Lesson 1: The Nature and Cycle of Real Estate Finance

Lesson Topics
This lesson focuses on the following topics:
- The Nature of Real Estate Finance
- Mortgage Lending Activities
- Real Estate Cycles
- Impact of the Economy
- Information Resources

Lesson Learning Objectives
By the end of this lesson, you should be able to:
- Explain the basic activities of real estate finance in detail.
- Explain how the economy and the availability of money affects the real estate market.
- Differentiate between the supply and demand of real estate and how they affect the value of real estate.
- List three ways the government influences real estate finance.

The Nature of Real Estate Finance
There are many different areas that lenders can specialize in. Most lenders choose to make either commercial real estate or residential real estate their specialty. Residential real estate lenders finance homes for individuals. Commercial lenders specialize in financing for income producing properties such as shopping centers, industrial and office properties and multi-family homes.

Portfolio lenders are very important to the commercial investor. Local banks that lend their own money and do not sell their loans on the secondary market are portfolio
lenders. The portfolio lender plans to keep the loan in their portfolio for the entire term of the loan. A portfolio lender will often have less stringent requirements than national banks. Big banks may not finance an investor if they have more than four mortgages, but local banks might. Good portfolio lenders who allow the investor to finance as many properties as they want, as long as they continue to qualify and have enough reserves are invaluable to the commercial property investor.

Since a portfolio lender lends their own money and do not sell their loans on the secondary market, they do not have to meet Fannie Mae lending guidelines, which allows them more flexibility.

Many commercial lenders will want 25% down on the property and limit loan terms to 15 years. By shopping around at local banks you may be able to help an investor client find more flexible terms. It is important for real estate licensees working in the commercial sales field to become familiar with the local banks and what they have to offer for their customers. The commercial financing industry includes investors, portfolio lenders and servicers. The real estate finance industry is big business. Over 280,000 individuals are employed in the real estate finance industry across the United States according to the Mortgage Bankers Association. The industry includes life insurance companies, mortgage companies, mortgage brokers as well as commercial banks, credit unions and savings and loans.

From qualifying the borrower and qualifying the property in the underwriting process to various types of financing, closing the sale, and the effect of significant federal legislation and the nature of finance is a valuable area to explore. Real estate licensees familiar with finance are an asset to their clients. Any discussion of finance must include information regarding the monetary systems that control the market, delve into supply and demand, cover housing agencies, and discuss the government influence on real estate.
Most purchasers need to borrow money to buy real estate. The methods of real estate finance are many and varied. Making real estate loans carries a certain amount of risk for lenders; for this reason, lenders must have a firm grasp of a borrower’s financial qualifications. Lenders consider a borrower’s income, credit, debt, source of funds, and net worth. However, no analysis, no matter how thorough, of a borrower’s creditworthiness can be enough to ensure that a loan is completely free of risk. Lenders must also consider the value of the collateral to lessen the risk.

Mortgage loan servicing is a big part of the lending industry. The following is an article published by the Federal Trade Commission that contains important information regarding loan servicing.

Making Payments to Your Mortgage Servicer

When you get a mortgage, you may think that the lender will hold and service your loan until you pay it off or sell your home. That’s often not the case. In today’s market, loans and the rights to service them often are bought and sold. In many cases, the company that you send your payment to is not the company that owns your loan.

A home is one of the most expensive purchases you’ll make, so it’s important to know who is handling your payments and that your mortgage account is properly managed. The Federal Trade Commission (FTC), the nation’s consumer protection agency, wants you to know what a mortgage servicer does and what your rights are.

Mortgage Servicers: Their Responsibilities; Your Rights

A mortgage servicer is responsible for the day-to-day management of your mortgage loan account, including collecting and crediting your monthly loan payments, and handling your escrow account, if you have one. The servicer is who you contact if you have questions about your mortgage loan account.
Escrow Accounts
An escrow account is a fund held by your servicer that you pay into for property taxes and homeowners insurance. Your escrow payment typically is part of your monthly mortgage payment. The servicer then uses your escrow account to pay your taxes and insurance as they become due during the year. If you do not have an escrow account, you must make those payments on your own.

If your mortgage servicer administers an escrow account for you, federal law requires the servicer to make escrow payments for taxes, insurance and any other escrowed items on time. Within 45 days of establishing the account, the servicer must give you a statement that clearly itemizes the estimated taxes, insurance premiums and other anticipated amounts to be paid over the next 12 months, and the expected dates and totals of those payments.

The mortgage servicer also is required to give you a free annual statement that details the activity of your escrow account, showing, for example your account balance and reflecting payments for your property taxes, homeowners insurance and other escrowed items.

Transfer of Servicing
If your loan is transferred to a new servicer, you generally get two notices: one from your current mortgage servicer; the other from the new servicer. In most cases, your current servicer must notify you at least 15 days before the effective date of the transfer, unless you received a written transfer notice at settlement. The effective date is when the first mortgage payment is due at the new servicer’s address. The new servicer must notify you within 15 days after the effective date of the transfer.

Both notices must include:
- the name and address of the new servicer
- the date the current servicer will stop accepting your mortgage payments
- the date the new servicer will begin accepting your mortgage payments
- telephone numbers (either toll-free or collect), for the current and new mortgage servicer, for information about the transfer
- whether you can continue any optional insurance, such as credit life or disability insurance; what action you must take to maintain coverage; and whether the insurance terms will change
- a statement that the transfer will not affect any terms or conditions of your mortgage, except those directly related to the servicing of the loan. For example, if your contract says you were allowed to pay property taxes and insurance premiums on your own, the new servicer cannot demand that you establish an escrow account.
- a statement explaining your rights and what to do if you have a question or complaint about the servicing of your loan.

There is a 60-day grace period after the transfer: during this time, you cannot be charged a late fee if you mistakenly send your mortgage payment to the old servicer.

**Transfer of Loan Ownership**

The ownership and servicing rights of your loan may be handled by one company or two. If ownership of your loan is transferred, the new owner must give you a notice that includes:

- the name, address and telephone number of the new owner of the loan
- the date the new owner takes possession of the loan
- the person who is authorized to receive legal notices and can resolve issues about loan payments
- where the transfer of ownership is recorded.

The new owner must give you this notice within 30 days of taking possession of the loan. It is in addition to any notices you may get about the transfer of the servicing rights for your loan.

**Posting Payments**

The servicer must credit a payment to your loan account as of the day it is received. Some consumers have complained that they’ve been charged late fees, even when they know they made their payments on time. To help protect yourself, keep detailed records of what you’ve paid, including billing statements,
canceled checks or bank account statements. You also may be able to check your account history online. If you have a dispute, continue to make your mortgage payments, but notify the servicer in writing and keep a copy of your letter and any enclosures for your records. Send your correspondence by certified mail to the address specified by the servicer, and request a return receipt. You also may wish to fax or email your letter and any enclosures. Be sure to follow any instructions the servicer has provided and confirm the fax number or email address before sending your letter. Keep a copy of transmittal confirmations, receipt acknowledgments and email replies.

**Force Placed Insurance**

It’s important to maintain the required property insurance on your home. If you don’t, your servicer can buy insurance on your behalf. This type of policy is known as force placed insurance. It usually costs more than typical insurance even though it provides less coverage. The primary purpose of a force placed policy is to protect the mortgage owner.

Read all correspondence from your mortgage servicer. Your mortgage servicer may ask that you provide a copy of your property insurance policy. Respond promptly to requests about property insurance, and keep copies of every document you send to your mortgage servicer.

If you believe there’s a paperwork error and that your coverage is adequate, provide a copy of your insurance policy to your servicer. Once the servicer corrects the error, removes the force placed coverage and refunds the cost of the force placed policy, make sure they remove any late fees or interest you were charged as a result of the coverage.

**Fees**

Read your billing statements carefully to make sure that any fees the servicer charges are legitimate, including fees that may have been authorized by you or the mortgage contract to pay for a service. If you don’t understand what any fees are for, send a written inquiry asking for an itemization and explanation. Also, if you call your mortgage servicer to ask for a service, like faxing copies of loan
documents, make sure you ask whether there is a fee for the service and how much it is.

(Source: https://www.consumer.ftc.gov/articles/0190-making-payments-your-mortgage-servicer)

**Mortgage Lending Activities**

Most purchasers do not have the cash to completely pay cash for their real estate purchases. Most real estate transactions include a real estate loan.

If the purchaser is buying an investment property, and may want to purchase multiple properties, it is important that they understand the terms of the loan and where the funds originate from. Investment loans come from many different sources and have a variety of ways the terms are structured.

Many lenders choose to specialize in financing for consumers purchasing a home.

Mortgage lending activities include qualifying loan applicants and the property to be mortgaged. This involves a thorough and accurate property valuation, using the sales comparison or cost approach for residential property and a cap rate for income producing property.

An article by Appraisal IQ describes the three approaches to value as follows:

1. **The Sales Comparison Approach**
   
The most frequently-used and accepted approach to determining value in real estate appraisal practice is the *sales comparison approach*. This approach to value bases its opinion of value on what similar properties (otherwise known as “comparables”, or “comps”) in the vicinity have sold for recently. These properties are adjusted for time, acreage, size, amenities, etc. as compared to the property that is being appraised. Understanding which (and to what extent) adjustments are reasonable for a given market area (for a given property) relies on the
experience of the appraiser. A property characteristic that is highly valued in one neighborhood may not be valued to the same degree in a different area.

2. The Cost Approach
The second approach to determining the value of a property is the cost approach. This approach seeks to determine how much a property would cost to replace (meaning, rebuild) after subtracting accrued depreciation. Accrued depreciation is the reduction in actual value of property over a period of time as a result of wear and tear or obsolescence. The term reproduction cost is used if an exact replica of the original property is produced. The term replacement cost is used if a property is rebuilt with comparable utility, but using current design and construction methods and materials.

The cost approach is considered to be more reliable when used on newer construction. The methods and results of the cost approach are considered to be less reliable with older construction.

The cost approach appraisal is frequently the only approach that is considered to be reliable when appraising special use properties such as commercial/industrial properties or public properties such as libraries, schools or churches which are not traded on the open market.

3. The Income Approach
The third approach to value is called the income approach. When a property generates income for its owner, that income, or potential for income, helps to substantiate, calculate or identify the market value of the property. Apartment buildings and duplexes are examples of income-producing properties. Appraisers use the income derived from the property as part of the assessment the market value of the property.

(Source: http://theappraisaliq.com/industry/approaches-to-value/)

These methods of valuation will be discussed further in depth, in Lesson Nine, so that you will feel confident and familiar with them when you encounter them in the real world.
Residential Real Estate Financing

Banks, credit unions, mortgage companies and savings and loans are some of the traditional lenders in the residential finance business. This group of lenders is called the primary mortgage market. This is where the consumer can walk in and make an application to finance their home.

After the borrower makes an application the lender evaluates their credit, their income and expenses, and their assets and liabilities. The lender is trying to ascertain that this borrower will be able to pay, not only their down payment, but all of the future payments. Most residential loans require a 20% down payment unless the loan is covered by private mortgage insurance (PMI) or is insured by FHA or guaranteed by VA. The lender will verify the purchaser’s employment. They want to not only verify that the borrower has income but that the income is likely to continue.

There are many loan programs for the home buyer to apply for. The information can be overwhelming especially for a first time homebuyer. A knowledgeable real estate agent and a good loan officer can be a valuable asset in explaining the different programs to the borrower.

Loans are either government guaranteed or insured such as FHA or VA loans, or are Conventional Loans.

FHA insurance (MIP) protects the lender against loss if the borrower defaults on the loan. Your client will need to understand the benefits and the price for FHA insurance. FHA insurance is expensive. It protects the lender, but it is paid for by the borrower. FHA insurance requires an upfront fee as well as a monthly fee. As a real estate agent you will want to ascertain that the loan officer has explained the cost thoroughly to your client. There are a couple of valuable benefits to the borrower with an FHA loan. These include much lower down payments than conventional loans require and a loan that is assumable (at the original interest rate) with qualifying. This will have a value of its’ own
if interest rates begin to go up. FHA is also a little less stringent on debt ratios than conventional loans.

VA loans are similar to FHA loans. VA guarantees loans instead of insuring them. The guarantee protects the lender if the borrower defaults on the loan. The borrower pays a fee up front for the guarantee but there are no ongoing monthly premiums. Veterans can buy a home with a -0- down payment. And if the seller is willing to pay the cost of the buyer’s closing cost, in addition to his or her own closing cost, VA allows it. So the VA buyer can actually move in for -0-.

Conventional loans have no government guarantee or insurance. At one time conventional loans all required a 20% down payment. Later an industry developed that provided Private Mortgage Insurance (PMI) on conventional loans. Now PMI provides insurance on 90% and 95% conventional loans. The insurance is for the protection of the lender; the cost of the insurance is to the borrower.

The next breakdown on conventional loans is that they are conforming or non-conforming. A conforming conventional loan has been made according to the guidelines that will allow the loan to be sold on the secondary market. A non-conforming conventional loan will probably become a loan held in the lender’s portfolio because it does not meet the guidelines to be sold. For example, a “Jumbo” loan will be a non-conforming loan because it exceeds the maximum loan amount allowed to be sold on the secondary market.

FHA, VA and conforming conventional loans are all able to be sold on the secondary market. You will learn more about the secondary market in Lesson Four.

When the purchaser’s credit and assets cannot secure a traditional loan, some non-traditional loans may be available. They include, but are not limited to:

- **Seller financing:** the seller becomes the lender and mortgage payments are made directly to them. The Texas Real Estate Commission (TREC) provides an
addendum for the parties to negotiate seller financing. With interest rates on money in the bank at an all-time low, the seller can frequently make more profits by leaving the money in the property and becoming the lender. This can be a win-win for the buyer and the seller.

- **Interest-only loans:** monthly payments are applied to the interest only for a set period. For example, if a borrower believes he or she will be in a better position to get a good interest rate on a 30-year loan next year, they may purchase the home on an interest only one-year term loan from their bank and refinance on the 30-year loan before the one-year term loan comes due. For example, if they borrow $200,000 at 8% for one year they will pay $200,000 x .08 divided by 12 for 12 payments of $1333.33. Since the monthly payments go to interest only the loan will begin and end at $200,000. After they refinance they will begin to pay both principal and interest.

- **Assumption transactions:** the buyer purchases the home and assumes the existing mortgage on the property. (FHA and VA loans are assumable with qualifying.) This can be very valuable if interest rates are rising and there is a low rate on the FHA or VA loan. If the seller bought the home in 2014 with a 3.5% interest rate on an FHA loan and then sells the property in 2019 and interest rates have risen to 8% on new loans, it would probably be to the buyers' advantage to buy the seller’s equity (equity is the difference between the value of the property and the current loan balance) and assume the seller’s old loan. The buyer will want to thoroughly research the loan he will be assuming and the seller will want to ascertain that he or she is being released from liability on the old loan. TREC provides an Addendum to help the buyer and seller negotiate the terms of an assumption.

- **Friends and family:** the buyer finances their property using funds borrowed from their friends and relatives. Both the buyer and friends or relatives making the loan should be certain that everything about the loan agreement is in writing with all of the terms of the loan detailed. Both parties will have rights and responsibilities. An attorney will be needed to draw up the Note and Deed of Trust to protect the parties. The title company attorney will be able to provide that service if needed.
Remember that the lender (a friend or relative) will have the right to foreclose on the property if the borrower is not able to make the payments. This type of arrangement can sometimes be hard on the relationship.

**Real Estate Agents Have an Important Responsibility**

Clients expect their real estate agent to be knowledgeable and to have their best interest at heart. Your first time homebuyers may have no idea how much house they can afford. The last thing you want to happen to them, if you are representing them, is for them to buy a home from you and then lose it because they cannot keep up with the house payments. Help them to understand that as a homeowner they will have responsibility for maintenance on their new home. If their total house payments (principal, interest, taxes, insurance, plus PMI or MIP) are about the same as their rent payment and they have not been able to save any money with that amount for rent, they may need to keep the payments down a little more to allow for the cost of unforeseen maintenance issues on their new home.

A good agent will recommend the buyer get pre-qualified before beginning to look at homes. But make sure the buyer understands that the amount they qualify for is the maximum for them. They may want or need to keep the payments lower to enable them to continue to live the life style they are comfortable with. They will make the decision but you can encourage them to think through those issues first.

**Commercial Real Estate Financing**

Commercial real estate financing is usually done by banks and private lenders.

Bank lenders will assess the real estate investor’s credit history and income from his businesses, employment or investments. A good credit history and solid income will enable the investor to usually have access to good financing. The bank will want to examine the investors personal and business balance sheets for the past 3-5 years.
Lenders are especially interested in the investor’s past financial history. A reasonable expectation of future income is important.

Most commercial property lenders want 30% of the purchase price as a down payment. Investor qualifications such as an up-to-date business plan, assets and a good credit history can cause the required down payment to vary.

Investors should ask a bank lender for information about the typical terms and required documentation for a commercial loan before applying since it can be a time-consuming process. Some loans require the investor to meet certain requirements regarding their debt-to-cash ratios, cash flow, etc. If the borrower cannot meet these requirements it could result in a higher interest rate.

Having an attorney to review loan documents is always a good idea. However, on commercial loans, a smart investor will certainly ask his or her attorney to review the documents prior to signing them.

Family, friends, neighbors, and co-workers can become private investors. Through online research professional investors or professional lending institutions can be located. The investor will still want to have his or her attorney review the documents prior to signing. Private investors may have higher interest rates or unusual terms.

Once an investor has paid the first property in full or paid off a significant portion of the loan, a lender will often give them a line of credit. At least the down payment on the new loan can be secured by the first property. The investor will need to be sure the properties will produce enough income to pay the payments on the credit line and the loan. He or she could lose both properties if the payments are not made.

Types of credit lines include, but are not limited to:

- **Balloon Loans:** Usually for 3 to 15 years and are indexed against a Treasury index.
• **Real Estate Loans**: Secured by other real estate you own. Usually you can borrow up to 75% against the value of the property for a term of between 10 and 20 years.

• **Short Term Loans**: Secured loans for a term of a year or less.

• **Asset Based Loans**: Secured by your professional or perhaps your personal assets.

• **Term Loans**: Usually made by traditional lenders and secured, for a fixed term, at least partially determined by the investor’s income statements and projections.

• **Equipment Loans**: Secured by business equipment and against which you can usually borrow 60-80% of the value of the equipment for the projected life of the equipment.

Real estate licensees that work on the commercial side of real estate must be very knowledgeable to assist their investor clients. Knowledge of commercial property values are important to help the investor know generally how much they will be able to finance. Interest rates will probably be higher on commercial loans. These loans are not backed by government insurance or guarantees so the lenders’ risk is higher. The investor must also project what their ability to pay off short term loans or balloon notes will be at the end of the term. If they are forced to refinance, the terms could be unfavorable.

There are other charges such as survey fees, loan application fees, and legal fees that may need to be paid before the loan application process begins.

Mortgage lending activities also include dealing with buyers in default and foreclosure. Lenders sometimes help borrowers to prevent foreclosure through forbearance, moratoriums, and recasting. When these techniques fail, the property is foreclosed and sold at auction and the creditors are repaid. You will learn more detailed information about defaulted loans and foreclosures in Lesson Ten.

The following article is from the Federal Trade Commission on the role of the servicer when a loan is in default.
Special Considerations for Loans in Default

If you fail to make one or more payments on your mortgage loan, your loan is in default. The servicer may then order “default-related services” to protect the value of the property. These services may include property inspections to make sure you are still living in the home and maintaining the property. If the property is not being properly maintained, the servicer may order “property preservation services,” like lawn mowing, landscaping and repairing or boarding up broken windows and doors. The costs for these services, which can add up to hundreds or thousands of dollars, are charged to your loan account. If the servicer starts to foreclose on your property, additional costs like attorneys’ fees, property title search fees, and other charges for mailing and posting foreclosure notices will be charged to your loan account. That can add hundreds or thousands of dollars more to your loan, and make it even more difficult for you to bring the loan current and avoid foreclosure.

If you find yourself in this situation, stay in touch with your servicer. Servicers have different policies about when they will order default-related services. Some may not order property inspections or property preservation work if you let them know each month that you are still living in the home, keeping it well maintained, and are working with them to resolve the default on your account. Even so, it’s important to review your billing statements carefully and question added fees. If fees appear on your statement under general headings like “other fees” or “corporate advances,” contact your servicer – in writing – as soon as possible to get an explanation of those fees and a reason they’ve been charged to your account.

Struggling to Make Your Mortgage Payments?

If you are struggling to make your mortgage payments – or you’ve missed payments – contact your servicer. It’s critical to keep the lines of communication open when you’re trying to resolve issues with your account. If you have difficulty reaching or working with your servicer, call 1-888-995-HOPE for free personalized advice from housing counseling agencies certified by the U.S. Department of Housing and Urban Development (HUD). This national hotline – open 24/7 – is operated by the Homeownership Preservation Foundation, a
nonprofit member of the HOPE NOW Alliance of mortgage industry members and HUD-certified counseling agencies. For free guidance online, visit www.hopenow.com.

(Source: https://www.consumer.ftc.gov/articles/0190-making-payments-your-mortgage-servicer)

The financial market has developed many types of loans including conventional loans, both conforming and nonconforming; FHA; VA; adjustable rate; graduated payment; growth equity; and reverse annuity mortgages, to name a few. Depending on the type of financing the borrower needs, there are advantages and disadvantages to each loan.

Changing Legislation
The Real Estate Finance industry is constantly changing because of changing legislation. One of the recent legislation changes that has affected the financial industry is the Safe Mortgage Licensing Act (S.A.F.E. Act):

Title V of P.L. 110-289, the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 ("SAFE Act"), was passed on July 30, 2008. The new federal law gave states one year to pass legislation requiring the licensure of mortgage loan originators (MLOs) according to national standards and the participation of state agencies on the Nationwide Mortgage Licensing System and Registry (NMLS).

The SAFE Act is designed to enhance consumer protection and reduce fraud through the setting of minimum standards for the licensing and registration of state-licensed mortgage loan originators. Mortgage loan originators who work for an insured depository or its owned or controlled subsidiary that is regulated by a federal banking agency, or for an institution regulated by the Farm Credit Administration, are registered. All other mortgage loan originators are licensed by the states.
The SAFE Act requires state-licensed MLOs to pass a written qualified test, complete pre-licensure education courses, and take annual continuing education courses. The SAFE Act also requires all MLOs to submit fingerprints to the Nationwide Mortgage Licensing System (NMLS) for submission to the FBI for a criminal background check; and state-licensed MLOs to provide authorization for NMLS to obtain an independent credit report.

(Source: http://mortgage.nationwidelicensingsystem.org/safe/pages/default.aspx)

Mortgage loan originators in Texas have the state license as well as the national license and must qualify for both licenses.

**Real Estate Cycles**

The following is from Brandon Turner’s article “The Real Estate Market: How to Analyze and Predict Cycles”:

Real estate follows a pattern that can be observed and thus predicted. However, unlike the consistency of autumn or the regularity of pancakes, the real estate cycle moves at its own pace, and that is the difficult thing to predict.

The real estate market typically moves through four phases before going back and repeating again. Those phases, as labeled in a recent Harvard Blog post, can be described as:

- Phase 1: Recovery
- Phase 2: Expansion
- Phase 3: Hyper supply
- Phase 4: Recession
Phase 1: Recovery
During phase one of the real estate cycle (which has no real beginning; we are just picking an arbitrary start point), the market is recovering from the last downturn. The market is no longer in a “free fall,” but has begun to look upward. This, I believe, is the best time to buy real estate: the bottom. (Remember, the old cliché — buy low and sell high!)

This phase of the real estate cycle is represented by high (yet stabilized) unemployment, a high number of home foreclosures, and a lot of fear in the general population. This is the time you’ll hear most people saying, “Oh, I would never invest in real estate. After all, look what it just did! My uncle lost a fortune!”

Phase 2: Expansion
During the expansion phase, businesses are once again adding employees to their ranks, and confidence in real estate is once again growing.

Home prices begin to rise, triggered by a decreased supply but climbing demand, as more and more individuals decide that buying real estate might be more advantageous than renting or living with family. Businesses also decide to expand, thus creating a shortage of available commercial buildings. As a result of this expansion, real estate developers begin to build new homes and new properties to cater to this demand.
During this phase of the real estate cycle, it can still be a great time to invest in real estate. Prices are rising, rents are going up, and people are generally optimistic about the future. Good deals can still be found, as the market is still dealing with some of the foreclosure mess that existed previously, but those deals are not simply lying around waiting to be picked up; they must be worked for.

While this can be a good market to be a part of, during this period of growing prosperity, a major problem is brewing: speculators are entering the picture. Speculators are investors who heavily rely on future growth of the real estate market to generate profits and base their numbers upon this need. In other words, they begin to pay more for properties than they should because they can. And this leads us to the next phase.

**Phase 3: Hyper Supply**

The third phase in the market cycle is the “boom” time known as “Hyper Supply.” If you were paying attention to American real estate in the mid-2000s, you’ll recognize this era characterized by skyrocketing prices, mass building projects, and by everyone and their brother wanting to buy real estate.

This hyper supply is largely caused by builders who are paying more for land and construction than they should, basing their numbers on the belief that rents will continue to rise and thus justify their speculation. House flippers do the same thing, as they pay far too much for property because they know someone else will come and overpay them for the completed flip.

Demand during this time begins to level off as the supply built during phase 2 reaches equilibrium. In other words, during the expansion phase, new construction is being built to accommodate the increased demand for real estate and at some point, it will catch up, and the amount of supply will equal the demand. In a perfect world, the market should stabilize nicely at the point because everyone is happy, but because developing real estate is a slow process that can take years, the construction that began during the expansion phase is continuing at rocket speed. The supply overtakes the demand, and
vacancies begin to rise. A house of cards is being built on the greater-fool theory, and it’s just primed for a gust of wind to come knock it over.

During this period in a real estate market, spectacular stories of wealth being generated by real estate are told because, in truth, many people were making money — even idiots! As Billionaire businessman and celebrity “shark” Mark Cuban famously said, “Everyone is a genius in a bull market.” That said, this game of musical chairs will soon come to an end, the music will stop, and many people will be left without a chair.

I would encourage real estate investors to recognize when they are in this kind of market and not get lured by the stories of wealth being made from the greater fool. Be patient, stick to your numbers, and if your numbers don’t work, find a real estate niche that does or be patient and wait for the next phase...

**Phase 4: Recession**
Finally, the house of cards built during phase two and three collapses.

The building projects that seemed so promising just a few years earlier are unable to sell, driving prices down quickly. Foreclosures skyrocket as more and more owners find themselves underwater and more and more investors find themselves unable to pay the mortgage with the decreasing rents and increased vacancy. Combine this real estate recession with an economic recession like we saw in 2007 and 2008, and you’ll find millions of homeowners out of work, unable to pay their mortgage on their home that they paid far too much for in the first place.

This can be an exciting time for real estate investors, but one that must be carefully examined. While the rest of the world is running around like a chicken with its head cut off, savvy investors are looking for “the bottom,” waiting for the supply to once again dip below the demand where great deals can be found. Once the market hits bottom, this is the best time for a real estate investor to jump in and get some fantastic deals and help save the plunging economy.
I believe far too little has been said about the role that real estate investors played in the past decade in keeping the United States’ “Great Recession” from becoming the “Second Great Depression.” While most of the country had decided they wanted nothing to do with real estate, large and small investors across the country saw the potential during this fourth phase and saved the economy, plain and simple. Yes, the government played a role in steering us away from collapse, but it was the local mom and pop real estate investor that truly saved America.

After the real estate market bottoms out, it begins to rise once again. Confidence begins to grow in real estate and in a cycle that repeats generation after generation, the real estate market once again enters phase one: Recovery.

(Source: https://www.biggerpockets.com/renewsblog/2015/03/06/real-estate-marketanalyze-predict/)

According to an article titled “Recession” by Mark Koba, Senior Editor of CNBC:
Every few years, countries experience an economic downturns, also known as a recession. Companies lay off workers, consumers stop spending, and the average American experiences a financial pinch.

But what exactly is a recession? How does it differ from a depression? And when does a recession end? Here are the basics.

**What is a recession?**
The textbook definition of a recession is a downturn in economic activity, characterized by at least two consecutive quarters of decline in a country's gross domestic product (GDP).

Translation? A big drop in consumer spending ending in a loss of jobs, personal income and business profits. This is usually the result of an economic shock, such as a 'bubble' bursting.
An economic bubble happens when products, such as stocks or homes, become worth more than their actual value. When the bubble bursts, the prices of these products fall.

This is usually coupled with less business investing, because business profits drastically decline. The slowdown in business investing in turn results in more bankruptcies, both personal and business, and higher unemployment rates because too many people are chasing too few jobs.

**What causes recessions?**
They usually result from an economic shock. There are many ways a shock can come about.

The 2007-2009 recession was mostly blamed on a housing bubble. After a run-up in housing prices in the early part of the decade, home prices plummeted, then thousands of borrowers couldn't afford to pay their loans. Meanwhile, Wall Street sold financial instruments tied to the loans that were eventually discovered to be of little value.

Looking at other recessions, we can see their 'shocks.' The recession of 2001 was caused by the 'Internet Bubble,' in which internet stocks and businesses eventually fell to much lower prices. That brought about a huge decline in business investing and a spike in unemployment.

The recession of 1973-1975 in the U.S. came about because of rocketing gas prices caused by OPEC's raising oil prices as well as embargoing oil exports to the U.S. Other major factors included heavy government spending on the Vietnam War, and a Wall Street stock crash in 1973-74.

At the time, this recession was the worst in the U.S. since the Great Depression. Today, most economists believe the Great Recession of 2007-2009 superseded the 1973-1975 recession in intensity.
There was even a recession during the Great Depression, say economists — and at the time it was the worst recession in the nation’s history.

The ‘recession’ in 1937 and 1938 had several causes. When the U.S. was trying to get out of the Great Depression, it spent a lot of money. That was the New Deal — President Franklin Roosevelt's plan to get the economy moving — which started in 1933.

But as the economy appeared to be recovering in 1937 and because Congress wanted to balance the budget, the government pulled back on spending and then raised taxes. That was enough of a ‘shock’ to put the economy into recession. Unemployment rose again and business profits declined, as did business investing.

As a result, the Great Depression continued, economists say, until the U.S. entered World War II in 1941.

**What’s the difference between a recession and a depression?**

Harry Truman, the 33rd president, is credited with saying, “A recession is when your neighbor loses his job. A depression is when you lose yours.”

A depression is a far more serious downturn in a country's economic growth for a longer period of time, resulting in much higher unemployment and much less spending by consumers, than a recession.

That's why the Great Depression of the late 1920's and 1930's was called just that. The economic suffering was long and painful. In fact, the term recession became more commonplace after World War II to describe an economic downturn less severe than a depression. Before that, almost all economic downturns in the U.S. were called depressions or panics.

The Great Depression was primarily started by the Wall Street crash of 1929, as well as bank failures in the early 1930's. Depositors’ money was not insured by the Federal Government as it is now. That insurance is a legacy of the New Deal.
Also helping to bring on the Great Depression were protectionist trade policies to help boost American businesses but put higher prices on products—plus a severe drought in the Midwest known as the Dust Bowl that put thousands of farmers out of work.

The U.S. hasn’t experienced anything close to a depression since World War II.

Can a recession get worse?
Yes. It can become a depression — meaning the economic slowdown can deepen and go on for a longer time.

There hasn't been an official case of that transition yet, but as noted above, the 1937-38 recession helped prolong the Great Depression.

A recession can also 'double dip.' This is often referred to as a W-shaped recession. That means a recession can end for a time but come roaring back because of another economic shock.

Economists point to a double dip recession in the 1980’s. The first part of the double dip started in January 1980 and lasted through July of that year. After the economy started growing for a while—and considered out of recession—the Federal Reserve raised interest rates to stop inflation.

That turned out to be an economic shock and sent the country into another recession from July 1981 to November 1982. That made it a double dip.

When Does a Recession End?
Technically, a recession ends when economists say it does, but those on the streets may feel differently.

The National Bureau of Economic Research—an independent group of economists—is charged with the official proclamation of a U.S. recession's end.
In general, however, a recession ends when the economy starts to grow for a period of time, usually two or more business quarters. That means companies are hiring again, consumers are spending, and businesses are investing.

That doesn't mean everyone has gotten their jobs back or businesses are investing more than before the recession. It just means a country's overall economy is expanding or growing on a somewhat more consistent basis.

(Source: http://www.cnbc.com/id/43563081)

Real estate finance is constantly in a state of flux, and there are several factors that cause this. First among them is the real estate market: the supply of and demand for real property. The real estate market affects, and is affected by, the primary lending market, the basic subject of this course. This primary market is in turn affected by the secondary lending market.

In addition to market influences, the government plays a large role in shaping real estate financing. Two particular government agencies, the Federal Reserve, which is in charge of the nation's monetary policy, and the Department of Housing and Urban Development, which is responsible for the nation's housing policy, have the most significant roles.

For anyone interested in real estate finance, it is imperative to understand the economic indicators and market characteristics of the residential real estate market.

Some such indicators include:

- Supply and demand of housing
- Mortgage rates
- Other indicators influencing the market
- The monetary system
Other Indicators Influencing the Market

The ability for people to afford a home drives demand. A Housing Affordability Index greater than 100 means that the median-income family could qualify for more than the median-priced home with an 80 percent loan. If the Housing Affordability Index is below 100, then the same median income cannot qualify to buy the median-priced home, which is normally the case during times of inflation and high interest rates.

Characteristics of the population, the social attitudes prevalent at the time, and the legal and tax structure of the economy also shape real estate expenditure.

Inflation

Inflation is a general rise in prices; it results in a decrease of the dollar’s purchasing power. That is, because of inflation, what $1 could buy back in 1900 now takes many, many more dollars today. Inflation is a normal part of the operation of a free market and there are many indexes used today to measure it, such as the Consumer Price Index (CPI) and the Producer Price Indexes (PPI). It is important for those involved in real estate finance to be able to accurately predict rising or falling inflation, especially if it occurs at a quicker than average rate.

It is important to note that inflation is influenced by governmental actions such as increasing the money supply. For example, if the money supply only increases when added goods and services are produced, then inflation stays down.

Inflation Predictors

Economists, market analysts, and investors are highly concerned with predicting inflation. Unfortunately, it is one of the most difficult aspects of the economy to predict accurately, and there are several indicators, all of which are imperfect, that can be considered:

- **The Exchange Rate:** The exchange rate is the amount of a foreign currency that a dollar can buy. For example, if $1 can buy 11 Mexican pesos, then the exchange rate is 11 pesos on the dollar. When one currency buys less foreign
currency than before, it is said to be depreciating. Depreciation of the dollar is a good indicator of a high inflation risk.

- **GDP:** Strong economic growth can also indicate future inflation. Growth, measured by the *gross domestic product* or GDP, is often accompanied by an increase in aggregate demand. Greater demand leads to rising prices, that is, to inflation. One-year GDP growth is a more reliable predictor of inflation in the United States than it is in many other countries and can be monitored to an investor’s benefit.

- **Unemployment:** Falling *unemployment* often accompanies economic growth as well. When more people have jobs, there is more disposable income in circulation, thus greater demand and higher prices. Economists use a function called the Phillips curve, which states that high unemployment is correlated with deflationary pressures, and low unemployment with inflationary pressures. The point along the curve at which there is no pressure for either inflation or deflation is known as the NAIRU or non-accelerating inflation rate of unemployment.

### The Effect of Inflation on Real Estate Investments

Real estate is recognized by most investors as a good hedge against inflation. That is, real estate investments are less likely than many other investments to suffer the ills of rising inflation. But it is not immune to such ills. During periods of high inflation, investors may rush to real estate to hedge against inflation and end up causing higher real estate prices through excessive demand.

An asset manager can benefit from accurate inflation prediction. For example, lower vacancy rates are to be expected during periods of high inflation.

In certain situations, inflation can be a predictor of a property’s future value.

### Inflation and Interest

High inflation also can be damaging to the real estate market. When inflation is low, interest rates are usually low as well. The opposite is also true: High inflation and high
interest rates go hand-in-hand. Investors may desire to purchase real estate to hedge against high inflation, only to be deterred by the interest rates necessary to make a purchase. This can, however, be an advantage if the current owner holds an assumable loan at a rate lower than the market rate. An investor may be enticed to buy the property at a level much higher than market value in order to assume the favorable loan and hedge against inflation.

The two largest contributors to inflation in the United States are the cost of health care and the cost of housing.

**Homelessness in America**

Unfortunately, because of inflation, the cost of housing in America has increased faster than income earned in many employment fields.

One of the financial challenges our country faces is being able to provide housing for prices that can be affordable for low income families. Many families in low paying jobs such as cashiers, cooks, health aides, janitors, maids, retail clerks, waiters and waitresses, and drivers are homeless even though they are working.

According to an article by the National Alliance to End Homelessness:

On a single night in January 2015, 564,708 people were experiencing homelessness — meaning they were sleeping outside or in an emergency shelter or transitional housing program.

- In total, 33 states and the District of Columbia (D.C.) reported decreases in overall homelessness, while 16 states reported increases. The states with decreases in homelessness were concentrated in the South and Midwest.
- Despite a national decrease in unsheltered homelessness, only 18 states reported decreases in the number of people living in unsheltered locations, including the street, cars, and abandoned buildings. The national decrease in unsheltered homelessness was driven
in large part by decreases in unsheltered homelessness in Florida, Texas, and Georgia.

- The **national rate of homelessness in 2015 fell** to 17.7 homeless people per 10,000 people in the general population from 18.3 in 2014. The rates in individual states ranged from 111 in D.C. to 7 in Mississippi.
- The rate of veteran homelessness **continued its descent** of the past several years to 24.8 homeless veterans per 10,000 veterans in the general population. The rates in individual states ranged from 145 in D.C. to 9 in Virginia.
- The majority of states had **decreases in every major subpopulation**: family homelessness (33 states and D.C.), chronically homeless individuals (31 states and D.C.), and veteran homelessness (33 states).

(Source: [http://www.endhomelessness.org/library/entry/SOH2016#ChapterOne](http://www.endhomelessness.org/library/entry/SOH2016#ChapterOne))

**Taxes**

The government also influences the market by imposing taxes on consumers. Taxes raise the price of goods, and, therefore decrease the quantity consumers are willing to buy. The government may also increase the quantity demanded of a good or service by granting tax incentives. The same is true for supply. Taxes on builders or lenders will decrease the amount of real estate or loans that are available, and tax incentives will increase this amount.

**Property Tax Incentives**

Tax incentives include tax exemptions, tax deductions, and tax credits. A tax exemption is a dollar-by-dollar reduction in the appraisal value of a property. For example, if a property owner has a $15,000 exemption and that owner's property is appraised at $100,000, then she or he will pay ad valorem taxes as though the house were appraised at $85,000. Tax exemptions vary by state both in amount and qualifications, but some of the most common include:

- **Homestead exemption**: A property that is occupied by its owner as a permanent residence is considered a homestead. Most states provide some sort of homestead exemption, either to a husband and wife or to a single person.
For instance, the exemption in Florida, as of this writing was $25,000, and in Texas it was $25,000 for school taxes, which may be supplemented by exemptions from other taxing authorities.

- **Disability exemption:** People with disabilities may receive a property tax exemption in certain states. This exemption is sometimes augmented for those whose disability is related to military service.

- **Senior citizen exemption:** Additionally, several states provide exemptions for senior citizens. Each state determines for itself the age at which a person is to be considered a senior citizen. Usually it is somewhere between 63 and 66. Texas offers a $10,000 senior citizen exemption in addition to the homestead exemption for residents who are 65 or older. School taxes are also frozen when the homeowner files for the over 65 exemptions in Texas. Therefore, school taxes will no longer increase unless there are property improvements that cause the tax appraisal to increase. The percentage of the freeze is portable if the senior citizen were to move to a different property.

**Income Tax Incentives**

Income tax incentives also include deductions and credits. Tax deductions are reductions in a taxpayer’s taxable income, which in turn lower the amount of that taxpayer’s income tax liabilities (that is, his or her taxes owed). Tax credits, on the other hand, are immediate, dollar-for-dollar reductions in a taxpayer’s tax liabilities. For example, if a taxpayer owes $100 in taxes and claims a $25 tax credit for the same tax year, then she or he owes only $75 in taxes.

Common tax-deductible expenses associated with real estate purchase and ownership include mortgage interest, real estate taxes, discount points paid at closing, and loan origination fees. In addition, married couples who sell their principal residences are exempt from the capital gains tax up to $500,000, and homeowners who are single are exempt up to $250,000 (Both are examples of a tax-free gain on the sale of a house).
Consider the following example: A taxpayer and homeowner sells her principal residence, realizing $40,000 in capital gains. If she makes $38,000 a year and paid $1,000 in mortgage interest in the year of sale, what is her taxable income?

To solve this problem, we simply subtract the taxpayer’s exemptions from her income:

\[
\begin{align*}
&\text{\$38,000 Gross Income} \\
&\text{\$40,000 Capital Gains Income} \\
&\text{\$40,000 Capital Gains Exemption} \\
&\text{\$1,000 Mortgage Interest Exemption} \\
&\text{\$37,000 Taxable Income}
\end{align*}
\]

**Impact of the Economy**

Supply and demand are the basic forces that control markets. A market is a theoretical construct that isolates the selling and purchasing of any one particular commodity from the economy as a whole. For instance, the sale of residential property constitutes a specific real estate market, and the sale of loan products by lenders constitutes another. For real estate finance, more than for any other type of real estate studies, it is necessary to know the basic workings of the market and, most especially, the impact of supply and demand.

**Demand**

The demand for real estate is affected by several factors. Price is the clearest example. When real estate costs more, fewer people are willing to buy. The price of a particular piece of real estate is influenced by many things, such as increases in construction costs, the cost of financing, and property taxes.

Additionally, the price of purchasing real estate can be affected by the prices of other commodities. For instance, if the cost of leasing an apartment is low, the cost of purchasing a house might decrease to attract more buyers.
The second factor affecting real estate demand is personal income. If the average salary goes down, or the unemployment rate goes up, the demand for certain types of housing is likely to decrease.

Finally, a buyer's expectations of the future state of himself or herself, and of the economy as a whole, will affect the demand for real estate. If buyers expect that their income will decrease in the near future; if they expect that the price of housing will decrease in the near future; or, if they expect that the price of housing will decrease at the time they expect to sell their house, then they may be less likely to buy.

The market demand for a commodity is often represented graphically by economists. In the graph below, the demand curve for real estate is shown. As price increases (vertically), the quantity of real estate buyers is willing to purchase (horizontally) decreases; as price decreases, the quantity increases. Each point on the curve represents a possible state of the current market: for example, at an average price of $100,000, buyers in this market are willing to purchase 15,000 properties.

**Demand Curve:**

![Demand Curve for Real Estate](image-url)
The Texas Real Estate Center at Texas A&M reported this in June of 2016 regarding the Texas Economy:

The state gained 169,400 non-agricultural jobs from May 2015 to May 2016, an annual growth rate of 1.4 percent, lower than the nation's growth rate of 1.7 percent. The nongovernment sector added 134,000 jobs, an annual growth rate of 1.3 percent compared with 1.9 percent for the nation's private sector.

According to the Real Estate Center's latest Monthly Review of the Texas Economy, the annual employment growth rate in May 2016 was lower than the corresponding growth rates in the past four months, suggesting that the state's slow labor market recovery may be fragile.

Texas' seasonally adjusted unemployment rate in May 2016 was 4.4, the same as in May 2015. The nation's rate decreased from 5.5 to 4.7 percent.

All Texas industries except mining and logging, manufacturing, and the transportation, warehousing, and utilities industries had more jobs in May 2016 than in May 2015. Leisure and hospitality ranked first in job creation followed by education and health services, financial activities, and trade.

All Texas metro areas except Beaumont-Port Arthur, Longview, Midland, and Odessa had more jobs in May 2016 than in May 2015. Dallas-Plano-Irving ranked first in job creation followed by Austin-Round Rock, College Station-Bryan, Lubbock, and San Antonio-New Braunfels.

The state's actual unemployment rate in May 2016 was 4.2 percent. Amarillo had the lowest unemployment rate, followed by Austin-Round Rock, Lubbock, College Station-Bryan, Dallas-Plano-Irving, and San Antonio-New Braunfels.

(Source: https://assets.recenter.tamu.edu/documents/articles/1862.pdf)
Supply

Supply is an economic term meaning the willingness and ability of sellers in a given market to sell their property. Several factors affect supply. First among these is the selling price: As the price of housing increases, owners become more willing to sell. Similarly, as the price of a loan increases—that is, as the interest rate goes up—lenders become more willing to lend (but buyers become less willing to take loans because of the higher interest rate).

To some extent, price does not play as important a role in real estate as it does in other types of commodities. For example, apartment complex managers are not more willing to rent when the price of apartments increases than when it decreases because to not rent is to not receive income—although they may be more desirous to offer long-term leases.

The supply of real estate also is affected by the cost of its production. If construction costs go down, it is cheaper to build houses, apartments, and office buildings, so more appear on the market. If, on the other hand, the cost of construction goes up, the greater expense to builders makes new housing scarcer. An increase or decrease in the price of raw land has a similar effect. However, because real estate is a long-lasting commodity, there is usually an existing supply of houses that have already been built on the market.

Finally, expectations affect supply as much as demand. If sellers expect the price of real estate to go up in the near future, they will be less likely to sell right now; and if sellers expect the price to go down soon, they will be more likely to sell now. The case is similar for lenders as the interest rate is expected to increase or decrease. However, lenders are much like apartment managers. They cannot afford to not receive interest for any significant period of time.

As with demand, supply may be represented graphically as a function of price. As you can see, supply increases when price increases and supply decreases when price
decreases. On this supply curve we can see that, at an average price of $100,000, the sellers are willing and able to supply 25,000 properties in this particular market.

Supply and Demand
The two forces of supply and demand together help to determine the actual price and quantity of real estate on the market. The law of supply and demand states that the forces of supply and demand push the market price of any commodity to one particular point, the market equilibrium. This equilibrium is the point at which the supply and demand curves cross.

The graph below combines our supply curve S with our demand curve D to determine the market equilibrium. In this case, the equilibrium is a price of $95,000, at which buyers are willing to buy 20,000 properties. This means that if the average market price exceeds $95,000, sellers will have properties that they are unable to sell; and if the market price falls below $95,000, there will be more people who want houses than there are houses to be purchased.
Supply and Demand:

The supply curve and the demand curve for any particular commodity are independent of each other; however, they are not independent of the curves for other commodities. For instance, because most real estate is purchased with borrowed money, the supply of loans affects the demand for real estate. The supply of loans is in turn affected by the supply of money and the interest rate. This will be important to know when we discuss the Federal Reserve’s monetary policies and their effect on the real estate market.

In short, one very important factor affecting the supply and demand of housing is the supply of money. In general:

- The higher the supply of money available to finance real estate ventures, the higher the demand for housing.
- When the demand for housing becomes higher than the supply, property price increases.
- The lower the supply of money available to finance real estate ventures, the lower the demand for housing.
- When the supply becomes higher than the demand, property price decreases.
This, in effect, is the real estate cycle, which repeats itself according to the conditions of supply and demand. Therefore, any person associated with the buying and/or selling of real estate should know the current economic cycle.

What a Great Time to Buy a House

Compare the mortgage interest rate in January 2016 with the rate in January 1982. It is 3.87 today compared to 17.48 in 1982.

Average Commitment Rate and Points on 30-Year Fixed-Rate Mortgages Since 1971

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<td>13.82</td>
<td>2.2</td>
</tr>
<tr>
<td>December</td>
<td>9.32</td>
<td>2.1</td>
<td>11.26</td>
<td>2.3</td>
<td>13.18</td>
<td>2.5</td>
<td>13.42</td>
<td>2.2</td>
<td>13.62</td>
<td>2.2</td>
</tr>
<tr>
<td>Annual Average</td>
<td>10.19</td>
<td>2.2</td>
<td>12.43</td>
<td>2.5</td>
<td>13.88</td>
<td>2.5</td>
<td>13.24</td>
<td>2.1</td>
<td>16.04</td>
<td>2.2</td>
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</tbody>
</table>

(Source: http://www.freddiemac.com/pmms/pmms30.htm)

A Practical Use of Supply and Demand for a Real Estate Agent

One of the things that real estate agents use when evaluating a property to help a seller select a good listing price is to research the number of homes that have sold in the market area in the last three months. For example, if nine homes have sold in this area in the last three months then we know approximately three homes sell per month. If there are 15 homes listed for sale in the same area we know there is a five month supply of housing on the market. If this is a seller that wants to sell quickly, they may need to make sure their price is competitive with the best three or four properties listed.

On the other hand, if three sell a month and there is a total of four homes for sale in the area they may be able to stay a little higher and still get attention and a sale. When you are the listing agent you will want to stay constantly aware of property coming on the market and where your listing fits competitively.
Another article published by the Real Estate Center at Texas A&M in July 2016 read as follows:

**Not Back Yet: Some States Still Lagging After Great Recession**

*By Harold D. Hunt and Luis B. Torres (Jul 1, 2016)*

It should come as no surprise that the Texas economy has outperformed most states and the United States as a whole over the last decade. However, it may be surprising to learn that by the end of 2015, 11 states still had not returned to their prerecession employment levels.

Texas had matched its prerecession nonfarm employment peak by the end of 2011, a period of only three years. The U.S. took seven years, attaining parity in 2014.

Based on the Federal Housing Finance Agency’s (FHFA) home price index, home prices in ten of those 11 states also had not returned to their prerecession highs by the end of 2015. Housing prices in the U.S. ended 2015 barely above their prerecession peak as well. While Texas recorded a small dip in home prices during the recession, it was nothing like the double-digit drops in many states.

Why did Texas employment and home prices perform so much better than the 11 hardest hit states and the U.S. overall during one of the worst economic downturns in decades?

The general thought is that a boom in oil and gas activity occurred at just the right time to carry Texas through the recession. That is indeed part of the story, but head-to-head data comparisons reveal that Texas has been at a comparative advantage for some time.

(Source: https://assets.recenter.tamu.edu/Documents/Articles/2135.pdf)
Texas is a Top Business Destination

- In 2016, Chief Executive Magazine named Texas the “Best State for Business” for the 12th year in a row.
- Texas received an A+ on Thumbtack’s Annual Small Business Friendliness Survey in 2016.
- Texas is home to over 50 Fortune 500 companies.
- The Tax Foundation ranks Texas one of the top 10 states for lowest overall tax burden.
- Texas’ corporate franchise tax levies a low flat rate of 0.75 percent (for most entities) on taxable margins.
- Texas has no personal income tax.
- Texas is a right-to-work state.

Infrastructure

- Texas’ central location within North America facilitates domestic and international transportation, as well as easy access to markets.
- Texas has more miles of public roads (over 313,220) and freight rail (10,425) than any other state.
- Texas has 11 deep-water ports, with channels at least 30 feet deep along the Gulf Coast.
- The state’s two largest airports, Dallas-Fort Worth International (DFW) and George Bush Intercontinental in Houston (IAH), are major domestic and international hubs.
- Texas’ two intermodal facilities, Fort Worth’s Alliance Airport and San Antonio’s Port San Antonio, integrate high-capacity industrial airports, Class I rail terminals, and direct interstate highway access.

International Trade & Investment

- In 2015, Texas was the top exporting state for the 14th consecutive year with exports valued at over $251 billion.
• Texas' top exports are petroleum products, computer and electronic products, chemicals, nonelectrical machinery, and transportation equipment.
• Texas' top export markets include Mexico, Canada, China, South Korea, and Brazil.
• Texas is a top-ranked destination for foreign direct investment (FDI). Texas ranks second nationally for the number of jobs at U.S. subsidiaries of global companies and the number of manufacturing industry jobs at U.S. subsidiaries, according to the Organization for International Investment.
• Texas retains an investment-ready portfolio of cutting edge companies, across a number of industries.

Incentives
• Property tax abatements
• Permitting fee waivers
• Local cash grants
• Local funding to business-related infrastructure and recruitment, equipment, land, and economic development purposes.
• The Texas Enterprise Fund (TEF) is the largest “deal-closing” fund of its kind in the nation. For select projects, the TEF may provide cash grants for business expansion or relocation to Texas.
• The Texas Enterprise Zone Program provides state sales and use tax refunds to qualified projects in economically distressed areas of the state.
• The Texas Skills Development Fund provides financing for customized job training programs for businesses who want to train new employees or upgrade the skills of their existing workforce.
Information Resources

One of the best resources to maintain your knowledge of the current economic cycle in Texas comes from the Real Estate Center at Texas A&M. They issue a monthly report that covers employment, unemployment, growth of different communities, building permits, housing activity, and more.

In addition, the Real Estate Center provides education in the form of various conferences, and they publish a monthly magazine for Texas licensees called the Tierra Grande that provides statistical information about Texas real estate. Visit the Texas A&M Real Estate Center at http://recenter.tamu.edu/.

The Texas Association of REALTORS® has a site focused on educating home buyers. The site includes information regarding various types of available affordable housing financing, how student loans affect financing a home and how to avoid mistakes between loan approval and closing. The site also has an article on Four Reasons to Contract a Texas REALTOR®. The Texas Association of REALTORS® public site: https://www.texasrealestate.com/for-buyers-sellers-renters/buying-a-home

Another great resource is the USDA Home Loans and First Time Homebuyers. USDA loans are an ideal option for first time homebuyers. However, you do not have to be a first time homebuyer to get a USDA loan. One advantage is that the USDA Home Loan Program does not require a down payment. This is beneficial since some buyers have not been able to save for a down payment and for the closing costs associated with most mortgage programs. Visit the USDA Rural Development website at http://www.rd.usda.gov/tx.

The Texas Veterans Land Board offers home loans, home improvement loans and land loans for Texas Veterans and unmarried spouses of veterans currently residing in Texas. Their website is http://www.glo.texas.gov/vlb/loans/home-loans/index.html.
Review

Fill in the blanks from the list below. Words can be used more than once.

1. Local banks that lend their own money and do not sell their loans on the secondary market are ______.

2. ______ specialize in financing for income producing properties such as shopping centers, industrial and office properties and multi-family homes.

3. Over ______ individuals are employed in the real estate finance industry across the United States according to the Mortgage Bankers Association.

4. Lenders consider a borrower’s ______, ______, _______, source of funds, and net worth.

5. ______ and the rights to ______ them often are bought and sold.

6. ______ is responsible for the day-to-day management of your mortgage loan account, including collecting and crediting your monthly loan payments, and handling your escrow account, if you have one.

7. ______ is a fund held by your servicer that you pay into for property taxes and homeowners insurance.

8. The mortgage servicer is required to give you a free ______ that details the activity of your escrow account, showing, your account balance and payments for your property taxes, homeowners insurance and other escrowed items.

9. If your loan is transferred to a new servicer, you generally get two notices: one from your ______ and one from your ______.
10. The sales comparison approach to value bases its opinion of value on what similar properties (otherwise known as ________) in the vicinity have sold for recently.

11. A loan that has monthly payments for a number of years but does not fully amortize and has a balance due at the end of the terms is a ________.

12. The ________ approach to value seeks to determine how much a property would cost to replace (meaning, rebuild) after subtracting accrued depreciation.

13. The ________ loan has monthly payments that are applied to the interest only for a set period. All of the principal on the loan is due at the end of the term.

14. A tax ________ reduces the amount of income taxes will be based on.

15. A tax ________ reduces the amount of taxes due.

16. PMI is for the protection of the ________, the cost of the insurance is charged to the ________.

17. ________ provides an addendum for the parties to negotiate Seller Financing.

18. ________ can buy a home with a -0- down payment.
Review

1. portfolio lenders
2. Commercial lenders
3. 280,000
4. income, credit, debt
5. Loans, service
6. The Loan servicer
7. An escrow account
8. annual statement
9. current servicer, new servicer
10. comparables
11. balloon loan
12. cost
13. interest only
14. exemption
15. credit
16. lender, borrower
17. TREC
18. Veterans

Lesson Summary

Employees in the real estate finance business may be working for firms including pension fund companies, insurance companies, private-equity firms, to commercial lenders. They may be an investment banker, a mortgage banker or broker, or an underwriter.

Major commercial loan business is done with refinancing old loans, new construction loans, permanent financing on leased projects, mezzanine debt, and acquisition loans. Job functions in the field involve consulting potential borrowers and originating loans, servicing existing loans by making sure payments are being made and taxes and insurance are paid, selling pools of loans on the secondary market, and much more.

Loan underwriters evaluate deals to determine loan amounts, creditworthiness of borrowers, and income potential of projects. Lenders usually specialize by product type including single family residential, multi-family, retail, office, industrial, and more.
Most real estate is purchased with borrowed money. The methods of real estate finance are many and varied. Making real estate loans carries a certain amount of risk for lenders; for this reason, lenders must have a firm grasp of a borrower’s financial qualifications. Lenders consider a borrower’s income, credit, debt, source of funds, and net worth.

During this course you will learn the methods used by lenders to qualify loan applicants and property to be mortgaged. Methods of valuation of real estate will be discussed in depth so that you will feel confident and familiar with them.

The real estate market typically moves through four phases before going back and repeating again. Those phases, as labeled in one article, can be described as:

- Phase 1: Recovery
- Phase 2: Expansion
- Phase 3: Hyper supply
- Phase 4: Recession

Real estate finance is constantly in a state of flux, and there are several factors that cause this. First among them is the real estate market: the supply of and demand for real property. The real estate market affects, and is affected by, the primary and secondary lending markets.

The demand for real estate is affected by several factors. Price is the clearest example. When real estate costs more, fewer people are willing to buy. The price of a particular piece of real estate is influenced by many things including increases in construction costs, increases in the cost of financing, and increases in property taxes.

According to an article published by the Texas A&M Real Estate Research Center in July 2016, the general thought is that a boom in oil and gas activity occurred at just the right time to carry Texas through the recession. That is indeed part of the story, but
head-to-head data comparisons reveal that Texas has been at a comparative advantage for some time.

Statistical information regarding Texas real estate and the economy can be found at the Texas A&M Real Estate Center. The Real Estate Center also publishes the Terra Grande, a monthly magazine that furnishes statistical information for Texas licensees. For information regarding first time home buyers and other programs for help with down payments and closing cost, the USDA website is a valuable resource.

The website at Texasrealestate.com is provided by the Texas Association of REALTORS® and answers many questions for home buyers and gives them information about the different types of financing available for low income buyers.

Please return to the course player to take the lesson quiz.