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Feburary 2004 www.kirchmeyer.com Issue #66

INSIDE...

1 • Honoring rate locks
2 • Rate locks (cont.) • Appraisers central to new home mortgages
3 • New builds (cont.) • Employee feature
4 • Menu of Services • Calendar of events • Our web

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Why do some lenders fail to honor rate locks?

By Jeff Guttentag

Inman News Features

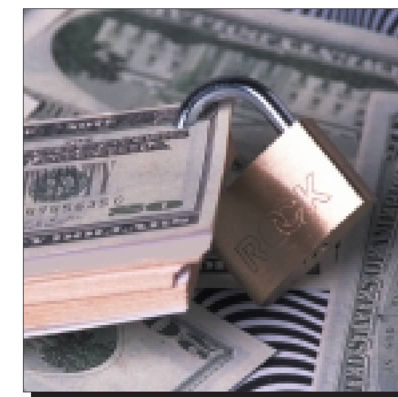
Why have lock failures increased recently?

A lock failure occurs when a lender refuses to honor a mortgage price that a borrower had believed was guaranteed. Lock failures occur when interest rates are rising and honoring locks is costly to lenders. The bulge in lock failures in recent months reflects an increase in interest rate volatility, relative to prior years. When market interest rates are stable or declining, locks are always honored because it doesn't cost lenders anything to do so. If a lock expires because the loan could not be fully processed within the lock period, the lender will extend it. In a rising rate market, however, expired locks will be extended only at the new market rate.

But saying that mortgage lock failures result from rising interest rates is like saying that the failure of a casualty insurance company to pay off on a fire was a result of the fire. Mortgage locks are supposed to protect borrowers against rising interest rates. The fact that the protection often fails reflects weaknesses in the lock system.

Why are mortgage locks so unreliable?

One reason is that the adverse event that triggers the insurance - a rise in interest rates - affects every locked loan in lenders' pipelines. In contrast, the adverse event that triggers homeowner insurance is usually an isolated event. One house fire will not seriously damage a casualty insurance company, but a rise in interest rates can force a lender who is not adequately hedged into insolvency.



Most lenders hedge against a major hit to their profitability from rising rates. They hedge by executing transactions that will increase their profits when rates increase, offsetting their lock losses. A lender who is fully hedged would not be affected by a rise in rates, but since hedging is costly, few lenders are fully hedged. A long period of declining interest rates weakens the lock system. Hedging during such a period is money down the drain, so lenders are tempted to do less of it. And a few may actually adopt a "go-for-broke" policy where they don't hedge at all. They look to make as much money as they can during the low-rate period, and go out of business when it ends, leaving failed locks behind. Indeed, a significant proportion of the failed locks in 2003 can be traced to one large lender who evidently pursued such a policy. When it closed its doors, hundreds of borrowers were left stranded.

(continued on page 2.)

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failed rate locks

(continued from page 1.)

Another weakness of the lock system is that some borrowers, especially among those refinancing, game the system. They lock the price with a lender, but if rates decline, they lock again with another lender. This practice raises the cost of locking, pushing lenders to find ways to protect themselves.

Some lenders try to protect themselves against this practice by charging a lock fee that is credited back to the borrower at closing but is not refundable if the borrower walks from the deal. Or the lender may insist that the borrower pay one or more fees, such as an appraisal fee, which the borrower would have to pay again if he went with another lender. These are fair conditions, but lenders who impose them place themselves at a competitive disadvantage, so they are far from universal.

A less savory practice that underlies many lock failures is to load the loan approval with conditions that allow the lender to back out. Every lock is conditioned on the borrower being approved for the loan, and approval is frequently subject to conditions. Most of these are completely reasonable, for example, the removal of a lien on the property. But some conditions are designed to allow the lender to exit the lock lawfully.

I recently heard of an interesting one from a puzzled borrower. His commitment letter stated that if the loan application, which the lender had approved, was rejected by the investor to whom the lender intended to sell the mortgage, the lender's lock was no longer valid. This borrower was alert, caught the condition, and asked me what I thought about it. I told him that it was the lender's responsibility, not his, to determine whether he met the investor's requirements. The lender removed the condition.

Many lenders would rather protect themselves with contractual escape clauses rather than charging a non-refundable fee because they know that most borrowers don't read contracts, but fees drive them away. Other things the same, smart borrowers should prefer lenders who charge a non-refundable lock fee. Lenders who protect themselves from being gamed in stable and declining rate markets are more likely to honor their locks in a rising rate market.

The writer is Professor of Finance Emeritus at the Wharton School of the University of Pennsylvania. Comments and questions can be left at www.mtgprofessor.com.

Appraiser 'central' to mortgage process on newly built home

By Katherine Salant

Inman News Features

New-home buyers know that an appraiser stands between them and a mortgage, but few appreciate the appraiser's central role in the mortgage underwriting process or what, exactly, the appraiser does. He or she assigns a value to your proposed new house, based on what buyers have paid for properties that are similar in age, size and location. This information is critical to the lender because he needs corroboration that the house is worth at least what he is lending to you. In the worst-case scenario, you default and he has to unload your house in a foreclosure sale. The lender wants assurance that he can get his money out.

The lender turns to the appraiser for this information because he is an objective third party who has no vested interest in the sales transaction itself. The appraiser is paid a flat fee for his services, and, unlike the broker, the seller and the buyer, he has nothing to gain or lose in determining a dollar value for it.

When the transaction is a production house in a subdivision where the builder has four models,the appraiser's job is easy because the builder is selling the same houses over and over, and there is a ready measure of how other buyers value the house that you want. If you are building a custom house and need a construction loan, the appraiser's job is much harder because there is no existing house to examine. He has to pour over your drawings and specs and compare them to other, similar custom houses. If the documentation is not a complete bid set, which is often the case, he will have to make specific assumptions about roofing materials, siding, kitchen cabinets and other missing pieces of information, said Great Falls, Va., residential appraiser William Harvey, who added that it is in the owner's best interest to ensure that an appraiser has as complete a bid set as possible.

After your house is finished, the appraiser has to inspect the finished house to ensure that it merits his earlier evaluation. This can sometimes bring unwelcome surprises. Karen Mann, a residential appraiser in Fremont, Calif., recalled measuring a finished house that turned out to be 345 square feet short. After determining that the final cost of the house was $162 a square foot, the builder had to refund $54,200 to the owners.

If you want to build a custom house that is unusual for your market, the appraiser may have a hard time comparing it to other houses and arriving at a valuation. He may have to use older properties or compare it to houses that are not that similar. And, he may decide that the value of the house is less than the builder is charging you, based on the sales data available in your market area.

To get your construction loan you may have to put up a bigger down payment than you expected. This is unusual, but it is a risk that owners run when they decide to build something that is out of the mainstream, said Mark Simpson, director of property and valuation standards and practices at Fannie Mae, a federally chartered corporation that buys home mortgages on the secondary mortgage market.

(Part 2...to be continued in our March issue)

Interested in AVM's?

Interested in AVM's? Real-info has just produced a guide which explains in layman's terms what an AVM is, how the AVM helps the appraiser, broker, lender, and more importantly, how it saves our client's money! If you are interested in this FREE guide, please contact Jim Kirchmeyer via e-mail at jakirch@real-info.com and request one today!

Employee spotlight

Amy Wittman

WORKS FROM: Buffalo, NY Headquarters

PHONE : 800-771-5246 ext 130 or 716-558-2800 ext 130

E-MAIL: amyw@kirchmeyer.com

POSITION: Team Leader – Order Entry Dept.

JOB DUTIES: Amy is responsible for checking, verifying, and entering all orders into our secure web site. She is also responsible for all calls regarding fees and turn times and for initial assigning of all orders in our Buffalo, Rochester and Syracuse markets. Amy also takes care of confirmation reports sent to us by certain lenders.

When not at work, Amy enjoys spending time with her husband, camping, hiking, watching a good movie or sporting event, and hanging out with her friends.

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