the Mortgage Bulletin

Week of June 6th, 2011

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Property value and borrower's equity

As promised in last week's Bulletin, this week we discuss the importance of the borrower's equity in the property securing the mortgage. Simply put, lenders want to know that the borrower's real equity (investment) in the property is sufficient.

For purchase and refinance transactions, an appraisal is used to determine the property value. For purchase transactions, the lender requires documentation proving the borrower's equity (down payment) comes from the borrower.

Let's discuss refinances first. Borrower's equity is a relatively simple thing to determine. He or she already owns the property and the difference between the appraised value and the new loan is the equity. The amount of the borrower's initial down payment when the property was originally purchased is irrelevant. Equity is the difference between today's appraised value and the loan.

This can be difficult for borrowers to accept – if the property appraises for less than original purchase price or – (ugh) less than the loan amount.

IT IS IMPORTANT TO NOTE THAT AN APPRAISAL IS AN OPINION OF VALUE.

And while one can disagree with an opinion, it is impossible to prove that an opinion is wrong. Unless a factual mistake has been made by the appraiser, such as wrong room count, wrong square footage, inaccurate mathematics, or a valid comparable closed sale was missed, the appraiser's opinion of value cannot be successfully challenged.

As almost everyone knows by now, loan originators can no longer select the appraiser, nor even speak with them about anything of consequence.

Some lenders use appraisal management companies (AMCs) to select and oversee appraisers. The AMC collects a fee, pays the appraiser a lesser fee and keeps the difference. This has led to appraisals of inferior quality because appraisers are not paid enough to spend the time necessary to do a good job.

Others are developing their own list of approved appraisers. These appraisers are paid their full fee and therefore they can spend the time to do the research required for a good appraisal job. Hopefully this trend will continue.

For purchase transactions, in addition to an appraisal to determine value, lenders require evidence that the down payment comes from the borrower's own funds or a gift from a relative. This ensures the lender that the borrower has "skin in the game" so to speak, and is therefore not likely to walk away from the loan.

No part of the down payment (equity) can be borrowed. To ensure themselves that the funds come from the borrower, lenders carefully scrutinize the borrower's asset accounts. They do this not only to satisfy themselves but also to satisfy secondary market investors who will be purchasing the loan.

The Mortgage Bulletin has addressed this issue before, but it bears repeating.

Purchase borrowers must provide two current months' asset statements showing funds to close and post closing reserves. In addition, borrowers must document the source of unusual deposits into these accounts. Unusual deposits are those other than paychecks.

This can be painful, but – it is a requirement.

Refinance borrowers provide the same documentation for any accounts used for reserves or to pay closing costs.

Loan originators have become used to the new rules and regulations surrounding appraisals and intense scrutiny of borrower's funds. And as time goes by, borrowers will also come to understand. And it's really a small price to pay.

Some of the rules can be annoying but investors in mortgage backed securities (MBS) like them. That's good for MBS prices and therefore for mortgage rates.

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