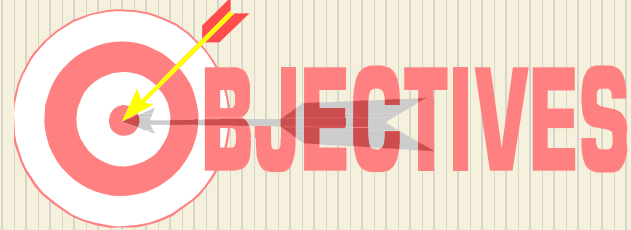


LESSON ELEVEN

QUALIFYING THE BORROWER

STUDENT LEARNING OUTCOMES (SLOs):



1. *Cite some of the more important reasons why lenders need to scrutinize applicants for real estate financing.*
2. *Offer an example for each of the "Cs of Credit".*
3. *Discuss how lenders assess the credit-worthiness of prospective borrowers.*
4. *Evaluate the stability and durability of income, and the quantity and quality of borrower assets.*
5. *Contrast income and expense requirements for conventional, FHA, DVA, and Cal-Vet loans.*
6. *Consider the roles that Fannie Mae and Freddie Mac play in the qualification process.*

I. WHY QUALIFY BORROWERS?

- A. Role of the lender
- B. High LTV Ratios
- C. Borrower obligations
- D. FICO Scoring

1. The percentage breakdown of a **FICO** score:

- a. 30% - **payment** history
- b. 30% - debt **ratio**
- c. 15% - length of **credit** history
- d. 10% - **types** of credit
- e. 10% - number of credit **inquiries**

FICO Score

5. FICO credit score range = 300-850
 - a. Below 600 = **high** risk borrowers
 - b. 620 is the **dividing** line between good and bad
 - c. 640 or above = “pretty good”
 - d. 650 as average general credit-use behavior
 - e. Above 690 or 720 = excellent
 - f. 723 = **median** FICO score of Americans
 - g. formula of scoring the applicant to evaluate the credit

Credit

E. Credit score is based on a **statistical** analysis of individual's credit files .

It answers the question:
“What is the likelihood that people **will** pay their bills?”

The score is obtained from one of three major credit bureaus: Experian, Trans Union, and Equifax.

Income is **NOT** considered.

F. Risk Is believed to be highly **predictive** of future payment risk.

1. Using a credit scoring system may remove **subjectivity**
2. The applicant's score is derived by evaluating the credit information at a particular point in **time** and assessing points for each credit item.
3. FICO scores do vary, depending on the credit depository used and the applicant's geographical location. Having credit “pullings,” commonly referred to as **inquiries**” on the credit report, affect one's FICO score (may lower the score).

Credit

- G. Individuals are entitled to one **free** credit report within a 12-month period.

- H. Under the Fair Credit Reporting Act, a consumer is entitled to one free credit report within **60** days of any adverse action, e.g., being denied credit or receiving sub-standard credit terms from a lender.

- I. Under the Wall Street reform bill passed on 7/2/2010, a consumer is entitled to a free credit report score if **denied** a loan or insurance due to their credit rating.

II. WHAT ARE THE “C”*s* OF CREDIT?

1. **COLLATERAL**
2. **CAPACITY**
3. **CHARACTER**
4. **CAPITAL**
5. **CHANGING CONDITIONS**

III. HOW DO CONVENTIONAL LENDERS QUALIFY BORROWERS?

- A. Borrowers are qualified by lenders according to **ratios** (in addition to credit standards and property value and condition), which measure the borrower's **gross** income to the proposed housing expense and gross income to **total** debt obligations (housing expenses plus current liabilities).



B. What about *Front-End (or top)* and *Back-End (or bottom)* Ratios?

1. Front-end ratio.

- This is a fraction whose numerator is the monthly loan payment. The payment includes the condominiums or planned unit developments, homeowner Association dues and the loan, which consists of the Principal, Interest, Taxes, Insurance (hazard, mortgage insurance, flood)(A PITI). The denominator is gross income. Most lenders like to see no higher than a 28% front-end ratio.

2. Back-end ratio.

- This is a fraction whose numerator is the *total* monthly expense, including the loan payment *and* long-term debts, such as car and other installment obligations that are expected to last at least another 10 months.
- The denominator is gross income.
- Most lenders like to see no more than a 36% back-end ratio.

C. The Gap Ratio

1. **Freddie Mac**, the second largest source of mortgage money in the country, considers high overall utilization of **revolving** credit an important factor.

2. Freddie Mac spells out risk-layering factors in three broad categories:
 - a. **Credit**. Its internal test is whether you have more than one credit line, such as credit cards, with more than 50% of the credit maximum utilized.

 - b. **Capacity**. This is the borrower's ability to manage the debts he or she is taking on, including such things as cash reserves and whether the borrower is applying for a "cash-out" refinance.

 - c. **Collateral**. Freddie views the borrower as a higher risk whenever he or she is applying for a loan with a small down payment, seeking maximum financing, or are financing 2-4 units, a condominium, or a manufactured home.

Gap Ratio

3. Total monthly income to total household debt, commonly expressed at a **maximum** of **36%**, has been creeping in the 1990s above 40% and lately to 55% and higher.
4. The Gap Ratio is used in so-called manual underwriting.
5. The Gap Ratio is the difference between the monthly **debt** payment to income **ratio** and the monthly **housing** expense to income **ratio**. If the “gap” between these two ratios should not exceed 15% percentage points.

Gap Ratio

D. Restrictions on the amount of debts

1. Short-term vs. Long-term Debts.
2. Qualifying **long-term** debt
3. Track record to evaluate how applicant handles debt

E. **Offsetting** factors. Such items as time on the job, credit rating / scoring, propensity to save, asset accumulation and job promotion possibilities can offset high ratios that might otherwise disqualifying a loan applicant.

F. Computerization in loan qualification. Secondary market loan purchasers are providing automated underwriting service programs to aid lenders in the loan qualification process. This has not led to an elimination of “live” underwriters. Both of these programs expedite underwriting for the highest quality loans.

1. Fannie Mae’s processing program is called “**Desktop Underwriter.**” A companion system, “Desktop Originator”, allows wholesale lenders to expand their reach to third-party originators by providing quick access to Desktop Underwriter’s findings and analyses.
2. Freddie Mac’s automated processing program is called “**Loan Prospector.**”

FHA Loan Qualification

IV. HOW DOES THE FEDERAL HOUSING ADMINISTRATION (FHA) QUALIFY BORROWERS?

The FHA used to apply a seven-step process, but changed it to a very simple formula that patterns the process used for qualifying conventional borrowers according to the guidelines as set forth by Fannie Mae and Freddie Mac. The only difference is that FHA used a 29% front-end ratio, and a 41% back-end ratio.



DVA Loan Qualification

V. HOW DOES THE DEPARTMENT OF VETERANS AFFAIRS (DVA) QUALIFY BORROWERS?

1. Residual Method –

- The minimum residual income must be sufficient to cover the applicants' **cost** of living (COL).
- Any balance remaining after all deductions and COL expenses is called "**excess residual income**".

- 2. Income **Ratio** Method - Loan applicants may still qualify even though the income ratio guidelines are not met, if the excess residual income is **20%** or more.



Cal-Vet Loan Qualification

- Cal-Vet use to employ a rather complicated qualifying ratio process. It now has changed to mirror that of the DVA, with the 41% debt to income ratio and the residual method of qualifying veteran applicants.



VII. HOW FANNIE MAE and FREDDIE MAC INFLUENCE THE QUALIFICATION PROCESS

A. **Purchase** of qualifying loans

B. Uniformity

C. Qualifying guidelines for the borrower:

- 1. Housing Expenses / Gross Income, should not exceed **28%**
- 2. Combined Fixed Obligations / Gross Income, should not exceed **36%**
- 3. Ratios may be exceeded if offsetting factors are present, such as time on the job, credit scoring, propensity to save, assets owned, down payment, credit rating, and opportunity for job advancement.

VIII. THE ROLE OF PRIVATE MORTGAGE INSURANCE COMPANIES?

A. Insurance provided:

- To protect the lender or purchasing investor from loss due to a **foreclosure**
- Loans exceeding 80% loan-to-value (less than **20%** down payment) will probably require a borrower applicant to pay for mortgage insurance.
- The **cost** of the insurance will depend on the loan program, the loan-to-value, and the lender coverage requirement.

B. Private mortgage insurance companies pattern their qualifying guidelines after that of Fannie Mae and Freddie Mac.

IX. ACCOUNTING FOR INCOME

C. TO WHAT EXTENT IS THE CO-BORROWER'S INCOME CONSIDERED?

D. HOW ARE COMMISSIONS TREATED?

E. HOW ARE SELF-EMPLOYED EVALUATED?

F. HOW IS INCOME FROM REAL ESTATE INVESTMENTS TREATED?

G. 1. HOW IS OVERTIME TREATED?

G. 2. HOW IS BONUSES TREATED?

G. 3. HOW IS PART-TIME WORK TREATED?

I. HOW IS INCOME FROM PENSION FUNDS AND SOCIAL SECURITY TREATED?

H. HOW IS INCOME FROM ALIMONY AND CHILD SUPPORT TREATED?

J. HOW IS INCOME FROM MILITARY SERVICE TREATED?

K. HOW IS INCOME FROM UNEMPLOYMENT AND WELFARE TREATED?

X. ADDITIONAL SECURITY

A. How do Lenders View Co-Mortgagors?

1. Relationship
2. Credit-worthiness
3. Risks

B. What about a Co-Signer?

1. Definition: a **second** party who is to **sign** the promissory **note**, along with the primary borrower.
2. Supplement.
3. Government-backed loans

XI. STABILITY OF INCOME

- A. How long has prospective borrower been on the job?
- B. In what type of work is the applicant engaged?
- C. How much longer will be the borrower be able to continue making payments?



XII. ASSETS OF BORROWERS

A. Sufficiency

B. Back-up **Support**

C. Start-up Funds. FHA is especially strict about borrowing such "front money" except under certain prescribed circumstances, including:

- 1. Borrowing against one's **life** insurance policies.
- 2. Using one's **stock** and certain other collateral as security. Because of its high depreciation and limited resale value, furniture does not qualify as collateral.
- 3. Loan applicants over age **60**, who may be permitted to borrow the necessary down payment.

XIII. WHAT IS MEANT BY THE CONCEPT, DESIRE TO PAY?

- A. How do lenders determine and measure desire to pay?
 1. **Past** payment record
 2. Exceptional circumstances
 3. Motivation
 - a. Down payment
 - b. **Reason** for buying

XIV. WORKING WITH LENDERS

- A. Varying points of view
- B. Role of **licensees**
 - 1. Absurdity
 - 2. Honest
 - 3. **Cooperative** with the lender
 - 4. Further inquiry
 - 5. Government-backed
 - 6. Second-chance
 - 7. Self-examination
- C. Is it really best for the client?

XVII. Predatory Lending

A. Predatory lending practices

1. Predators present **high** interest rates and inflated fees when compared to reputable lending sources.
2. Predators use **bait** and **switch** tactics by presenting one set of terms (the bait), switch to another that is less desirable, then pressure you to accept the less attractive terms.
3. Predators present themselves with similar backgrounds to you, hoping to gain your trust and confidence.
4. Predators claim to offer most everyone a loan, even though common sense would tell you that it is not possible, e.g., no job, no credit, no problem.
5. Predators try to get you to sign the contract **today**. They don't want you to have the time to review of the paperwork.

Predatory lending

B. What should you do?

- Ask **questions**. Check the paperwork to confirm that the answers you have been given are not in conflict with the contract.
- Read the **entire** contract to insure that you understand your obligations and all provisions. Take your time.
- Never allow yourself to be pressured to sign a contract that you are not comfortable with.
- Check to see if you have **cancellation** rights.

Predatory lending

C. Predatory lending practices specifically prohibited by law:

1. Flipping – the frequent making of new loans to refinance existing loans.
2. Packing – the selling of additional products without the borrower's informed consent.
3. Charging **excessive** fees.

D. Facts, not fantasy, is the watchword.

1. Know what you can afford.
2. Manage your credit history responsibly.
3. Do not inflate your earnings or provide false information.
4. Do not allow your decisions to be based on future income increases as there is no certainties with future events.
5. Choose a **reputable** loan representative.