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## **NEWSLETTER**

**NOTE: If you think your colleagues would benefit from this TIP, please forward it to them and ask them to reply to me by email for inclusion in this free Newsletter.**

**Also, if you have a topic you would like me to analyze and discuss, please email me and I would be glad to consider it in a future Newsletter**

A realtor recently wrote me:

*It is very confusing how to handle inspection credits. Some mortgage companies require inspection credits to be phrased as "credit towards closing costs and pre-pays". For example: If the inspection credit is \$6,000 for a new roof, the mortgage company may require the roof to be done before closing but the seller does not have the money to do so. Then if the closing costs are less than the credit who gets to keep the overage? Can a buyer walk away from the closing table with cash? (I may have now entered into another topic) Any advice you have on this topic will be greatly appreciated. Thanks so much!*

There are many questions contained in this inquiry. If the Seller does not have the money to do a roof repair prior to closing, we can solve this dilemma by convincing the lender's underwriters to allow the closing to occur and permit an escrow from the closing proceeds of 150% of the cost of repair with an agreement of the Buyer to complete the work post closing within a reasonable period of time.

The balance of the questions raises several other complex problems, made more so because many people think they are not complex. I think it easier to understand if I address the general question of how Lenders perceive and deal with the following questions:

### **Questions:**

- 1) What is the relationship between the Sales Price of a contract and the maximum amount of a Mortgage Loan?**
- 2) What are the Seller Credits to Buyers that are recognized by Lenders as not affecting the maximum loan amount?**

### **Answers:**

1) One of the primary Lender principles in determining the maximum amount of a mortgage loan is the sales price of the property. The reasons are plainly obvious. Lenders will customarily fix the maximum loan amount as a percentage of the Sales Price. Such an analysis requires the sales price to be an exact

figure. The price, according to lender guidelines must be, for example, \$300,000.00, not \$299,995.00. Surprisingly, even a \$5.00 variance can throw a closing into a tailspin!

**Is the contract sales price the only variable used to determine the maximum loan amount?**

The general rule is that the Lender sets a maximum loan based upon the LESSER of:

1. the sales price in the contract, OR
2. the sales price in the contract minus any Seller Concessions or credits to the Buyer, OR
3. the appraised value of the property.

Now here is the Key!

A Seller Concession or Credit is any reduction in the Sales Price for any reason **EXCEPT** a Concession to Credit for ***Seller paid Buyer-closing costs***. The Lender industry does not consider it a Seller Concession or credit that affects the sales price if the Seller pays some or all of the Buyer's closing costs (usually, but not always, up to 3-6% of the sales price).

I am going to give concrete examples of how this works. Assume the Seller wants to net \$300,000.00 and you want the Seller to pay \$5,000.00 of the Buyer's closing costs. You then write a contract for \$305,000.00 with a provision for seller-paid buyer's closing costs of \$5,000.00 netting the Seller \$300,000.00. We will assume no appraisal problems. You want the Lender to accept the sales price at \$305,000.00 and set the maximum loan amount using that number.

Whenever preparing a contract with seller-paid closing costs as a term, always be as certain as you can that the appraised value of the property is at least the net price to the Seller plus the amount of seller-paid closing cost. For example, if the Seller wants to net \$300,000.00 and the seller-paid closing costs are \$5,000.00, the gross sales price must be \$305,000.00 and the property must appraise for \$305,000.00 to make the deal work.

If you have a sales price of \$300,000.00 with a seller repair credit of \$5,000.00 and the property appraises for \$290,000.00, the Lender will consider \$290,000.00 as the basis for setting the maximum loan amount, not \$300,000.00 or \$295,000.00. However, if you have no appraisal problems, the Lender will consider the sales price to be \$295,000.00 if the credit is for repairs of \$5,000.00 and thus set the maximum loan amount using \$295,000.00 as the basis.

Thus if the Seller and Buyer reduce the contract price by \$5,000.00 as the result of negotiations for a faulty furnace or a damaged roof, the Lender will consider the real Sales Price (assuming you have not appraisal problems) to be the contract price minus the negotiated reduction. Thus, if the contract price is \$300,000.00 and the cost of repair is \$5,000.00, the net sales price is \$295,000.00. That amount (\$295,000.00) is the amount the Lender uses to determine the maximum Loan amount. Thus if the Buyer is seeking a 95% loan, he or she would obtain a loan of \$280,250.00 on a price of \$295,000.00, not a loan of \$285,000.00 on a price of \$300,000.00. Big difference!

However, to use the same number example and again assuming no appraisal problems, if the \$5,000.00 credit were stated in the contract as a credit for Closing Costs and not repairs, the sales price would become \$305,000.00 in order to net the Seller \$300,000.00. The Lender would consider the sales price to be the contract price of \$305,000.00, not the net to the Seller of \$300,000.00 because a closing cost credit is not considered a Seller Concession!! Thus, the Buyer would get a 95% loan of \$289,750.00, not \$285,000.00! What an important difference!!

Now, suppose the contract called for the Seller to give the Buyer at closing a \$5,000.00 credit for closing costs and the actual closing costs came in less than \$5,000.00, what happens at closing to the difference? As an example, if the actual closing costs were \$4,500.00 and the contract Seller-paid closing cost credit was \$5,000.00, what happens to the \$500.00 difference? Does the Seller keep it? The answer is, unfortunately, yes. The Seller can walk away with a windfall. Why, because the HUD-1 closing statement prepared by the lawyers must, by law, reflect accurately the true uses and distributions of funds at closing. It is a Federal crime to do otherwise.

2) Do you, as a realtor, have the power to prevent or at least alleviate this unfairness from occurring? You have raised the sales price from \$300,000.00 to \$305,000.00 (assuming again no appraisal problems) and have given the Buyer a closing cost credit of \$5,000.00. What if the closing costs are actually \$4,500.00? How do you prevent the Buyer from losing \$500.00? **The best solution to this question is the answer to the second question.** Unfortunately, there is no black and white answer. The best you can do is to speak to the Lender or Mortgage Broker before you write the offer (hopefully the Buyer has provided a pre-approval letter from a Bank or Broker) and determine the closing costs from the Good faith Estimate. Obviously you can ask this question of Lenders outside the context of a particular closing by calling any lender or broker at any time you have a moment. Simply ask the Lender or the Broker what amounts the Lender considers to be closing costs that can be paid by the Seller as an approved credit. Armed with this information, you can carefully write in an amount in the contract.

Some Lenders will allow escrows to be considered closing costs. Some will allow the short term interest as a closing cost. Pre-paid annual insurance premiums are another possible permissible closing cost. You must ask as many lenders as possible to get a good idea of what expenses are considered as permissible pre-paid closing costs. This way you can have the necessary information to insert the correct amount in the contract.

I hope I have addressed these questions clearly. If anyone has any further questions on these issues, please let me know.