal owners of the properties, (a) at the time their mortgages are paid in full (through prepayment or at maturity); or (b) when voluntary termination of insurance occurs. (See Chapter IX of this Handbook).

Section 1308: RESERVE FOR LOSSES: At the time of endorsement of the mortgage for insurance, and for several years thereafter, a deficit exists with respect to such mortgages. The chief reasons for this are that the revenue received from the initial fees and premiums is not sufficient to cover the cost of processing, inspecting and placing the mortgage on the books, and the fact that during the first several years the ratio of defaults in mortgage payment is the highest and, consequently, allocations made to cover their share of future losses during this period must be correspondingly greater.

In other words, mortgages must bear their proportionate share of the charges involved before they develop an interest in the Participating Reserve Account which would entitle mortgagors to a share in any distribution of these funds. It is not possible to predict with any degree of accuracy when that will occur as this depends on foreclosures and losses, but usually, under favorable economic conditions, it happens within the first 5 to 7 years.

Section 1309: INCOME TAX TREATMENT OF PARTICIPATING SHARE PAYMENTS: Of importance to mortgagors is a recent amplification of a previous ruling by the Internal Revenue Service of the Treasury Department relating to the treatment of participating share payments from the Mutual Mortgage Insurance Fund, which is here quoted:

> 'The distributive share received by an original, successor, or assignee mortgagor from the Federal Housing Administration, as a result of mortgage prepayment, constitutes gross income, for Federal income tax purposes, to the extent such distributive share exceeds the total of premiums paid by the distributee on Federal Housing Administration mortgage insurance with respect to that portion of the term of the mortgage beginning with the date when the distributee assumed the mortgage. However, if the distributee was entitled to deduct the premiums as a business expense, the full distribution is taxable to him.
>
> Revenue Ruling 56-302, C.B. 1956-2, 19, amplified.
>
> 'A question has arisen with respect to the applicability of Revenue Ruling 56-302, C.B. 1956-2, 19, in a situation in which the Federal Housing Administration makes a distribution from its 'Participating Reserve Account' to a successor or assignee of the original mortgagor. The purpose of the present Revenue Ruling is to state the position of the Internal Revenue Service with respect to the treatment for Federal income tax purposes of such distributions to original, successor, or assignee mortgagors, as the case may be.

'In accordance with the provisions of Section 205(c) of the National Housing Act, 12 U.S.C. 1711, as amended, the Federal Housing Administration makes distributions of funds from its 'Participating Reserve Account' to mortgagors upon the payment of mortgages insured by it and the consequent termination of its obligation thereunder. The maximum amount distributable to a mortgagor is the aggregate amount of the annual premiums paid on the insurance to the year of termination. Where the distributee is the original mortgagor, Revenue Ruling 56-302, supra, holds that such distributions to the extent that they do not exceed his premiums, are not subject to tax, except where the mortgagor was entitled to deduct the premiums as a business expense. However, <u>in many cases, the distributee,</u> although not entitled to deduct his premiums, <u>is a successor or assignee of the original mortgagor. In such instances, the distributive share, while not exceeding the total premiums paid on the insurance, may exceed the premiums paid by such successor or assignee mortgagor during his period of ownership.</u>

'It is the position of the Service that the distributive share received by an original, successor, or assignee mortgagor from the Federal Housing Administration as a result of mortgage prepayment, constitutes gross income, for Federal income tax purposes, to a distributee not entitled to deduct his premiums, to the extent that such distribution exceeds the total of premiums paid by him or on his behalf with respect to that portion of the mortgage term beginning with the date when he assumed the mortgage.

'Where the distributee is a taxpayer who was entitled to deduct the insurance premiums paid as a business expense, the total amount of the distribution received is required to be included in his gross income, except for an amount equal to the sum of any insurance premium deductions, beginning with the date he assumed the mortgage, which did not result in a reduction of his tax within the meaning of Section 1.111-1 (a) of the Income Tax Regulations.

Revenue Ruling 56-302, supra, is hereby amplified.'

Section 1310: <u>PAYMENT OF PARTICIPATION SHARES:</u> The FHA calls special attention to the fact that if a distributive share is due, it is payable only once and that occurs, (a) at the time the mortgage is paid in full (through prepayment or at maturity); or (b) when voluntary termination occurs. <u>It is not necessary for a mortgagor to make formal application for his share in the Mutual Mortgage Insurance Fund.</u> When FHA is notified by the mortgagee that a mortgage has been paid in full, and there is a share due, the legal owner of the property at the time of such payment is automatically notified of the amount payable.

Likewise, when a voluntary termination of insurance occurs, <u>the FHA directly notifies the legal owner of the property as to the amount of share, if any, payable</u>. The mortgagor is then required to execute and submit a Mortgagor's Confirmation Certificate attesting to his right to receive the share together with appropriate documentary evidence, if required, to prove his ownership of the property, and thereafter payment is made directly to him.

(some underscoring supplied)

PRACTICAL APPLICATION:

These sections provide that upon termination of the insurance obligation of the Mutual Mortgage Insurance Fund by payment of any mortgage insured thereunder, the Commissioner is authorized to distribute to the mortgagor, in the form of a participating payment, a share of the Participating Reserve Account in such a manner and amount as he shall determine to be equitable and in accordance with sound actuarial and accounting practices. A limit is set on the amount that may be refunded as not to exceed the aggregate scheduled annual premiums of the mortgagor to the year of termination of the insurance.

Another instance of return of premium funds may occur during the term of the insurance, without a termination of insurance coverage. When FHA insures a loan it is assigned to a group of loans. These various groups of loans formed are based upon the degree of risk involved. In cases where the degree of risk is at a minimum, the mortgagor may receive a refund(s) of unearned premium <u>during the term of the insurance</u>.

Frequently termination checks arrive months after the payment of a loan insured by FHA. Distribution may be made difficult since the transaction is commonly associated with the sale of a residence and the moving of the mortgagor to a distant address.

SUGGESTION:

Obviously FHA should provide sufficient information regarding these two types of possible refunds in the Mortgagor Handbook suggested as a part of this study.

SUMMARY OF SUGGESTIONS AND RECOMMENDATIONS OFFERED IN THE REPORT

(In the order of presentation in report)

1. Rate of interest on FHA or VA loan should include all costs to the veteran or home-buyer incidental to financing his home and should be insured or guaranteed by these governmental agencies at whatever the regional market establishes. Follows "Truth in Lending Act," Senate Bill 1740 of the 87th Congress 1st Session. (Chapter I)

2. FHA should clarify its agreement with the builder-seller on Form No. 2004 relative to delivery of Statement of Appraised Value to the home-buyer. (Chapter III)

3. VA should issue a purchaser's Certificate of Reasonable Value and make such a separate veteran's copy available to him prior to execution of any purchase agreement. (Chapter III)

4. Seller should be required to obtain from veteran or home-buyer a receipt of delivery of the FHA Valuation or the suggested Veteran's Copy of the Certificate of Reasonable Value. Such a receipt showing delivery to the veteran or home-buyer prior to execution of any purchase agreement or acceptance of any deposit, should be required by both FHA and VA to be submitted with any application for a FHA insured loan or VA guaranteed loan. (Chapter III)

5. Duplicates of the FHA Valuation (Form No. 2562) and suggested veteran's copy of the Certificate of Reasonable Value should be made available for those cases which do not follow through to closure. (Chapter III)

6. Nevada could require that a state agency control the matter of notification prior to purchase agreement, relative to VA-CRV and FHA Valuation, as an additional state requirement where sellers traffic in FHA and VA insured or guaranteed loans. (Chapter III)

7. Similar control by a state agency for proposed construction providing that the seller promptly deliver such notification after made available by FHA or VA. (Chapter III)

8. A subdivision report to the purchaser (prior to making any deposit could be made a state requirement for any sales type homes in tract areas. (Chapter III)

9. Deposits received toward the purchase of a dwelling to be placed in a trust account and separate from the assets of the seller. (Chapter IV)

10. FHA should move to clarify its regulations and Mortgagees' Handbook instructions relative to credit report charges for one report or more. (Chapters V & VII)

11. FHA and VA should prohibit the charging for credit report, where such charges are primarily for the benefit of the mortgagee moving the mortgage into the secondary market. Possibly to prohibit from charging for more than one report. (Chapter V)

12. FHA should change their regulations if it is their intent (as practiced) to allow those othern than the mortgagee to charge for a credit report. (Chapter V)

13. FHA and VA should require that any following escrow document be furnished to them with the submission of the case for insured loan or guaranteed loan. However, a stronger suggestion would be a required deposit receipt form for all FHA or VA transactions which would be standardized by FHA and VA for several regions or states, if necessary. (Chapter VI)

14. Deposits to be protected by provisions in the purchase document for complete return (any credit report charges excepted) if buyer not accepted. (Chapter VI)

15. Proper acknowledgment of non-returnable credit report charges in the purchase document. (Chapter VI)

16. Proper description of property being sold and total sale price in the purchase document. (Chapter VI)

17. Purchase document should set forth the amount of loan proceeds and terms to be properly identified, which, if not obtained, guarantees return of deposit to purchaser. .(Chapter VI)

18. The amount of the down payment and a prohibition against requiring purchaser to make any down payments prior to time he has received complete approval by mortgagee and governmental guaranteeing or insuring agency should be contained in the purchase document. (Chapter VI)

19. Where occupancy is effected prior to closure, the builder-seller should be provided with security in the form of a down payment prior to closure, at sellter's option. (Chapter VI)

20. Provision for hazard insurance coverage should be settled in the purchase agreement with proper buyer's authorization set forth indicating his selection of insurance placement. (Chapters VI & XIV)

21. Closing costs should be identified in the purchase agreement to clearly identify which of four areas of cost are included in such terminology, when employed. Further, provisions should specify whether these closing costs relate to, (1) not to exceed a certain amount; (2) specific cost items, or: (3) will be actual. (Chapter VI)

22. Any purchase agreement which is not in the form of a deposit receipt should indicate that it is to be followed by an escrow agreement or a master escrow agreement to be made available to the purchaser. However, the preferred FHA and VA standardized form of deposit receipt is recommended. (Chapter VI)

23. FHA and VA to review their required form of standardized regional deposit receipt to ascertain if charges made at closure are those agreed to by purchaser. (Chapter VI)

24. FHA and VA to require that mortgagee supply them with an exact copy of closing statement to the purchaser. FHA and VA to review same for charges they will not

accept under their regulations and also (by comparison with the purchase agreement and any escrow instructions) to review for charges the purchaser has not obligated himself to pay. (Chapter VII)

25. All extras, and extra work to be performed by the seller, to be covered by a formal contract and preferably incorporated into the basic purchase document, with a copy made available to the purchaser. (Chapter VII)

26. Penalties for purchaser violation of proper change notice to FHA and VA for extra work and equipment to be included in the suggested certification for receipt of FHA Valuation and VA Certificate of Reasonable Value. (Chapter VII)

27. All rental agreements between buyer and seller, to cover for portion of time prior to closure while dwelling is occupied, should be in a written and formal agreement incorporated in the basic contract or executed at the time of execution of the purchase contract, with adequate protective features for both buyer and seller. (Chapter VIII)

28. Rental agreement should provide for builder-seller protection in the event the prospective purchaser's loan is not approved and the sale is not consummated. (Chapter VIII)

29. Written agreement relative to assumption of any utility charges should be made between buyer and seller in cases of occupancy before closure. (Chapter IX)

30. Buyer not to assume any costs of hazard insurance covering interim loans (during period of occupancy prior to closure) and prohibition for assignment of such interim coverage to the buyer without his expressed authorization. Suggested automatic cancellation of such interim insurance at date of closure. (Chapter IX)

31. Buyer to receive copies of any and all statements from the mortgagee to any closing officer relative to charges to be made to the purchaser. (Chapter X)

32. FHA and VA to require that they and the purchaser be furnished with copies of any escrow agreements for review by all parties concerned in the event FHA and VA do not establish a standard deposit receipt. (Chapter X)

33. FHA and VA to require that they and the purchaser be furnished with a copy of the master escrow agreement where such is employed in the event FHA and VA do not establish a standard deposit receipt. (Chapter X)

34. FHA and VA should require standardized deposit receipt to eliminate many of the other suggestions and to streamline procedure on review for insurance or guarantee of loans. (Chapter X)

35. Builder control operations in Nevada should be investigated, licensed, and bonded by the state for adequate protection to builder and consumer. (Chapter X)

36. FHA and VA to review the standardized deposit receipt form suggested, by requiring regional offices to review this deposit receipt for possible charges which either FHA or VA will not accept or charges the veteran or home-buyer has not obligated himself under its terms. (Chapter X)

36A. FHA and VA should revise their deed of trust forms to eliminate onerous provisions identified in this report. (Chapter XI)

37. FHA and VA should provide in their regulations for the proper disbursement of the original and mortgagor's copy of the deed of trust and deed of trust note. Likewise, the disbursement of the deed to the property. (Chapter XI)

38. FHA and VA to require that itemized closing statements to both buyer and seller be made available to the home-buyer. (Chapter XII)

39. Where deposit receipts are not employed, FHA and VA should provide that they be furnished with a required escrow instruction copy for review by regional offices to prevent charges to the purchaser which have not been agreed to. (Chapter XII)

40. Elimination of the origination fee in FHA and VA cases. (To be incorporated with whatever market rate of interest or return the mortgagee feels necessary.) (Chapter XII)

41. FHA to prohibit anyone other <u>than the mortgagee</u> from charging recording fees and other charges incident to recordation, or modify their regulations to allow the charges to be made by others. (Chapter XII)

42. FHA and VA should prohibit a charge for more than one credit report under the terms of their own current regulations by further clarification. (Chapter XII)

43. FHA and VA should restrict and properly identify those who may collect for the credit report charged to the purchaser. (Chapter XII)

44. If FHA and VA wish to allow more than one credit report charge, then they should prohibit a credit report charge that is primarily for the purpose of moving the mortgage into the secondary market. (Chapter XII)

45. FHA and VA should prohibit the cost of any title insurance policy fees or title examination or ATA costs to be charged to the purchaser. (Chapter XII)

46. In the absence of FHA and VA action, the Nevada Legislature could prohibit by statute any buyer from having to pay the cost of any title insurance on real estate transactions. (Chapter XII)

47. FHA should enforce its regulations which do not provide for a taxpaying service charge to be made to the home-buyer. (Chapter XIII)

48. FHA and VA should enforce their own regulations and prohibit the passage of an escrow fee, attorney fee, or conveyancing fee to the veteran or home-buyer. (Chapter XIII)

49. In the event of the FHA and VA failure to enforce many of their own regulations, Nevada might be placed in a position to make such regulations a part of state law under real estate transactions relative to FHA and VA regulations. Such a suggestion seems hardly necessary unless there is a complete breakdown of enforcement of FHA and VA regulations. (Chapter XIII)

50. FHA and VA and/or the State of Nevada should move to prohibit the payment of interest in advance by the purchaser. (Chapter XIII)

51. FHA should require that all costs made to the home-buyer be itemized on a certification of loan disbursement (separate and complete form) such as now employed by the VA, as well as such itemized costs on initiation papers similar to VA procedure. (Chapter XIII)

52. Required statement under both FHA and VA from the purchaser indicating his selection in the matter of handling fire insurance. (Chapter XIV)

53. Possibility of automatic cancellation of interim insurance at closure. (Chapter XIV)

54. Possibility of purchaser's selection of a method of handling fire insurance to be a part of FHA Valuation and suggested veteran's copy of the Certificate of Reasonable Value. (Chapter XIV)

55. Mortgagor's certification at closure that he was given an election of fire insurance placement, to be included with other certifications now employed. (Chapter XIV)

56. Elimination of FHA and VA requirement that monthly payments to principal and interest include monthly trust fund payments for fire insurance. (Chapter XIV)

57. Suggested elimination of the trust fund and monthly payment to such fund. (Chapter XV)

58. FHA and VA should move to provide processing procedures which will provide for an accurate review of all collections made from the purchaser to make certain proper credits have been given the buyer on his closing statement and made to his trust reserve. (Chapters XVI & XVII)

59. FHA and VA to insure and guarantee loans at the market rate of interest to be established regionally (co-extensively by FHA and VA) and subject to monthly revision by these agencies. (Chapters XXI, XXIII, & XXXI)

60. FHA and VA to immediately enforce those regulations which it now has at hand to protect the home-buyer and veteran. (Chapter XXI)

61. Guaranteed rate of interest at market to include any and all return the mortgagee requires including most of the origination fee. (Chapter XXI)

62. Continuation of authorization for 1% origination fee to be applied in certain cases. (Chapter XXI)

63. Like the VA system, FHA Valuation should also establish the maximum sale price to the buyer. (Chapter XXI)

64. FHA Valuation should be made similar to VA and exclude the closing costs now incorporated into such a valuation. (Chapter XXI)

65. FHA and VA to provide for more accurate appraisals. (Chapter XXIII)

66. FHA and VA should be memorialized by the Nevada Legislature to enforce their regulations relative to the complete disbursement of the loan by the mortgagee. (Chapter XXIV)

67. Disbursement check from the lender should be made out to both the title or escrow company and the home-buyer. Where direct disbursement is made from the mortgagee, then a check made out to the mortgagor for his signature should be a requirement. (Chapter XXIV)

68. FHA and VA to require in their mortgagor's certification the additional item of certification, that the mortgagor has properly endorsed the mortgagee's disbursement check, and that such check was made out in the full amount of the loan. (Chapter XXIV)

69. FHA to employ a separate Certification of Loan Disbursement as VA now does, itemizing each and every separate charge made to the home-buyer. (Chapter XXIV)

70. Certification of Loan Disbursement now used by VA (and suggested for FHA) should also include a certification from the mortgagor that he has endorsed the lender's check which was made out in the full amount of the loan obtained. (Chapter XXIV)

71. A transmittal of closing documents to the mortgagor. (Chapters XXV & XXXII)

72. VA to provide the veteran with an amortization schedule as now done by FHA. (Chapter XXV)

73. FHA and VA to require itemized closing statements of both buyer and seller to be delivered to the veteran or home-buyer. (Chapter XXV)

74. FHA and VA to expressly prohibit the collection of advanced interest from the mortgagor. (Chapter XXVI)

75. Mortgagee to supply mortgagor with letter of explanation for first odd interest collection not a part of subsequent collections. (Chapter XXVI)

76. Elimination of the trust reserve funds collected in advance as a withholding for insurance, taxes, and any FHA premium payments. (Chapters XXVII & XXX)

77. In the absence of elimination of the withholding system for the trust reserve, the FHA and VA should at least provide for interest payments on such funds held by the mortgagee to be made to the mortgagor. (Chapter XXVII)

78. Direct billing from FHA to mortgagor for FHA Premium Payments. (Chapter XXVII)

79. Monthly accounting to the mortgagor by way of payment book or automation systems, which properly indicates disbursements and payments and contain a running balance for accurate mortgagor information on the current status of his loan and trust reserve at all times. To be used only if collections for trust reserve are continued. (Chapter XXVIII)

80. FHA and VA should make any necessary amendments to their deeds of trust forms and regulations to allow for excess trust reserve funds to be returned directly to the mortgagor upon their development at tax or insurance paying time. (Only in the event trust reserves are continued.) (Chapter XXIX)

81. No commingling of trust reserve funds. Any overage to be returned immediately to the mortgagor upon the payment of any accounts. (Only in the event trust reserves are continued.) (Chapter XXIX)

82. Emphasis in the suggested home-owner's handbook of what fees may be charged by the mortgagee for late payments. (Chapter XXX)

83. Emphasis in the suggested home-owner's handbook of certain selling tactics which establish inadequate trust reserve collections. (Only in the event trust reserves are continued). (Chapter XXX)

84. FHA and VA to issue approved lists of credit reporting agencies eligible for FHA or VA work on insured or guaranteed loans, or tighten up their own loan processing as a double-check against credit reports. (Chapter XXXI)

85. FHA and VA to conduct extensive audits of credit reports on a periodic basis and delete names of any credit bureaus from the suggested approved list when such action is justified by the results of their audits. (Chapter XXXI)

86. FHA and VA should establish a "Transmittal of Documents to Mortgagor," identifying papers to be received prior to, at, and following closure. (Chapter XXXII)

87. FHA and VA Transmittal of Documents to Mortgagor should contain four certifications covering parties who have or will deliver certain documents. (Chapter XXXII)

88. FHA and VA to receive final copy of Transmittal from mortgagor after receipt of last documents by veteran or home-buyer. (Chapter XXXII)

89. Transmittal of Documents to Mortgagor to indicate if mortgagor is to receive original or copy of documents listed. (Chapter XXXII)

90. Borrower's copy to be red-stamped in large block letters on document originals or copies destined to be delivered to the mortgagor. (Chapter XXXII)

91. FHA and VA should establish a true mortgagor's handbook covering in particular the veteran or home-owner's position in regard to financial and document complexities of his transaction, especially matters prior to purchase. (Chapter XXXIII)

92. In absence of a federal handbook for the mortgagor the state might consider the issuance of such a publication aimed at assistance to veterans or home-buyers under the federal insured or guaranteed loan programs. (Chapter XXXIII)

93. Mortgagor to request all warranties and guarantees and execute same, inspect dwelling and give written notice of deficiencies to builder. (Chapter XXXIV)

94. FHA-VA warranty, guarantee and instructional papers, to be included in Transmittal of Documents to Mortgagor. (Chapter XXXIV)

95. Builder-seller to transmit guarantee or warranty papers and instructions papers directly to mortgagor. (Chapter XXXIV)

96. Many builders might become more familiar with the use of component construction and manufactured home techniques. (Chapter XXXV)

97. FHA to provide complete and adequate protection to the mortgagor at time he pays his loan in regard to the matter of unnecessary collections for prepayment premium collections, and provide for immediate refund in those cases where it has been unnecessarily collected. (Chapter XXXVI)

98. FHA's new form 2344A to be redesigned to offer adequate notice to mortgagor that they are relieved of mortgagee collections. (Chapter XXXVI)

99. FHA to revise its official FHA deed of trust form No. 2146m to indicate that the 1% adjusted premium charge will not be due to be collected by the mortgagee under certain cases. (Chapter XXXVI)

100. Mortgagor to receive a copy of FHA's new form No. 2344A at closure and also his copy if and when this form is executed. (Chapter XXXVI)

101. Complete trust reserve balance be credited to mortgagor at closure with any prorations of these trust funds charged through escrow closure. (Chapter XXXVII)

102. FHA to supply adequate information in suggested mortgagor's handbook relative to Participating Reserve Account Refunds to mortgagor. (Chapter XXXVIII)

103. As final suggestions, the State Legislature should consider the desirability of regulating escrow companies and likewise granting authority to the Insurance Commissioner or some other agency to regulate charges made for title insurance and escrow costs.

104. The Nevada Legislature should memorialize the Congress to appropriate sufficient funds to FHA from FHA income to enable that agency to operate efficiently. Many of the recommendations of this report if adopted by the Congress and/or FHA would require additional processing of FHA applications. However, if other recommendations were placed into operation, considerable savings in processing would undoubtedly develop. In any event, it is questionable if FHA operating under its current regulations and policy has the necessary authorization from the Congress to expend sufficient income (from the 1/2% mortgage insurance premium charge to the mortgagor) for the proper administration of the FHA program.

105. The Nevada Legislature should memorialize the Congress to appropriate sufficient funds to VA for the proper administration of the VA program. Although the VA receives some income from its direct loan program, this should not be expected to carry any major portion of their guarantee mortgage program, particularly in those offices where the direct loan program is not a significant operation. Necessary technicians are not available for proper VA processing through local and regional offices serving the state of Nevada.

APPENDIX "A"

HOUSING POLICY

Housing Act of 1961: costly, controversial

Democrats: 'A giant step toward better cities, improved housing.'

Republicans: 'The worst features of both bills.'

BY: Gurney Breckenfeld

The Housing Act of 1961 is the most controversially costly and crazily complex piece of law housing has ever had. It is loaded with something for everybody--cities, railroads, farmers, poor people, middle-income families, builders, S&Ls, prefabbers, public housers, urban renewal promoters, even trailer park operators.

The new law--and the administrative regulations that are following--is stuffed with new programs intended to stimulate housing (unemployment is heavy among construction workers). But don't expect it to produce a quick upturn in housing. For one thing, most of the new programs are so complicated it will be months before the industry--and officials--know how to use them. For another, the Housing Act has not repealed the laws of supply and demand. And the evidence is strong that housing demand isn't what it was.

Parts of the new omnibus legislation will be put to immediate use. Most important is the sizable cut in FHA down payments in middle-bracket prices from $14,000 to $27,000.

But even this long overdue correction of discrimination against middle-bracket home buyers (a result of down payments and mortgage ceilings on a barely amended formula from the 1930s while construction costs have trebled)--even this long overdue correction is offset by the Kennedy Administration's effort to play King Canute with the money tides. The second cut in FHA rates, from 5 1/2 to 5 1/4% in May, has not produced any corresponding drop in actual mortgage yields. All that has happened, House & Home's survey shows, is that discounts have gone up two points to compensate. But because of the timing of the rate cut many builders are stuck with advertised prices and find themselves unable to bury the 2% extra cost in the retail price of their houses. So the incentives to use FHA are not all they would appear on the surface. The rate cut "merely impairs the usefulness of the FHA program and has hurt rather than aided housing," charges President Otto L. Preisler of Home Federal S&L, Chicago.

Moreover, Congress' refusal to let FHA spend enough of its own income to operate efficiently--a refusal as stubborn as it is idiotic--now means the agency is thoroughly fouled up on its processing of applications for mortgage insurance (eight weeks behind in San Francisco, for instance instead of the normal one or two).

Mortgage men are warning FHA Commissioner Neal Hardy that FHA operations have now grown so sloppy that the FHA 203 sales and 207 rental programs, which have been the backbone of the agency, will evaporate unless FHA acts quickly. Items:

. Home sellers have to wait 4 to 6 weeks to learn if FHA will insured a loan on an existing home. So S&Ls get more and more of the business.
. Builders have to wait 4 to 6 months to learn if FHA will insure loans on a new subdivision or rental project.
. Investors must wait 8 to 10 months for settlement of claims and issuance of debentures on defaulted loans. "Disgracefully slow," cries one mortgage expert.

(underscoring supplied)

Source: House & Home Magazine, August 1961, page 44.

APPENDIX "B"

HOUSING POLICY:

Housing Act of 1961: costly, controversial

BY: Gurney Breckenfeld

Questionable Stimulus: 3% down, 35 year FHA loans

Builders are banking on stretched-out mortgage terms to qualify more buyers and so sell more homes. But many a realty analyst questions how effective this will be in today's market. Predicts President Richard Nelson of Real Estate Research Corp., Chicago: "It won't work this time. There is no longer a backlog of people who are ineligible because of financing terms."

Another question is whether 35-year terms are a good deal for house buyers. Almost all the arguments against 40-year, no-down loans apply nearly equally to 35-year, 3% down loans.

1. Take the question of the house deteriorating faster than it is paid for. A man buying a $10,000 house with a 40-year, no-down loan would have an equity of only $312 after paying on the mortgage for 20 years. That is 1% less than the real estate commission to sell it. With a $12,000 house and a 35-year, 3%down mortgage, the buyer would have a $406 equity after 20 years--if you figure the depreciation at 2% per year. That would just about pay the cost of selling the house-with a conventional mortgage. With FHA loans commanding a discount of 4%, as they now do, the owner would not get his money back if the house was sold FHA.

2. Consider how much longer loans boost the total cost of a house to a buyer. With a 40-year, no-down loan, a $15,000 house could cost a total of $37,137. A $10,000 house would cost $24,768. With a 35-year, 3% down loan, a $15,000 house would cost $34,373. A $12,000 house would cost $27,405. A $10,000 house would cost a mere $22,915.

Is this a good deal for buyers? Lenders chorus: "No." FHA Commissioner Hardy concedes: "I have mixed feelings. But it's the only alternative I have seen for people at certain income levels to acquire and live in decent housing rather than in more expensive substandard housing."

In the Senate, the attack which killed the no-down payment provision focused on these low equity, high cost features. But after Rep. Albert M. Rains (D. Ala.), House manager for the housing bill, adroitly volunterred to shave the maximum term from 40 to 35 years, the bumbling Republican opposition muffed the point that this concession has much more form than substance.

Private lenders dislike 35-year loans so much that you can expect only a few banks and S&L's to start making them soon.

Best guess in the lending fraternity is that a 35-year FHA loan will cost about 1/2 point more discount than a 30-year loan does now. But don't be surprised if lenders insist on 1 point more discount at the outset. The big market for 35-year loans is clearly going to be Fanny May. Up to mid-July, Fanny May had not announced its prices for 35-year FHA's, but a good guess is that it will charge 1/2 point more.

What 35-year, 3% down loans on new homes may do to sales of existing homes worries many an analyst. The trouble is that mortgage money on FHA 30-year minimum down terms for used houses is hard to get in many cities. More often, much bigger down payments than FHA's are required by conventional lenders. The net effect could well be to depress the prices of used homes (they have already begun to slip in some cities).

(underscoring supplied)

Source: House & Home Magazine, August 1961, pages 45 and 46.

APPENDIX "C"

CED STUDY URGES FREE FHA RATES

A major study of the nation's money and credit system sponsored by the Committee for Economic Development has just published a report (Money and Credit, Their Influence on Jobs, Prices and Growth, Prentice-Hall) which makes halfhearted obeisance to a free-market economy but leans toward putting more and more reliance on government for the stability and vitality of the economy.

It has strong undertones of a desire to give the President more power over the nation's monetary policy by decreasing the independence of the Federal Reserve Board.

For housing, the commission makes some free-market, some "let Uncle Sam-do-it" recommendations:

<u>FHA interest rates should be freed to seek a level dictated by the market</u>. But other FHA mortgage terms and conditions should fluctuate in the interests of economic stability. (The commission came close to urging direct controls on credit for housing along with consumer goods and inventories.) Special purpose programs to meet social needs in housing should be broadened. The Voluntary Home Mortgage Credit Program (to steer private funds into credit-shy areas) and FHA's certified agency plan (to farm out mortgage underwriting so FHA will be easier to use in small towns) should be continued and expanded.

VA home loans should be left to expire but Congress should consider a new direct loan program to substitute for the VA direct loan program.

<u>Federal National Mortgage Association should stop trying to control FHA and VA discounts.</u> The prices at which it buys and sells loans should reflect market prices. Direct lending programs may be preferable to FNMA special assistance operations.

(underscoring supplied)

Source: <u>House & Home</u> Magazine, November 1961, page 53.

APPENDIX "D"

MORTGAGE BANKERS ATTACK 'WELFARE DRIFT' OF FHA

For a long time mortgage bankers have looked askance at the Congressional itch to use FHA's mortgage insurance mechanism and its accumulated reserves as an instrument for vote-getting social housing programs.

This fall, leaders of the mortgage banking and real estate industries are speaking up in tones much sharper than they have used before to protest this drift.

President Bob Tharpe of the Mortgage Bankers Association calls for a major renovation of FHA to free it from "political domination" and the burdens of special programs to promote social change. "The usefulness of the FHA system as a market mechanism. . .already has been badly impaired," cries Tharpe. ". . .The original simplicity of the system has been completely lost amid the tangle of special-purpose operations. The lack of variability in the premium induces excessive caution especially in the handling of novel situations and so creates the demand for special purpose insurance, where soundness of operation may be dispensed with.

"The effort (by the Kennedy Administration) to dictate the interest rate that will be charged on FHA mortgages has proven to be the most disruptive and inhibitive feature of the existing system. Every serious study of mortgage problems has pointed out the folly of interest rate control. The experience of this year has given a demonstration of its destructive effects on the availability of funds for insured mortgages*--a demonstration that should be convincing to all except the most doctrinaire devotee of the planned economy."

MBA Vice President Carton S. Stallard (who is due to succeed Tharpe as president this month) calls for concerted efforts to reverse the trend toward more government control of housing and housing finance before it is too late. "This may be our Berlin," says Stallard. If a stand cannot be made now to save one of the largest areas of private enterprise and private investment, it is hard to say just where one can be made.

"There is an unmistakable drift (accelerated by the 1961 Housing Act) away from dependence on and confidence in the private market as the means through which constant improvement in housing conditions can take place. Instead, we have a startling increase in direct government lending. We have a shift in the Federal National Mortgage Association from its original, basically market-oriented program to a mounting number of special purpose operations nearly all of which depend for their success upon Treasury support. We find FNMA special assistance looming larger than its secondary market program and, in its latest development, financing FHA mortgages at a lower rate than the Treasury itself could obtain for long-term financing--a clear subterfuge for direct lending. . .We even find the Treasury suggesting, in its report on taxation of savings institutions, that more dependence on FNMA special assistance may be the better way to reach "the goal of a high level housing construction."

President O. G. (Bill) Powell of NAREB complains that the new housing law will launch a $7 billion invasion of the real estate business "which belongs by an application of reason to the little people of the nation." Says Powell: "What shall we gain to build millions of houses at the price of untold billions of debt? What shall the progress be to house all the poor in new units of political housing only to extinguish the right to own a home in an environment of the individuals own choosing--even if that should be a slum?

With each new tax burden, each new bureau of governmental function, each new progress in aid, welfare, and so-called security, another chip is shaved from human freedom." Powell adds that he isn't against better housing for the poor or hospitals for the infirm. "But I maintain that when these responsibilities are removed from local administration the price to be paid is multiplied beyond the value of the benefits."

(Underscoring supplied)

* - FHA's share of housing starts has been falling for four years--from 26% in 1958 to 19% for the first seven months of this year.

Source: House & Home Magazine, November 1961, page 53.

APPENDIX "E"

ARE SOME LENDERS JACKING UP YIELDS WITH DUBIOUS FEES?

Yes, contends a New York State legislative committee. To get higher yields, say the legislators, these lenders are tacking on fees and closing cost charges which boost the cost of homebuying excessively. The extra financing charges stifle sales by pricing houses beyond the reach of many prospective purchasers, claims the committee. Moreover, add the legislators ominously, some mortgage costs may be usurious under the state's 6% maximum interest law.

Prompted by complaints that tight mortgage credit was bottlenecking housing, the State Assembly's committee on mortgage and real estate started its investigation in 1960 under Chairman Ernest Curto (R., Niagara Falls). Now its report is finally out, based on a questionnaire survey of commerical and savings banks, savings & loan associations, and insurance companies covering loans made in 1957-59 and three public hearings. The report concedes that a more thorough investigation is needed to pinpoint mortgage loan abuses, but it cites these examples of what it considers questionable lending practices:

. Closing costs varied widely. On a $10,000 loan, four New York City savings banks listed costs ranging from $258.50 to $312.

. For title insurance, "the title companies apparently pay the attorney or institution recommending their services a fee representing 15% of the premium payment." Some institutions rebate the 15% to the borrower, some let the bank's attorney keep it, some keep it themselves. "If title insurance is required and fees are uniform, it would appear that in all cases the borrower is paying 15% more for that insurance than should be the case."

. Survey costs, paid by the mortgagor, vary without reason. Compared to VA and FHA appraisal fees of $25 and $20 respectively, conventional loan appraisals run as high as $100. In FHA and VA loans, some institutions require the buyer to pay for a private appraisal in addition to the government appraisal.

. Origination fees, ranging from 1% to 1-1/4% of the mortgage, are charged by some lenders to cover the costs of staff appraisers and attorneys. But some of these lenders make the borrower pay the origination fee in addition to the attorney and appraisal costs. Citing a New York state law barring a lender from charging a borrower more than the statutory rate to pay for the lender's general overhead expenses, the committee noted that institutions resort more to origination fees when interest rates approach the 6% legal limit. Says the committee: "It is difficult to conceive how an institution granting a loan at 6% interest . . . could substantiate a 1% origination fee without attributing it to general overhead or usurious interest."

. Placement fees, charged to a builder or seller as a condition of making the loan, are clearly a way of circumventing the state usury law. Such fees, more common with government-backed mortgages than conventional loans, range from 5% of the mortgage for FHA to 6% for VA. Although the buyer doesn't pay the fee directly, it is a hidden cost to him since the builder or seller boosts the price of the house to make up for the fee. Adds the committee: "With the reduction of the maximum interest rates on FHA loans by the Kennedy Administration, it is reasonable to assume that placement fees will be larger and more common or FHA mortgage money will become unavailable."

. Requiring the mortgagee to prepay real estate taxes and insurance represents another hidden charge. The mortgagee receives no interest on the escrowed money from the lender who in turn can put the funds in short-term investments until it must be paid out.

. Borrowers are often forced to pay a fee to a mortgage broker to get a loan. The fees range from 1% upward, says the committee (it noted an unconfirmed report of a $1,250 fee for an $8,000 loan). Using mortgage brokers is most prevalent among lenders in the New York City area, says the committee, and some lenders require as a matter of policy that all loans come in through brokers rather than through the builder or purchaser. Reason: the broker handles the paperwork, cuts down the need of a larger clerical staff for the lender. If a builder pays the broker's fee, the cost is passed onto the buyer, adds the committee.

As a second phase of its investigation, the committee studied the availability of mortgage money throughout the state. Two major questions: Do lenders shun sub-standard residential areas--the so called gray areas? Do out-of-state mortgage purchases by New York lenders create a shortage of mortgage money in the state? After wrestling with the questions, the committee came to the conclusion that a more searching analysis is needed to find the answers. Lenders do boycott housing in gray areas, says the committee, but it acknowledges merit in the lenders' argument that they must guard against jeopardizing depositors' money with investments in areas of swift depreciation and poor security.

The committee made no recommendations for specific legislation. Instead, it asked for more money and another year to delve deeper into the problems of mortgage finance.

(underscoring supplied)

Source: House & Home Magazine, November 1961, pages 57 and 63.

APPENDIX "F"

WHEN YOU BUY THAT HOUSE, DON'T FORGET THOSE CLOSING COSTS

"We've got the down payment. . .we can swing the monthly payments. . .let's buy that house!" So Mr. and Mrs. X signed, little suspecting that they would be slugged with a bill that would atomize their trim, tight budget.

At a paper-signing ceremony called settlement they were confronted with a bill for more than $500 that they hadn't counted on. They were told it was "just the usual closing costs." Swallowing dryly, Mr. X reached for his checkbook and paid.

This inevitable bite

The term "closing costs" is a catchall name for about 20 separate charges that may crop up when you buy a house. None of them is very high by itself. They may add up to only $100. But sometimes they total $700 or even more.

Let's look at the items most likely to occur on a closing statement to see what you pay and what you get.

Title insurance. In most cases this is the largest single charge. It buys protection against the risk that someone, sometime, might dispute your ownership.

When you buy a house, the title is searched to make sure that it is clear. That is, the records are examined to see that the seller has the legal right to convey the property to you. But there may be claims that not even the most scrupulous inspection of official records will reveal. A previous owner might have died leaving an undisclosed heir, or a previous deed might have been forged. If a claim based on such circumstances came up, you would have to fight to hold your property and might lose it. Title insurance defends your title and compensates for loss if the title proves defective.

Rates for this insurance usually are set by local schedules. In one city a $10,000 policy costs $125. This is a one-time premium. You pay no others.

Mortgage service charge. This charge goes by various names. It may appear as initial service fee, brokerage, flat fee, origination fee or some similar designation.

Basically, it covers the lender's expense in setting up the mortgage loan for you. Often the fee is a flat 1% of the sum you borrow. It pays for such expenses as inspection, preparing loan papers, attorney's services, photographs, notary fees, processing fees, commissions and overhead, such as postage and stationery. Some of these costs may be itemized separately.

Hazard insurance. This item may be termed fire and extended coverage or comprehensive coverage and is required by the lender to protect his loan if the property is damaged by fire, windstorm or other specified hazards.

You pay the insurance premium for one year at the time of closing. If you elect to pay your insurance along with your monthly mortgage payment, you will pay a premium for 13 months. The extra month's premium is held in escrow, to be added to each month so that enough accumulates during the year to pay for another year's insurance when the next premium is due. Insurance rates, of course, vary by type of house, location and policy provisions.

FHA insurance. If you are buying with an FHA-insured loan, you pay one-half of 1% insurance in addition to the interest. The money goes into the insurance kitty that enables lenders to make these loans at low interest and for long terms. This insurance, too, is prepaid. (Not prepaid now - FHA regulations changed).

Property survey. A land survey is made to determine lot lines, dimensions and the location of the house on the lot and to make sure that they match the description in your deed and earlier ones. If your house is newly built, there may be two survey charges, one to stake out the house and a recheck when it is finished. Surveyors usually charge $20 to $30.

Closing fee. When an outside attorney assists in the transaction, his fee will be itemized. It may amount to $25 to $50.

Appraisal fee. Determining the value of the house and lot is a key step in negotiating a loan. The lender has the appraisal made, by his own men or independent appraisers. The fee, generally $10 to $25, is passed on to you as part of the cost of getting the loan.

Documentary stamps. The U. S. and often the state governments tax deeds. Sometimes there is a state tax on mortgage notes. The taxes are paid by affixing revenue stamps to the document filed in county record offices. Passing these levies on to the borrower is common practice. This item may be less than $10, but it varies by locality and size of transaction.

Credit report. Before making a loan, the lender checks up on you through a credit bureau. You may have to pay for its report.

Prepaid interest. At closing, you may catch a glimpse of your borrowed money as it whisks from lender to seller. You begin using borrowed capital at that instant. At the same instant, interest begins to run.

The closing may occur any time during the month. You will be asked to pay the interest for the fraction of the month remaining before your first regular monthly payment date. The adjustment puts your account on an orderly, whole-month basis.

Prepaid taxes. This is another adjustment item to get you started toward meeting the tax bills.

Recording fees. When the documents formalizing the sale are entered upon the county's registry books, filing fees will be charged. There probably will be one fee for recording the mortgage, another for filing the deed. If an old mortgage is paid off as part of the deal, there will be a fee for recording that act, too.

What you really pay for

Not all these charges will appear on every settlement statement. But most will. And there may be others not mentioned here.

Looking back, you can see three completely different types of charges:

. First, items such as the mortgage service fee and the credit report that are costs of obtaining mortgage financing. If you paid cash, you wouldn't have these expenses.

. Second, charges that result from transferring ownership. The documentary stamps and recording fees are examples.

. Third, items that are not purchase expenses at all but merely your first outlays for ordinary, routine ownership expenses that will go on and on. Examples are the tax prepayment and hazard insurance premium.

What to do about them

Most of these charges are standardized. There is virtually nothing you can do to hold them down, beyond refraining from borrowing more than you need and buying where taxes and insurance rates are low.

But you can remember that these charges are coming, plan to absorb them and avoid the budget-busing surprise that jolted Mr. X.

By all means, find out in advance how high the costs will run. Some items, such as interest, are not figured until the last minute. So you can't pin the total down to the penny. Yet a telephone call a day or two ahead should get you a helpful estimate of the amount due.

(underscoring supplied)

Source: Changing Times, The Kiplinger Magazine, October 1957, pages 19 and 20.

APPENDIX "G"

HOME LOANS -- THOSE COSTLY DISCOUNTS

What and why are "points"?

Buy a house with a mortgage loan that is "discounted" and you may think you are getting a good deal. But the discount won't save you one penny.

Sell a house and you may have to cough up several hundred dollars in cash out of your own pocket simply because the purchaser finances himself with a discounted loan.

Discounts or "point charges" are common in home finance these days. And their effects often make people boil with indignation.

One man who was selling his home was faced with a demand for $400 from the lender who was financing the purchaser. The homeowner asked why. "Your buyer applied for an FHA loan," he was told. "We charge points for them. The law requires you to pay the charge."

A fuller explanation might have left this man less confused, if no happier. The complete story begins with the fact, not mentioned by the lender, that the government-set interest rates for FHA and VA loans are too low to attract many investors these days.

The rate on VA loans is 5-1/4%. The FHA rate, raised from 5-1/4% last September, is now 5-3/4%. But conventional home loans, those involving no FHA insurance or VA guarantee, bring 6% to 7%, sometimes more. (1960)

So, to justify putting money into VA and FHA loans at all, investors look for ways to make the return approximate what their money could earn in conventional home loans or other types of investment. Discounting is such a device, simple a way to bring the yield on the government-backed loans up to competitive levels.

For illustration, take an FHA loan of $10,000 for 20 years. At 5-3/4%, it produces $6,850 in interest. A conventional loan for the same amount at 6% yields $7,194. By charging a 3-1/2-point discount on the FHA loan, the lender increases his return by $350 (3-1/2% of $10,000). Thus his take is as much as he would get on a 6% loan.

This is not an extreme example, by the way. VA loans have been discounted as much as six, eight or even ten points recently.

Who pays the premium that sweetens the yield? Logically, it would be the borrower. He wants the loan. If a high price must be paid for it, he should foot the bill.

But both FHA and VA balk at that. They have a legal duty to limit the interest charged to borrowers for loans they back. They cannot permit that control to be evaded by discounts or any device that has the effect of hiking interest charges.

Since the borrower can't pay the premium, the seller must if he wants the loan to go through. If he is a builder, he can absorb the discount himself. It may be deducted from the proceeds of the loan or paid in cash. Either way, it comes out of his profit. He may try to boost his selling price to ease the pain. But in a competitive market, price boosting may be out of the question. Then he probably would avoid VA and FHA financing completely and sell only with conventional financing.

If you were offering your own home for sale, you would be in a similar fix. You would have to pay the points charged for your purchaser's loan, not because the law required you to, but because it prevented his doing it. You might pay up for the sake of making the sale. Or, like the builder, you might decline FHA or VA financing and hold out for a buyer who could manage a conventional loan with its bigger down payment and higher interest.

Discounts sound crazy at first. But as you can see, both lenders and the government agencies concerned have their reasons for bringing them about.

The real villain to blame is tight money. Anybody who buys or sells a house these days can expect tight money to make mortgage financing hard to find and more costly than it has been in years. That goes whether you "pay points" or not.

Source: Changing Times, The Kiplinger Magazine, January 1960, page 37.

APPENDIX "H"

EVERY 9 MINUTES, A NEW PREFAB HOUSE

A whale of a lot of prefabs are going up.
Come visit the world's biggest "house factory,"
see how they turn 'em out and truck'em away.

We should require buildings to do their
practical duty well. -- Ruskin

The average reading time of this article is nine minutes.

As you read these words, a big red trailer truck pulls away from the National Homes Corp. factory in Lafayette, Ind. At precisely 8 a.m. tomorrow, a builder's crew will start emptying the trailer of its contents, pre-built sections of a modern house.

The entire house is in that truck. It will be completely erected, ready for finishing touches, before sundown.

But that's getting ahead of the story. By the time you finish this article, another trailer carrying another new house will be leaving the factory for the highway.

This nine minutes between houses is the closest approach yet to a vision that has long tantalized dreamers--transformation of the cut-and-fit craft of building homes into the assembly-line manufacture of homes.

When home construction finally becomes preponderantly mechanized, National Homes can claim to have shown the way. It has been a leader in prefabrication for more than ten years. When it absorbed seven other major prefabricators last August, including the second- and third-ranking firms in the business, it became the General Motors of its field. With 13 factories coast to coast, National and its subsidiaries expect to produce 42,000 homes this year, about 30% of the total prefab output. Out of every 23 new homes buildt, one will be theirs.

And that's just the beginning. The Price brothers who head National, Jim and George, make no secret of where they are going. By 1975, they aim to build half the nation's new houses.

<u>This manufactured home</u>

What manner of house emerges from those big red trailers? A homey-looking house, clean in design and execution. Its air is strictly domestic, not industrial. Furthermore, it is attractive enough to grace the flossy color pages of the dream house magazines fairly regularly. In the next few months, five of these magazines will feature homes that came off National's assembly lines.

If you happened on one of these houses on a Sunday drive, you would never spot it as a prefab. Its architectural style might be contemporary, Cape Cod or colonial--National makes all three, plus a discreetly elegant style termed French regency. The subsidiary firms have their own designs, also in a range of modern and traditional types.

Nor is there much structural difference between the prefab and its conventionally built neighbors. It is a framing of 2 by 4's sheathed in gypsum board covered by a siding, with a roof supported by triangular trusses. Define the structure of a frame house, in other words, and you define the structure of a prefab.

The difference lies in the way it is done. Recall, for a moment, how most home-building sites look--white-aproned carpenters, spraddling sawhorses, construction litter all around. Then come inside National's vast Lafayette plant and see the difference.

<u>Building indoors</u>

Like all houses, a National prefab begins with raw lumber. From 4,000,000 to 6,000,000 board feet are on hand all the time. National consumed 80,000,000 board feet last year, most of it top-grade West Coast Douglas fir, and is the nation's largest lumber user by far.

Pieces destined to become rafters are crane-carried to the factory entrance, there to be fed into automatic saws. One of these, capable of making six to twelve different cuts in one operation, will turn out a finished rafter with compound miters and notches in just over three seconds.

Making the same rafter could take a conventional carpenter half an hour. And his hand-measured, pencil-marked, hand-sawed rafter might not fit. The machine-made one will. Precision-engineered to exact dimensions, it leaves no margin for human error.

Batteries of such automatic saws for shaping the 3,000 to 4,000 parts that go into a typical house are located throughout the plant. Many were designed and built right in the factory.

The cut-to-fit pieces move on to one of 23 assembly lines. Some produce exterior wall panels. Others put together roof trusses, gable ends, door assemblies, plumbing "trees" and other components. (Plumbing tree? That's a treelike system of pipes, mounted in place against a wall panel and ready to hook up to fixtures, water intakes, etc.)

Follow the line turning out exterior wall panels and you see the precut framing lumber laid on a steel jig that holds each piece tightly in position. Nailers on either side of the line expertly drive home their assigned set of nails and push the frame to the next nailers.

This manual operation is about the only example of old-time hand craftsmanship to be seen. One day power hammers or automated nailers may take over. Thus far, though, no machine has been devised to replace these skilled workmen and their hammers in this initial framing stage.

For a glimpse of what the eventaul triumph of mechanization will be like, go to the next station on the line where a simpler nailing job is done. Here gypsum wallboard sheathing, coated with an aluminum vapor barrier, is applied to the frame. Quick swipes of a roller coat the frame with adhesive. Then the wallboard is slipped into place and the assembly passes under an automatic nailer capable of driving a row of 12 nails simultaneously to fasten sheathing to frame.

A separate drive is required at each stud. Working a push-button control, the operator can select which of the dozen nailing heads is to function at each blow. This enables him to make the nailing skips required where door or window openings occur.

By this time the panel, sheathed on one side, weighs 400 to 500 pounds. It glides to a turn-table that deftly flips it over. Then workmen lay in close-fitting batts of glass fiber insulation, glued in place so that they can't sag or settle.

The sheathing process is repeated on the second side. If a door or window opening is to be cut, a swinging router drops into position. Guided by the framing of the opening, it swiftly chews its way around the four sides of the aperture. The unwanted slice of sheathing falls free and the panel is complete.

An 8-foot-square wall section has been manufactured in an elapsed time of 10 minutes. Now it is ready to be fastened to an overhead carrier and sent dangling toward the waiting trailer at the loading dock.

Assembly-line variety

The other assembly lines, meanwhile, are turning out other components. The procedures, dictated by the job at hand, differ in each instance. But they share the basic characteristics of the wall-panel line--precisely prepared parts, engineered jigs and patterns, machine work and a methodical flow of repetitive operations.

At the end is the loading dock, where all materials that make the package sent to the builder are ingeniously packed to be unloaded in the order needed with a minimum of on-site handling. And the package is complete, down to the last fastener and can of touch-up paint. The builder can finish his house without going to local suppliers for anything but extras specified by his customer.

A marvel of organization? Yes, and two significant marvels might escape the casual observer. One is the incredible smoothness with which the multitudinous parts, big and little, simple and intricate, can be manufactured in such coordination that they all show up at truckside together and in proper sequence.

The secret of this feat lies in a scheduling system so complex that it can be carried on only by high-speed electronic computers.

The other marvel is that mass production can produce such a variety of houses. A National Homes subdivision of ten shows less monotony and greater harmonious variety than tracts built by conventional one-at-a-time developers.

Credit for this is due to the architectural quality of the basic designs and the wide range of options offered buyers. The men working the wall-panel assembly lines, for instance, have at their elbows a manual nearly a foot thick. It contains nothing but specifications for wall panels, 1,200 different ones. National builds only on order never for inventory. A glance at the identifying ticket on each frame that comes over the lines tells the operators which panel design is required for that job.

Tomorrow and beyond

The prophets of prefabrication foretold that mass production would produce a house unlike anything seen before, revoluntionary in design and built of materials hitherto unknown in home construction.

As your look inside National's factory has revealed, this is not yet the case. National's method is radical, but not its house. Every material used is in use by conventional builders, too, usually in the same manner.

The most advanced aspect of National's current output is the heavy emphasis on aluminum. A line of aluminum-clad homes, the Viking series, was introduced last year and found wide acceptance. This year National has extended its use of aluminum to include not only aluminum siding but aluminum roofing, gable ends, soffits, fascia boards, windows and doors. None of it is bare metal. All of it is factory-painted.

The aluminum finish is one of the firm's new innovations. It is a Lucite acrylic lacquer developed for National by du Pont and much like the "lifetime" finishes introduced on General Motors automobiles last year. The house version, however, is a flat finish rather than glossy.

Jim Price says these aluminum houses will not require periodic repainting as other houses do. And interested customers will be treated to a convincing demonstration of the material's durability by a salesman who hammers a sample vigorously and then flexes it repeatedly to show that it is virtually proof against chipping and cracking.

Although it will continue making traditional exteriors, National expects that two thirds of its 1960 production will be aluminum.

National is not content with old ways. It prowls continually for better materials and methods. A current quest is for an adhesive so strong that it will eliminate the need for nailing sheathing. And it is hopefully searching for a forced-air heating system that will be quiet, really quiet.

But its most pressing concerns at the moment are assimilating the seven other prefabricators acquired overnight and adding to the ranks of builder-dealers who will sell their output. Right now, National has 1,000 builder-dealers. By giving them financial help in acquiring land, developing it, constructing houses and finding mortgage money for buyers, it means to keep these dealers in business even when other builders are squeezed out.

At the same time, National is striving to lessen its dependence on outside suppliers for materials and components.

In a recent step in that direction, it bought a plant to produce wood kitchen cabinets, formerly obtained from other firms. Top National executives are on the West Coast as this is written, organizing a lumber mill. Instead of shipping uncut lumber eastward, they plan to cut near the forests and ship the trimmed-down material by water to Gulf and East Coast ports and thereby net a 15% saving on their mammoth lumber bill.

How these ambitious plans will work out remains to be seen. But one thing is certain. National has built a fabulous number of America's homes already and will build lots more.

National makes it easy to tell just how many it has turned out, too. Each of those big red trailers carries a legend for all to see: "Transporting House No. ." In the blank space is a holder in which the serial number of the house within is inserted.

The next National trailer you see will carry a serial number higher than 167,000.

Will a prefab save you money?

Factory production saves consumers plenty on most products, but a house is different. Only part of a house can be factory built. For the other parts the consumer pays just as much whether the house is prefabricated or not.

Take the lot. You can't get that from a factory. Nor can you buy factory-made foundations, landscaping or utility connections. These items together will account for about one fourth the selling price and will cost the same, prefab or nonprefab. Financing, closing fees, insurance and legal fees also cost as much one way as the other.

The biggest saving created by prefabrication is on-site labor. Because so much of the prefab is economically assembled and finished at the plant, the prefab builder has less to do on the job. And site labor is no small item. For a conventionally built home, it may amount to more than a fourth of the selling price. With a prefab, it may be cut to a sixth.

The builder may achieve other small savings, too. His construction financing will cost less because the house goes up much faster, in about three weeks. Because he runs a fast, simple operation, his overhead is smaller. And because he deals in big volume, he can take a smaller profit on each house.

These savings may enable him to sell for $1,000 to $2,000 less than a comparable conventional house costs, particularly if he is in a high-labor-cost area.

Will you be able to pocket this difference? That depends on a couple of critical factors. One is your location. Transporting a manufactured house from the factory is costly. In fact, it probably is not economical for more than 300 miles. So if there is no prefabrication plant within that distance, you cannot expect to reap prefabrication's economies.

Another factor is the nature of conventional building where you live. Tract builders in some places employ elements of prefabrication in their operations and do enough business to gain the benefits of volume production. Their selling prices may be sharply competitive with prefab prices.

Source: Changing Times, The Kiplinger Magazine, December 1959, pages 33-36.

APPENDIX "I"

THE FHA, THE BANKERS, AND YOU

Whereas the Federal Housing Administration is an agency of the Federal Government and whereas the Federal Government is charged with promotion of the general welfare, it would seem a reasonable notion that the FHA has a major concern with the welfare of the home owner. And not only ordinary citizens but real-estate salesmen, builders, bankers, and Congressmen act and talk as though the FHA does bear prime responsibilities to home owners. Even the courts all the way up to, but not including, the U. S. Supreme Court have accepted this notion. Now the Supreme Court has put things harshly straight. The FHA's" mortgage insurance program was not designed to insure anything other than the repayment of loans . . .," wrote the Court in a recent decision. "There is no legal relationship between the FHA and the individual mortgagor."

The case from which this decision developed concerned the experience of Mr. and Mrs. Stanley S. Neustadt, who bought a 16-year-old house in Alexandria, Virginia. An official FHA appraisal valued the property at $22,750. The Neustadts bought it for $24,000, took an $18,800 FHA-insured loan, and moved in. Soon, however, the house began to fall apart. Cracks appeared in the ceilings and walls. When building repair contractors were unable to find the source of the trouble, four FHA building inspectors were called in to go over the structure. They discovered that the house was built on a kind of clay that becomes pliable when wet. Due to poor drainage, water had seeped into the clay, causing it to shift beneath the foundation.

The Neustadts sued the FHA, claiming that the house had been purchased in good faith on the basis of the FHA-appraised value.

The lower court held that the FHA had made a faulty appraisal. On its shifting foundations the house was worth no more than $16,000. Therefore, said the court, the Government should reimburse the Neustadts the difference between the true value and what they had paid--a sum of $8,000. In reversing this decision, the Supreme Court noted particularly its disagreement with the lower court's finding that the Government had a duty to make a careful appraisal and that, when this duty was negligently performed, the home buyer was injured.

"While we do not condone carelessness by government employees in gathering and promulgating such information," read the decision, "neither can we justifiably ignore the plain words (of) Congress. . ." And those plain words from Congress were put pretty plainly: ". . .all it (Federal housing legislation) says is that the FHA loans are guaranteed to the builder or to the bank."

For the home buyer the lesson is simple. Unless and until there is housing legislation tailored more closely to consumer than to banker needs, FHA appraisals should be supplemented by further investigation before a deal is closed. CU recommends that a prospective home buyer hire a competent builder or architect of his own choosing to make a thorough inspection of the property. Such an inspection might cost from $25 to $100, depending on local circumstances. It would not, of course, constitute a guarantee. But it would be the best assurance available now that a house is structurally sound.

Source: Consumer Reports Magazine, September 1961, p. 492.

APPENDIX "J"

CHAPTER III

INTEREST RATES AND LOAN FEES

A. Determination of Effective Interest Rate

The effective interest rate in connection with a mortgage loan is the actual net cost to the borrower, taking into consideration the nominal rate of interest, and, in addition, any commission, premium, loan fee, service charge or similar item, but excluding proper charges necessary for the protection of the association and the borrower in closing the loan, such as appraisal, legal, recording or inspection fees.

In the event that a service fee is payable on a monthly basis at a certain annual rate, this rate added to the annual nominal rate of interest would give the effective rate of interest of such a loan. Where the loan fee or service fee is paid in advance as part of the initial cost in connection with the closing of a loan, however, the effective rate of interest is not as easily determined.

The use of the following formula facilitates the approximate determination of the effective rate of interest:

$$\frac{f}{t \times 5} + i = e$$

In the formula (f) is the amount of initial loan or service fee per $1000 loan; (t) is the term of the loan; (i) the nominal rate of interest; and (e) the effective interest rate.

Assuming a $2000 loan is made at a nominal rate of 5%, with monthly payments sufficient to completely amortize the loan in 15 years, and that a loan fee of 3% is charged at the time the loan is made, the effective interest rate would be calculated as follows:

$$\frac{30}{15 \times 5} + 5\% = 5.4\%$$

Section 4 of the Federal Home Loan Bank Act requires members of the Federal Home Loan Banks to pursue a home financing policy consistent with sound and economical home financing. It is further provided in Section 5 of this Act that the effective rate of interest charged by members not be in excess of the maximum legal rate, or the contract rate applicable to such transactions (regardless of any exemption from usury laws). If no legal or contract rate is applicable, the effective rate of interest is limited to 8%. <u>The above formula may be found helpful in determining compliance with the Federal Home Loan Bank Act.</u>

Source: Unknown.

APPENDIX "K"

FACTORY-MADE HOUSE SECTIONS CUT COSTS FOR MORE BUILDERS

Koppers Expands Marketing of Wall Panels; GE Plans Pre-Fab Electrical System

By: Michael Creedman
Staff Reporter of the Wall Street Journal

Horsham, Pa.--One crisp morning, four carpenters start erecting the walls of a three-bedroom split-level house in this Philadelphia surburb. By the middle of the next day, they have completed the entire shell of the house, including the roof.

Such speed is no stunt. The Horsham carpenters are among a growing number of construction crews around the country who are assembling houses from factory-built section, such as wall panels and roof trusses, which lock together. By doing so, they're helping keep down the price of houses, generating more profit for builders, and giving some major industrial firms a crack at potentially hefty additional sales in the big residential housing market.

Houses built from such components are put together in a manner similar to the familiar pre-fabricated house, and an individual component-built house may look much like an individual pre-fab. But in pre-fabricated housing, one manufacturer builds all the sections for an entire house, and the number of house plans and designs available often is strictly limited because of the standardization necessary for mass production.

Interchangeable Parts

Components, on the other hand, are largely interchangeable, and can be arranged by builders in a variety of patterns to suit individual builders' house plans and individual home buyer's pocketbooks--using, perhaps, pre-built concrete foundation beams from one factory, wall panels from another, roof trusses from a third. In fact, some enthusiasts foresee a day when an architect can design a custom-built house to be put together entirely from factory-built components, and the resulting home can be assembled and ready for occupancy only two weeks after the architect finishes his drawings.

Builders concede such a day is at least 10 years away; not enough components are available for it now. But they see it coming steadily closer. Though the use of components is not new, building authorities agree it has grown rapidly in the past three or four years, and is likely to grow even faster from now on, as tightening competition among builders puts an ever-higher premium on cost-cutting.

Precise figures on the use of components aren't available. But Nathaniel Rogg, economist for the National Association of Home Builders, estimates that, even excluding prefabs, about 25% to 35% of all houses being built today use some kind of major component such as a roof truss. That compares with a figure of 5% to 10% about five years ago, he says.

Fast Growth Foreseen

Some housing experts think this is only the start. "There is absolutely no doubt in my mind that within this decade 50% of all new construction will involve components," declares W. E. Difford, executive vice president of the Douglas Fir Plywood Association--and Mr. Difford emphasizes he's talking only of plywood components. While more disinterested authorites are inclined to be more cautious, Neal Hardy, commissioner of the Federal Housing Administration, asserts: "There has been a definite move in the direction of factory-made parts, and I have no doubt that you will see an ever increasing trend."

For builders, of course, the big attraction of components is the speed of assembly, with consequent cost savings. Though the initial price of a pre-built component often is higher than the aggregate price of an equivalent amount of conventional building materials, their use cuts down sharply on the number of working hours for construction crews on the job site--a vital matter in building, because of the relatively high hourly wages most unionized construction workers command.

By using components in a 105-home Horsham development, for instance, Fox-Bilt Homes, Inc., is saving about 5% of the construction cost it would incur if it used only conventional materials, according to Richard Fox, a partner in the company. The homes are designed to sell in the $20,000 to $25,000 price class.

Such savings can keep prices down for home buyers. Andrew Place, a South Bend, Ind., builder, now is selling, for about $15,000 each, houses which have their foundations assembled from factory-built beams of pre-stressed concrete. If he had to use conventional materials and methods, he says, the houses would have to sell "for at least $500 more." In addition, he asserts, the components save him enough money to allow him to put a wooden floor in the $15,000 house instead of the concrete-slab floor he was offering earlier.

Use of components offers home buyers some other benefits, too, builders claim. For one thing, of course, a buyer who orders a component-built home may not have to wait so long before it's finished and he can move in. Also, component makers say, quality can be controlled better when components are built in a factory than when they're put together on the job site, so component-built houses frequently offer the buyer greater ease of maintenance.

Builders reap additional advantages, too. Many construction firms buy the land on which they build, and sell land and house in one package; the quicker they can get the houses up, the faster they get a profit return on the land investment. Also, with some components, builders can keep working in almost any kind of weather. Factory-built foundation beams can be set in place in freezing weather or during heavy downpours, for example, but concrete can't be poured into foundation forms in the conventional way under those conditions.

Bigger Profits for Builders

All this can have an important impact on builders' profits. While actual figures are difficult to get, the Lumber Dealers Research Council claims builders can realize up to three times as much profit, using components the council has developed, as they can with conventional building materials. The council now licenses some 1,800 building supply dealers to sell wall panels it has designed, under the trade name of LURECO.

For building-materials producers, the growing use of components promises a lucrative market. Mr. Rogg of the National Association of Home Builders figures roughly $8 billion of the nation's $17 billion annual housing bill goes for materials; a good share of this, he says, could be captured by components.

To capitalize on this potential, industrial firms are offering a lengthening list of the pre-built housing sections. In addition to wall panels, roof trusses and foundation beams, components now available include such items as pre-hung doors and windows installed in frames at the factory; interior partitions which already have been painted; floor and roof sections ready to be laid in place on the job; and a gadget called a "plumbing tree," which uses pre-cut and fabricated pipes ready to be installed and connected to water and sewer lines.

Wall-Component Push

Development of wall-component systems probably is being pushed harder than anything else in the component-housing field now, and it's attracting some big industrial names. Johns-Manville Corp. started offering a wall-component system, called Flex-Ponent, in St. Louis last spring. Koppers Co., Inc., has had a wall panel called Dylite on the market for 21 months; in July it established a special department to sell the panels because of what it called "the increasing scope of Dylite panel activities." The Douglas Fir Plywood Association, in addition, has several types of wall panels on the market.

One reason for the concentration on wall panels, according to one leading authority: "If you sell a builder the walls, you control the whole shooting match," with an excellent chance of also selling other components to go with the walls. All the wall components now on the market offer at least the outside sheathing and wood framing for a wall; some components are completely insulated and are painted in the factory on the exterior and inside, and one or two even come complete with electric wiring already installed at the factory.

Some other top building-supply firms don't yet offer components, but such major ones as Masonite Corp., U. S. Gypsum Corp. and Certain-teed Products Corp. say they're actively researching the field. Armstrong Cork Co. is trying to develop a component system to soundproof an assembled house.

Dow, Du Pont and GE

Some major companies outside the building-products field also are trying to cash in on the components market. Dow Chemical Co.'s Styrofoam plastic insulation already is used in many components, and Du Pont Co.'s Hyphalon waterproof coating has been factory-applied to roof and wall panels. American Radiator & Standard Sanitary Co. is experimenting with pre-assembled plumbing components that would cut the time needed to install a house's water system, and General Electric Co. is trying to design new component electrical systems.

Components, however, still face some big obstacles to further growth. Despite the work of GE and American-Standard, builders complain too much attention has been paid to components for the shell of a house, and not enough to internal mechanical parts, which might offer an even bigger field for cost-cutting. Harold Horowitz, an official of the Building Research Institute, says the cost of installing plumbing, heating and electrical fixtures is the biggest expense in building a house.

Local building codes, many of which were drawn up long before World War II, often forbid use of some of the newer components, such as plastic foam panels and pre-fabricated plumbing sections. The Federal Housing Administration prohibits the use of some new components, such as plastic-core panels, in houses on which it insures the mortgage, because it believes they have not been adequately tested. Building craft unions also are reluctant to see jobs traditionally done by highly-paid building workers transferred to lower-paid factory hands, though as yet they haven't complained loudly.

In addition, though components offer a greater variety of designs than pre-fab housing, the components still must be built in a relatively limited number of sizes so they can be put together without costly hand fitting or special adaptors. And the type and variety of finishes available on components is not nearly as wide as on conventional building materials, nor is it likely to be.

These drawbacks might not bother home buyers who think the ruling consideration is a combination of price and space, but they're important to more affluent purchasers and individualists who want their houses to be of a destinctive design. "The people I work for want design, they don't want components," says Edward Marks, an Evanston, Ill., architect.

Source: Wall Street Journal, September 25, 1961. (underscoring supplied)

APPENDIX "L"

JIM WALTER, SHELL HOME PIONEER, TO MAKE FINISHED UNITS TO MEET RISING COMPETITION

A Wall Street Journal News Roundup

Jim Walter Corp., leading producer of shell homes, announced plans for selling and financing low-cost homes with finished or partly finished interiors. The company previously marketed a basic shell, finished only on the outside, and will continue to do this.

The move is likely to bring Jim Walter into a head-on marketing war with Certain-teed Products Corp., U. S. Gypsum Co., and other firms that promote sales of almost completed and completed houses on installment notes. It also raised the question whether the trend in the field will swing strongly toward more completed houses from shells.

Jim Walter is credited with pioneering the marketing plan of selling bare shells with installment notes of four to seven years. The plan caught on, particularly among low-income groups in the South who often found their wages too uncertain to qualify for even the more liberal Government-insured mortgages. The plan attracted imitators, and by last year there were over 100 companies offering shell homes; they ranged in size from small lumber dealers to Jim Walter with $48.9 million sales, and had total volume of 90,000 to 100,000 shell homes.

Competition Has Cut Profits

The growth of competition, because of the small capital requirements to enter the shell home business, has increased selling costs and cut profits of major operators like Jim Walter. Competition sharpened further when Certain-teed entered the low-cost home market early last year with almost-completed houses, financed with up to 12-year installment notes. By stringing out the monthly payments, Certain-teed was able to keep them as low as the shell home companies were able to offer on bare shells bought over a shorter period.

In making its announcement, Jim Walter said it, too, would string out payments over as many as 12 years. Promotion will stress "extended terms" and "lower monthly payments." Offering the more complete house and extended terms are designed "to keep Jim Walter competitive," James O. Alston, executive vice president, said. He added that the company has "definitely lost some sales in recent months" to a growing number of shell and semi-finished home builders, who now offer low-cost homes with such features as interior walls, plumbing and electrical wiring already installed. Mr. Alston was apparently referring to companies such as Modern Home Construction Co., Valdosta, Ga., and Leeds Homes, Inc., Knoxville, Tenn., which now offer a single note at extended terms covering purchase of the bare shell and some of the materials to complete it.

One reason companies such as Jim Walter prefer shells to more completed homes is the lower apparent risk. Since notes on the homes are backed by the land, the house and any improvements in it, the resale value of the house, in case the purchaser defaults on his installment note, increases as the purchaser works on the house. Some critics of the more completed homes, financed over a longer period, wonder what will be the resale value of some such homes several years after they are built.

Apparently reflecting the impact of competition, Jim Walter's sales and earnings for the fiscal quarter ended Nov. 30 were "considerably below" the 3,941 home units and $958,961, or 59 cents a share, recorded a year earlier, according to Mr. Alston. The company doesn't report interim dollar sales.

Other Concerns to Follow Suit

Companies still offering only bare shells appeared reconciled to the probability that they, too, would have to follow Jim W lter's lead. "With Jim Walter lengthening his terms, we'll have to lengthen ours," said Joe Potts, president of Bevis Shell Homes, Inc., Tampa, Fla. "The competition may force us into interior finishing and longer-term financing, but we won't do it voluntarily," asserted Paul Schabel, president of Wise Homes, Inc., Greensboro, N. C.

Officials of Certain-teed or its housing subsidiary, the Institute of Essential Housing, were not immediately available for comment on Jim Walter's move. But there's evidence they've been gearing up for increasing competition in the nearly-finished low-cost house field. In recent months, they have turned "more and more" to selling houses through door-to-door canvassing instead of through lumber dealers. Lumber dealers, however, still supply materials for the houses and arrange to have them built; Certain-teed arranges for volume purchases of materials and for the installment credit. Door-to-door selling is widespread among shell home companies and is used by Jim Walter.

One of the reasons Jim Walter didn't move into the more-complete house field sooner was that "it took a considerable amount of time to line up suppliers for the new interior materials," Mr. Alston said. Most of these materials will be purchased by some of the 200 branches in 26 states.

Jim Walter and other shell house concerns have no plans for completely scrapping their shell home plans, even though they will augment their lines with more-complete houses. "We still like the concept of the shell home, and we still think there is a market for it," said Mr. Alston of Jim Walter. Added Mr. Potts of Bevis: "As far as possible, we're going to stick to the basic shell and the seven-year terms. We now have a package that includes sheet rock (for walls and ceilings) and wiring and we will furnish plumbing fixtures, but we certainly don't intend to get into installation of plumbing, inside doors or inside trim."

Source: The Wall Street Journal, January 11, 1962.

APPENDIX "M"

HOME LOAN WOES

RISING FORECLOSURES SPUR U.S. TO TIGHTEN ITS CREDIT MACHINERY
FHA Stuck With New York Area Apartments;
Stricter Screening Drive is Pushed

Defaults Well Below 1930s

A Wall Street Journal News Roundup

Along five blocks of Parkview Street on the north edge of Wichita, Kan., a visitor can count 58 houses with small white placards in the front windows--warning trespassers away from Government property. The not-so-proud owners are the Federal Housing Administration and the Veterans Administration, stuck after foreclosure of the easy-payment mortgages they insured. Of the 14 houses in the 1300 block of nearby Evanston Street, 12 are now in foreclosure proceedings.

In the Lindenwood co-op housing development at the fringe of New York City stand 23 four-apartment structures, mostly vacant. The New York State Employees Retirement System, which loaned $5 million, has foreclosed on their Government-insured mortgages--so FHA is left holding the bag.

In 10 counties of south Florida, FHA's inventory of foreclosed homes has climbed from 40 five years ago to 1,293, according to area director Billy Wilcox. Because of vandalism and deterioration, he figures it will cost $800 or more on the average to refurbish them for resale. Indictments for falsifacation of some FHA mortgage loan applications are being ground out. Predictions that the FHA will be holding more than 6,000 houses around Miami and Tampa before long are voiced at the agency's Washington headquarters.

Tightening Credit Machinery

Glimpsing scenes like these, seeing the tide of foreclosures rising nationally, housing chiefs of the Kennedy Administration are quietly trying to tighten up home credit machinery. FHA Commissioner Neal Hardy declares with deliberation that if his campaign for better screening is successful, "it might well lead to some increase in rejections" of applications for FHA mortgage insurance. He's calling for "prudence, sound judgment, restraint."

Yet officials find restraint a delicate, difficult business. It was at the Administration's urging that Congress last year made FHA credit terms the easiest ever (Down payments as low as 3% of purchase price; 35 or even 40 years to pay). Mr. Hardy still insists that was desirable legislation; he bristles at any suggestion FHA policies are becoming more "conservative." White House economists eager for full recovery and "economic growth" don't want to see a recent dip in housing starts grow deeper. Alabama's John Sparkman, chairman of the powerful Senate subcommittee which keeps an eye on housing policy, is among legislators complaining the FHA should show more zeal in lubricating housing credit.

While the Government has been helping hosts of Americans to realize the dream of home ownership, the by-product has been some nightmares.

Astonished Texas Bookkeeper

Consider a 33-year-old Texas bookkeeper who just before Christmas moved his family into a new $20,000 home in Dallas, using as a trade-in his previous $13,000 house which carried a VA mortgage. The builder who accepted the trade-in decided it could not be profitably sold, so he made not a single mortgage payment. A few days ago the VA informed the astonished bookkeeper that under the rules of the game he was still liable for the debt on his old house. He faced payments of $120 monthly on his new house plus $76.87 on the old one--a load he considered impossible on a $500 monthly paycheck. So he agreed to foreclosure and will, shortly after a sheriff's sale, be presented by the VA with a bill for more than $1,000.

Note the probe by a Brooklyn, N.Y., grand jury into charges of shoddy construction of hundreds of homes in the Canarsie and Mill Basin neighborhoods. Investigators assertedly found improper fireproofing and drainage and faulty structural beams. Two builders have been indicted thus far. Brooklyn District Attorney Edward S. Silver states, "We had some indications that people in the VA and FHA had received money that they shouldn't have; it has to be checked out." U.S. Attorney Joseph Hoey says this information was "turned over to appropriate agencies. They are investigating to see whether any VA or FHA inspectors had received gratuities to which they were not entitled."

'Farcical Credit Reporting'

Home buyers are not the only ones who end up with nightmares. The president of a Miami mortgage company gives this example of what happens with what he calls "the farcical system of credit reporting we've had down here": A "clean" credit report was received on an applicant for a mortgage; his firm granted it and the VA insured it. Five months later, wanting to re-sell the mortgage, the firm asked for a supplementary credit report. The credit reporting service, taking another look at its records, found the borrower was not only a slow payer but had been convicted of a felony and indicted for murder.

Government men say they've been fed misleading information on lots of their Florida credit risks. FHA director Wilcox, after ordering thorough re-checking of applications channeled through his office by "particular suspect operators," found four or five out of every hundred contained false claims. "Builders, real estate people or mortgage lenders would tell people how to falsify applications," he says, "or even worse, these poor people signed blank applications, and someone else filled them in." Assistant U.S. attorney Daniel Pearson, handling legal action on some cases, cites a couple of examples:

Two Miami real estate women, eager to sell a $10,000 house, found a lowly paid maintenance man willing to buy if he could raise a $9,150 FHA loan. His down payment, purportedly his own money, actually included $300 lent by the ladies, and his application was further reinforced by declaration of a fictitious second job.

Still under investigation, says Mr. Pearson, is the case of a young woman who bought a home with FHA blessing, supposedly after having borrowed maoney and placed it in a bank account to make a synthetic show of sufficient funds. Her application declared she worked full-time for a manufacturer, whereas apparently she actually had only part-time employment. Prosecutor Pearson says the case is embarrassing because the woman's employment claim was not verified at the time of application; he says it jeopardizes a fraud case if FHA appears to have been negligent.

FHA's Mr. Wilcos sees only a minor relationship between fraudulent applications and the high foreclosure rate. "The foreclosures were mainly a product of the recession," he asserts. "People moved here, bought homes, were dropped from their jobs. So they either turned in their keys or just picked up and left."

One of Florida's private mortgage experts puts it this way: "This petty finagling has been practiced in some degree since time immemorial; a broker in his zeal to make a deal, a builder in his zeal to sell a home will make little adjustments. Before the recession when everything was going smoothly, nobody said anything. Along came the downturn and the foreclosures, and now they're investigating the hell out of everything."

While foreclosures are particularly heavy in certain places (the Wichita area, after heavy cutbacks in aircraft employment, has more than 4,000 homes foreclosed or in process of foreclosure, according to its home builders association), a national trend is involved. Last year lenders foreclosed some 73,000 homes against about 51,000 in 1960 and 44,000 in 1959.

Conventional Mortgages Least Affected

Though this is the worst showing since 1940, it is well below the foreclosure totals of the depression '30s. And, of course, only a tiny fraction of all outstanding mortgages are in bad shape. The Mortgage Bankers Association, checking 2.8 million mortgages held by its members last Dec. 31, found that 0.37% of those insured by FHA were in foreclosure, and 0.32% of those backed by VA. The showing for "conventional" mortgages, those not insured by the Government, was far better: Only 0.07% were in foreclosure.

Harry Held, a senior vice president of big Bowery Savings Bank in New York, notes conventional mortgages are in less difficulty because they usually require down payments of a quarter or a third of purchase price. He believes unemployment is a minor factor in foreclosures; he thinks that with home prices no longer rising many a couple with marital troubles is just walking out of a Government-insured house in which it has no great equity.

FHA held title to 25,394 homes at the end of 1961, up from 19,765 in midyear and 12,864 at the end of 1960. Its top man, Mr. Hardy, says the rising foreclosures and acquisitions "are becoming sources of concern" through not reaching a level that would strain the agency's $1 billion insurance reserve fund.

Officials are tackling the default problem in a number of ways:

Better credit reports. A recent sampling of some 1,000 reports handed to FHA by lenders as part of home buyers' insurance applications showed more than 70% were "inadequate." About half of those failed to mention past credit delinquencies by the applicant. Mr. Hardy blames plain carelessness on the part of the private credit agencies which prepared the reports for the lenders, plus some deliberate falsehoods. The FHA chief is relying on exhortation to lenders to improve the quality of the credit reports. <u>He has no plan to work up an "approved" list of credit reporting agencies eligible for FHA work</u>. <u>The VA is stepping up its spot checks of credit reports to verify their accuracy</u>.

<u>Shorter Mortgages Stressed</u>

Propagandizing for prudence. FHA is stressing to home buyers that shorter-term mortgages may be best. Mr. Hardy has circulated a declaration that home buyers "should be fully aware of the savings in interest costs which can result from higher down payments and financing over a shorter period of time." FHA has mailed out 100,000 brochures to its approved lenders, with a similar message.

Local bans on "speculative" homebuilding. FHA has proclaimed that in seven Florida counties around Miami and Tampa, and in areas around Midland and Odessa, Tex., it will make no further mortgage insurance commitments to builders except when customers have signed up in advance of construction. Bernard Janis, president of the Miami Home Builders Association and himself a leading builder, says the industry in his area will not feel the impact for about 60 days because of a backlog of prior commitments; but he estimates it could then cut construction about 40%.

Close scrutiny of insurance applications. Mortgage lenders have complained bitterly about delays in FHA's processing; the agency takes four weeks or more to decide whether to accept or reject an application. Mr. Hardy has promised to cut out unnecessary delays, but he argues this is no time to relax barriers against bad risks. "I'll quit before we start cranking out insurance around here without looking at the applications," he declares.

More research on why mortgages go sour. The Census Bureau in late May will begin interviewing some 3,000 scattered ex-holders of foreclosed FHA, VA and conventional mortgages. Interviewers will ask about the home buyer's housing cost burden as a proportion of his income, and whether layoffs, strikes, sickness or marital spats helped cause the foreclosure. Preliminary interviews in Atlanta show foreclosed people are "happy to talk about what happened."

Source: <u>The Wall Street Journal</u>, April 2, 1962. (underscoring supplied)

APPENDIX "N"

REVIEW AND OUTLOOK

Compounding Credit Confusion

For the past couple of years, Senator Douglas of Illinois has been pushing a bill to require lenders and retailers to spell out credit charges for consumers, and President Kennedy recently gave the proposal a boost.

The bill's purpose, according to its backers, is to protect consumers--both from unscrupulous lenders and from themselves. The idea apparently is that if consumers had a clearer idea what they were paying for credit they would use it more intelligently.

All this certainly sounds reasonable. And yet we think the Douglas-Kennedy approach raises a number of serious questions.

First, is this Federal intervention really necessary? Almost all retailers and lenders, as a matter of course, go to great lengths to acquaint their customers with credit costs. And most states have extensive statutes in this area, along with a good deal of enforcement machinery. If these are not doing the job, wouldn't it be easier to improve them than to superimpose a new Federal bureaucracy?

Second, if you assume the need for Federal intervention, you come to the problem of drawing up an effective law. The difficulty of this task is evidenced by the great mass of state legislation. Consumer credit comes in many shapes and sizes, and each state has found it necessary to create not one set of statutes but several.

Senator Douglas, however, seems to think the problem is much simpler; he would merely have all lenders and retailers reduce credit charges to a simple annual rate of interest. Well, that certainly sounds simple enough, but it really isn't at all.

Suppose a bank lends a consumer $100 for one year. The credit charge is $6, discounted in advance. The consumer gets only $94, but he pays back $100 in 12 monthly instalments. In the first month, the customer has the use of $94; after the first payment, he has the use of somewhat less. Over the year, the average amount borrowed is about half of the original loan. So the simple annual interest rate is not 6% but about twice that. There are several mathematical formulas that will produce a close approximation of the rate but none that will give the exact figure.

What if the law did not require computation of an interest rate but merely stipulated that the full credit charges be stated in dollars? Even so, the problems would be far from solved. Many lenders as a matter of course provide life insurance on consumers to whom they extend credit. States or local governments may require lenders to pay recording fees that are passed on to borrowers. Pawnbrokers, in effect, provide their customers with storage service, as well as credit. In other words, it is difficult to draw a line to separate the things that are "credit charges" and the things that are not.

And even if an effective law, or set of laws, can be drawn up, there remains the problem of enforcement.

Senator Douglas proposes to give this job to the Federal Reserve Board, but the Board has already said that "it would not be appropriate for the monetary authority to administer what would be, in effect, a trade practices statute."

Perhaps with this in mind, President Kennedy wants to give the enforcement chore to the Federal Trade Commission. But FTC Chairman Dixon declares the "problems of administration would be tremendous."

As indeed they would. The law itself might increase deception. What if small retailers, leery of algebraic formulas, merely added all finance charges to their prices? Would the Government then be forced to clamp on price ceilings? Even apart from this, the number of credit transactions is so enormous that an army of Federal agents could be kept constantly busy, peering over businessmen's shoulders in every corner of the land.

Buying things on time can be confusing for consumers, it's true. But the Douglas-Kennedy proposal, for all of its talk of simple interest, would only compound the confusion.

Source: The Wall Street Journal, April 11, 1962. (underscoring supplied)

Note: While application of the Douglas-Kennedy credit provisions to all transactions on a broad consumer front might well develop into a matter difficult to control, it is suggested that such protection to the consumer under FHA and VA dwelling purchase transactions could be engineered on this one large single purchase where significant disclosures of real "cost of money" could be developed.

APPENDIX "O"

FHA QUIETLY REMOVES 6% INTEREST CEILING FOR INSURING BIG HOME-IMPROVEMENT LOANS

By Arlen J. Large
Staff Reporter of The Wall Street Journal

Washington--Reluctantly and without any public announcement, the Federal Housing Administration has scrapped as too low the 6% interest ceiling on its new program of guarantees for big home-improvement loans.

The agency has changed its rules so lenders can charge a "reasonable" premium that will push their investment return above the formal 6% ceiling.

"I guess a 6% guaranteed loan just isn't enough in the home improvement business," an FHA official said.

The new loan program was set up a year ago under provisions of the 1961 housing law sponsored by the Kennedy Administration. The law empowers the FHA to insure the repayment of private home-improvement loans as high as $10,000 with a maximum repayment period of 20 years. The new program is a companion to FHA's long-standing and popular system of insuring smaller home-repair loans of up to $3,500 with repayment in five years. The yield on these smaller loans can range as high as 9.58%.

New Program Was Unsuccessful

Administration housing officials had high hopes that the new lending setup would spark a boom in the home-repair business, especially in city neighborhoods that might otherwise be demolished as slums. Builders' groups backed the idea enthusiastically, seeing a broad market for construction work at a time when demand for new homes is tapering from post-war levels.

But government housing men concede the new program has flopped so far. In the first half of 1962, FHA received only 771 applications for insurance of the new-style loans. In contrast, the old program for backing smaller improvement loans enjoyed brisk business, with 371,000 loans insured during the same period.

Part of the blame for the new plan's failure is ascribed to lenders' lack of familiarity with it. The FHA also concedes the red tape involved in obtaining the new insurance is another reason for its unpopularity. But the main drawback is believed to be the 6% interest rate ceiling that Congress placed on the insured loans with the Administration's blessing.

"Title I" Loans Can Yield 9.58%

Under the FHA's old "Title I" program for insuring smaller repair loans, lenders can get a return as high as 9.58%, but this technically is not an interest rate. The return is achieved by giving the borrower less than the face amount of the loan, and his paying back the full amount if the loan runs to maturity.

Until now, FHA rules had forbidden lenders to tinker with the terms of the new-style loan in ways that would raise the effective interest rate above 6%.

FHA now, in effect, is willing to allow transactions between the original lender and the borrower of the home improvement loans in which the borrower pays a premium to obtain the loan. Its revamped rules allow a "reasonable" adjustment in the terms of the loan, with FHA insuring offices deciding what's reasonable in each case. Officials at the agency's Washington headquarters say the field offices probably will rely on local money market conditions in judging the new loan terms. This could put the premium paid by the borrower at $1 or $2 a $100 of face value of the improvement loan, or perhaps more in some areas. Officials are unwilling at this point to make a firm estimate of the degree of such "discounting" under the new plan, because they don't want to appear to be telling lenders how much can be charged.

Source: The Wall Street Journal, August 9, 1962.