

Chapter 3

The Mortgage Lending Process

In This Chapter

This chapter introduces you to the many roles played by the mortgage professional. It then walks you through the loan process and discusses the important differences between pre-qualification and pre-approval. It provides an overview of the tasks of the mortgage loan originator, qualifying buyers, and documenting mortgage files. Standards relating to income, credit history, and net worth are also discussed. You will also calculate housing expense ratios and total debt-to-income ratios using secondary market guidelines.

At the end of this chapter, you will be able to:

- Define the various roles that mortgage professionals play.
- Distinguish between pre-approval and pre-qualification.
- Identify the steps in the loan process.
- Discuss the information necessary to complete a standard loan application.
- Identify criteria for evaluating borrowers.
- Calculate income and debt ratios.
- Explain credit scoring.
- Discuss the settlement process, including reconciliation.

Assets
Bankruptcy
Credit History
Credit Scoring
Debts
Debt-to-Income Ratio
Discount Points
Float
Housing Expense Ratio
Liabilities
Loan Processor
Mortgage Loan Originator
PITI
Point
Pre-Approval
Pre-Qualification
Rate Lock
Reserves
Servicer
Stable Income
Underwriter
Yield Spread Premium

Role of the Mortgage Professional

Mortgage professionals can work for any bank, credit union, mortgage lender, mortgage investor, or mortgage broker. Depending upon the size of the company, one may need to wear many different hats in the organization. With a large company, duties may lie in just one area, such as taking loan applications from prospective borrowers. In other situations, one might perform any number of functions, and may even be responsible for guiding borrowers through much of the mortgage process. This chapter is designed to give you an overview of the various roles in the mortgage industry. It's important to understand the basics of mortgage lending, and what the duties may be, regardless of who you work for.

Functions of Mortgage Professionals

In addition to the typical duties and paperwork performed in most office jobs, there are specific functions for mortgage professionals, depending on the needs of the company. The terms origination, underwriting, and servicing may seem foreign now, but they have specific definitions that will mean more as you study the mortgage profession.

Origination

Origination is *the process of making or initiating a new loan*. Origination involves being the initial contact to a consumer and taking a loan application. It can also involve ordering a credit report and assembling all of the other forms and documents required by the person or company who is underwriting the loan.

Loan Processing

A loan processor works on the file assembled by the originator. The **processor** is typically *responsible for verification of the information contained in the file* (such as sending out employment verification forms) and also coordination of the various aspects of the loan (such as working with the title company).

Underwriting

Underwriting is *the process of evaluating and deciding whether to make a new loan and, if yes, on what terms*. This is done by the funding source—usually an investor, depository, or mortgage lender, but never by a mortgage broker, who only originates loans for lenders. Underwriting involves evaluating credit scores, credit history, appraisals, job history, and other measures of strength or weakness in the borrower and the collateral. There are specific skills and expertise required for this function that go beyond simply evaluating numbers produced by a computer. Additional experience and training are required in this area.

Servicing

Servicing is *the continued maintenance of a loan after the loan has closed*. This can be done, for example, by a lender, a servicing company set up solely to perform this function, or some other acceptable entity. Servicing involves maintaining direct contact with borrowers, sending mortgage and escrow analysis statements, collecting payments, and pursuing late payments. Often, a primary lender will sell a mortgage to the secondary market, but still service the loan for a fee.

Many mortgage companies offer a combination of these functions to their clients. For one loan, they may provide all of the services: Originate the loan (find the borrower), underwrite the loan (evaluate the borrower), and service the loan (continue to interact with the borrower). If the lender is not able to provide a loan product that meets the needs of a particular borrower, the lender may simply act as a broker and assist in finding another lender in order to earn an origination fee.

The Loan Process

Generally speaking, with today's federal disclosure requirements, borrowers should complete a loan application only when they are ready to buy a particular home. Even if the borrower is *not* ready to make an offer on the house, the borrower may be pre-qualified. This is *not* the same as pre-approving buyers. The two terms are not interchangeable, so it is important to thoroughly understand the differences between them.

Pre-Qualification

Pre-qualification is *the process of pre-determining how much a potential borrower **might** be eligible to borrow.* This may be done by any mortgage loan originator, but it **does not guarantee approval**. Pre-qualification of a buyer is *not* binding on the mortgage broker or lender—which is why the distinction is important. It is a free “test run” of the loan application process that usually takes only a few hours. The mortgage broker or lender is only saying that it looks *favorable* that the borrower will be approved. Often there’s more background research, documentation, and information that the mortgage broker or lender must obtain, but won’t until the borrower has actually applied for the loan. However, if the lender renders a credit decision, the pre-qualification becomes an application and the required disclosures will need to be delivered.

The pre-qualification process involves asking prospective borrowers questions about income and debts. A credit report may be pulled by a MLO, or the borrower may just be asked questions about his or her financial situation. A mortgage loan originator’s pre-qualification of a prospective borrower may be as simple as making sure that the borrower has a steady job and no glaring credit report problems, like a recent bankruptcy. Often, a MLO will compute the borrower’s income and debt ratios to get an idea of how much house a prospective buyer may be able to afford.

Some lenders or mortgage brokers offer a loan pre-qualification certificate form, which is not binding. Assuming a credit decision is not anticipated as a result of this, it does not trigger required disclosures. MLOs may also provide a closing cost worksheet while the loan is still in the pre-qualification state. If such a worksheet is provided, however, it must become a part of the loan file once it becomes a formal application.

Pre-Approval

Pre-approval is *the process by which a lender determines if potential borrowers can be financed through the lender, and for what amount of money.* They are rendering a credit decision. Generally speaking, a mortgage broker *cannot* give a borrower a pre-approval; only the lender can pre-approve. For a pre-approval, a borrower goes through most of the same steps in the loan process, such as completing an application and providing documentation of income and assets. With a pre-approval, a lender is stating that the prospective borrower’s situation has been investigated and, provided all circumstances stay the same, the lender is willing to loan a certain amount of money to purchase a house. This is especially helpful when working with buyers because it is a powerful negotiation tool in getting an offer accepted by a seller and, in most cases, is a requirement of contract acceptance.

Of course, a borrower’s circumstances can and do change which is why there are always conditions listed on a pre-approval. Depending upon internal pre-approval procedures, some pre-approvals are more specific and binding. This is where experience is helpful, and where you should take advantage of the wisdom and experience your employer and other senior mortgage professionals can offer. Pre-approvals are always in writing and always follow the policies and procedures established by your employer or mortgage lender.

Completing an application in anticipation of a credit decision triggers federally mandated disclosures, which includes a Good Faith Estimate of closing costs (GFE) and a Truth in Lending Statement (both of which will be discussed in detail in the next chapter). In order to submit a loan application for pre-approval, the borrower must be given a GFE, which binds the MLO to its terms. While the Department of Housing and Urban Development (HUD) allows a borrower to be pre-approved without identifying a specific property address, mortgage loan originators are *not* required to provide a GFE under such circumstances.

Information related to a loan application must also be reported on the Loan/Application Register (LAR) to comply with the **Home Mortgage Disclosure Act** (12 C.F.R. § 1026.16), which is covered in the next chapter.

Traditional Steps

The real estate loan approval process traditionally consists of four steps, including:

1. Consulting with the mortgage loan originator
2. Completing a loan application
3. Processing a loan application
4. Analyzing the borrower and property

REAL SUCCESS

Traditionally, borrowers went to a mortgage loan originator's office for face-to-face meetings. These days, though, with busy schedules and a competitive environment, many MLOs will visit prospective borrowers at home or at work. The Internet has changed this process as well—many of these steps can now be done quickly and conveniently online or by other electronic means. Answering initial questions, completing a loan application, getting final approval, and closing the loan can all be done electronically. Most of this chapter looks at the process from the traditional approach of meeting with the borrower face-to-face. Keep in mind that regardless of how the application is obtained, the mechanics of the loan process, the steps taken, information needed, and end result are still the same.

Consulting with the Mortgage Loan Originator

Whether a prospective borrower wishes to consult with a mortgage loan originator in person or online, the first step to choose the right one. If a borrower already has a relationship with a MLO, this may be a good place to start. On the other hand, if a borrower has past credit problems, it may be helpful to use a mortgage company that deals with many different lenders, although in today's tight market and stringent credit score qualifying standards, this is not the fix for credit issues it once was. As borrowers decide how to proceed with applying for their loan, remember these points:

- Do not interject your opinion into the situation. Let the person's job history and credit dictate the course of action you suggest. This is especially important if you are a MLO representing many different lenders and loan programs.
- Always let clients or customers have the final say as to how they apply for a loan and with whom.
- If you work with more than one investor or company program, always consult with your mortgage company or employer regarding the policies in all areas before giving any type of advice or recommendation.

After the lender is selected, initial discussions usually involve the various types of mortgages it offers (e.g., 30-year, 15-year, fixed rate, ARM) so the borrower can decide which loan best suits his or her needs. A borrower will need to give the lender a good deal of personal and financial data on which the lender will base the lending decision. Providing the borrower with a complete list of required documents and reviewing these documents early in the application will help speed up the approval process.

When the goal is an actual loan approval (not pre-approval) for a purchase, the **sales contract** will be examined as well. The MLO wants to ensure that it's possible to comply with the terms of the agreement. Of particular concern are the **financing commitment date** and the **closing date**. Often a contract calls for a closing date that is too early to be realistic. If it's impossible for the lender to meet the closing date, a more feasible date can be agreed upon by all parties to the contract to avoid frustration. Loan fees and pricing adjustments may also be listed in the sales agreement.

Interest Rates

One topic that inevitably arises very early in a borrower's conversations with a MLO is the interest rate that may be available. The **interest rate** is the *amount charged by a lender to a borrower for the use of assets, expressed as a percentage of the loan amount (the principal)*. When considering interest rates, you may hear the term **basis point**, which is 1/100th of a percentage point. For example, 325 basis points equal 3.25% or 3 1/4%.

A couple of other terms to keep in mind when discussing interest with borrowers:

- **Par rate** is a term that describes the rate without discounts or points that lenders offer only to mortgage brokers, also known as the "wholesale" rate, that does not create an additional charge or provide for a credit for the borrower.

- **Rate Lock.** This is a commitment guaranteed by a lender that an interest rate will not change on a specific loan for a specific period of time. Since a **lock-in agreement** generally requires that the loan close by a specific date, the anticipated close date should be carefully considered. If a loan closes after the rate lock expires, the lender may choose to offer the market rate current at that time or the original lock-in rate.
- **Float.** Between the time of application and closing, a borrower may choose to bet on interest rates decreasing by electing to float. Floating is essentially choosing not to lock the interest rate. Since it is the borrower's responsibility to lock his or her rate before closing, choosing to float is considered risky and may result in a higher interest rate.

Common Fees Associated with Real Estate Loans

In addition to the **interest**, there are other fees associated with processing a real estate loan, for example, fees for pulling a borrower's credit bureau report, securing a property appraisal report, and for completing inspections. Other items like title insurance and recording fees are paid if and when a loan closes. Fees that occur only when a loan closes are likely to be paid out of closing funds, but other early expenses incurred must be paid, even if the loan doesn't close.

A prior relationship with a mortgage loan originator can help when discussing fees, because the MLO may agree to absorb some smaller costs, such as for the credit report. More costly items, such as a property appraisal, may have to be paid for by the borrower before a final underwriting decision is made.

Lender's return—which you may see referenced as **lender's yield**—is essentially the *total amount of money the lender can make from a loan in relation to the amount invested*. Most of the lender's return is accounted for as a result of interest paid by the borrower. Another opportunity for a lender to recognize return is at closing when the fees are collected from the borrower. A lender could also recognize a return during the loan term through servicing fees or by collecting a fee for those loans that allow a prepayment penalty if the borrower pays off the loan before the end of its term. A lender is generally only interested in the total amount of money it will make from the loan, not necessarily its source.

Title XIV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173), which is designated as the Mortgage Reform and Anti-Predatory Lending Act, prohibits any direct or indirect compensation to a mortgage loan originator that varies based on the terms of the loan, other than the amount of principal (§ 1403 (c)(1)). Final rules that address this provision are covered in more detail in the next chapter.

Loan Origination Fees

For loans that actually close, lenders charge a loan **origination fee** to *cover the administrative costs of making and processing the loan*, including setting up the loan on the lender's books. Such fees may be referred to collectively as **points**. A point is simply *one percent of the loan amount*. So, on a \$120,000 loan, the borrower would have to pay an additional \$1,200 for every point the lender charged as an origination fee. Points can be charged for many reasons, such as closing fees, underwriting fees, documentation fees, etc., but all points serve to help increase the lender's return. Mortgage loan originators base loan fees on what the market will bear.

Another factor the lender considers when determining the number of points charged on a loan is the sale of the loan on the secondary market. For example, a lender may need to sell a loan at a discount to compensate that secondary market buyer for the time value of money. The lender can attempt to make up some of any loss by charging the borrower points. Alternatively, in a competitive environment, some of those fees may even be waived as the lender can sell the loan in the secondary market at a premium. It all depends on the current market and rate of the loan.

A MLO must set the fees to offset the **actual costs and expenses** incurred in the origination of the loan. If not, they can be fined for **upcharging** the borrower, which is *profiting from a third party or lender fee*. For example, on VA loans, this loan fee/origination can be no higher than one point. For FHA and conventional loans, the loan fee/origination varies, but is often in the one- to four-point range.

Origination fees must be disclosed to the borrower on the Good Faith Estimate (GFE) of closing costs within three business days of the MLO's receipt of a completed loan application.

REAL SUCCESS

MLOs can collect a credit report fee at application, but no other fees may be collected until a **Truth in Lending Statement** (TIL) and a **Good Faith Estimate** (GFE)—as required by the Truth in Lending Act and the Real Estate Settlement Procedures Act (RESPA)—are delivered to the borrower and the borrower indicates his or her intention to proceed with the transaction. At that point, other transaction fees—such as for an appraisal—may be charged. Furthermore, RESPA prohibits the collection of any fee unless it was properly disclosed to the borrower on the Good Faith Estimate. In order to keep borrowers satisfied with the mortgage application process and performance of the mortgage loan originator, it is crucial that their expectations are met as to what closing costs are and what they will need to bring to closing.

Discount Points

Discount points represent a *pre-payment of interest at the beginning of a loan for the purpose of reducing the note interest rate charged for some defined period of the life of the loan*. This essentially shifts the timing of when the lender collects its fees for making the loan. With discount points, the borrower pays *more* out-of-pocket upfront in order to pay *less* out-of-pocket later. Discount points, especially if paid by the seller, could allow the borrower to qualify for a loan that would otherwise be impossible to get.

By charging discount points up front, the lender is able to make up the required return on investment that is lost by making the loan **below par rate**. However, it's important to know that to be legitimate, the discount points must reflect a **bona fide reduction** to the market or par rate that is reasonably consistent with established industry norms and practices for secondary market transactions. In other words, a lender could not quote a higher interest rate than the borrower would qualify for, then offer discount points to lower it.

Discount points have traditionally been associated with FHA and VA purchase loans, but points for conventional loans are common in some areas. Although paying discount points to get a lower interest rate would seem to be of benefit primarily to the buyer, discount points can also benefit the seller. Who pays the points is open to negotiation; a seller or builder may be willing to pay discount points to make the property more marketable.

How the discount is priced, in other words, how many points it takes to buy the rate down, is based on many assumptions and calculations by the lender, primary of which is an assumption as to how long the loan might last and where the interest rates are headed. Generally, lenders assume that the typical 30-year loan is either paid off when property is sold or refinanced within eight to 12 years, and will price its discount points with that in mind.

The difference between origination “points” and discount points is apparent on the Good Faith Estimate. All origination points must be lumped together as the origination fee on the GFE, while discount points used to buy down the rate must be indicated as a **charge** the borrower incurs for the interest rate selected. This allows the borrower to make an informed decision about the rate options available and the impact on the loan.

Yield Spread Premium

Yield spread premium (YSP) is a tool that MLOs can use to *lower the upfront cash out-of-pocket expenses at closing* for a borrower in exchange for **higher monthly out-of-pocket payments** required by a higher interest rate. Like discount points, YSP also shifts the timing of the out-of-pocket fees that a borrower pays to a lender for the privilege of getting a loan, but with YSP, the borrower pays *less* out-of-pocket upfront, but pays *more* out-of-pocket later.

Yield spread premium must be disclosed to the borrower on the GFE as a **credit** the borrower receives for the interest rate selected. This allows the borrower to make an informed decision about the rate options available and the impact on the loan.

Qualifying Standards

When mortgage loan originators first meet with a potential borrower—either for pre-qualification or pre-approval—they will likely perform an analysis of the current or allowable monthly housing expense based on the borrower's gross income and debt. This provides the MLO—and the borrower—with a realistic understanding of what mortgage payment the borrower may be able to afford.

There are two qualifying standards:

- Housing expense ratio
- Total debt-to-income ratio (sometimes called total expense debt ratio or total debt service ratio)

Both ratios may be considered in the underwriting analysis, although some automated underwriting systems (AUS) rely only the debt-to-income ratio. Underwriting is addressed in more detail later in this chapter.

Besides gross income, the key element needed to determine these ratios is **PITI**, which is an acronym for a mortgage payment that is the sum of monthly **P**rincipal, **I**nterest, **T**axes (property taxes and perhaps mandatory special assessments, if applicable), and **I**nsurance (homeowners hazard/flood insurance and mortgage insurance, if applicable). When the collateral property requires **association fees** as a condition of ownership, for example as with a condominium, the association fees must be taken into consideration and PITI adjusted to get the complete housing expense.

Qualifying standards may vary from lender to lender, but with increased lender dependence on the national secondary market, the majority of lenders throughout the country have incorporated into their own conventional loan underwriting procedures the standards set by the major secondary market investors, specifically Fannie Mae and Freddie Mac. Of course, if the loan being contemplated is to be made in conjunction with the FHA or VA, those underwriting standards must be applied (underwriting standards for conventional loans and FHA and VA loans will be discussed in more detail in later chapters).

Housing Expense Ratio

A borrower's housing expense ratio, also called the **front end ratio**, is the relationship of the borrower's total monthly housing expense to gross income, expressed as a percentage:

$$\text{Total Housing Expense} \div \text{Gross Income} = \text{Ratio \%}$$

Conventional lenders consider a borrower's income adequate for a loan if the proposed total mortgage payment of PITI does not exceed **28%** of stable monthly gross income. **Stable monthly income**, which is covered in more detail later, is *a borrower's monthly income that can reasonably be expected to continue in the future*. This is usually a borrower's **gross monthly income** from primary employment and any other acceptable income.

Case in Point

Mark has a stable monthly gross income of \$2,900 and the house he wants to buy would have a monthly mortgage payment of \$700:

\$2,900	Stable Monthly Gross Income
\$ 700	Proposed Mortgage Payment (PITI + association fees, if required)
$\$700 \div \$2,900 = 0.24$ or 24%	

His housing expense ratio in this example is 24%, which is acceptable for a conventional loan since it's below 28%.

Total Debt-to-Income Ratio

A borrower's total debt-to-income ratio (DTI), also known as the **back end ratio**, is the relationship of the borrower's total monthly debt obligations (including PITI housing and long-term debts) to gross income, expressed as a percentage.

$$\text{Total Debt} \div \text{Gross Income} = \text{Ratio \%}$$

Conventional lenders want to be sure the borrower's housing expenses (as explained previously), plus any installment debts with 10 or more payments left or other debt that will not be cancelled, do not exceed **36% of stable monthly gross income**. Here, alimony, child support, or any other court-ordered obligations the borrower has must count as debt against this ratio. Debts with fewer than ten payments remaining may still be counted against the borrower if payments are high (e.g., \$600 car payment). If there are student loans currently in deferment, these need to be calculated as debt regardless of how soon the loans will be repaid.

Case in Point

\$2,900	Stable Monthly Gross Income
\$700	Proposed Mortgage Payment (PITI + association fees, if required)
\$225	Auto Payment (18 payments left)
+ \$100	Child Support
<u>\$1,025</u>	<u>Total</u>
$\$1,025 \div \$2,900 = 0.35 \text{ or } 35\%$	

The borrower's total DTI ratio in this example is 35%, which is acceptable for a conventional loan since it's below 36%.

When the underwriter considers both ratios, the borrower must generally qualify under **both**.

Using Ratios to Determine Maximum Mortgage Payment

Using the housing expense ratio and debt-to-income ratio, it's easy to determine the maximum mortgage payment for which a borrower should qualify. To determine the maximum mortgage payment allowable under the first ratio, take the borrower's stable monthly income and multiply that by the maximum housing expense ratio (28% or 0.28 for conventional loans).

To determine the figure that represents the largest mortgage payment allowed under the second ratio, take the borrower's stable monthly income and multiply it by the maximum total debt-to-income ratio (36% or 0.36 for conventional loans). This provides the amount of total long-term debts the borrower is permitted to have. Take this total and subtract the monthly long-term obligations the borrower has already (not including mortgage PITI payments) and this provides a figure that represents the largest mortgage payment allowed under the second ratio.

The total debt-to-income ratio is a more realistic measure of the borrower's ability to support the loan payments because it considers *all* of the borrower's recurring financial obligations, which means that the maximum mortgage payment allowed is likely to be smaller than if only the housing ratio were considered. When the underwriter considers both ratios, the **smaller of the two** would be the maximum mortgage payment allowable.

Case in Point

Mary Smith has a stable monthly gross income of \$3,200. She has three long-term monthly debt obligations: A \$220 car payment, a \$75 personal loan payment, and a \$50 revolving charge card payment. What's the maximum monthly mortgage payment for which she can qualify?

Housing expense ratio: 28%

	\$3,200	Monthly Gross Income
x	0.28	Income Ratio
	\$ 896	Maximum Mortgage PITI Payment

Total debt-to-income ratio: 36%

	\$3,200	Monthly Gross Income
x	0.36	Income Ratio
	\$1,152	Maximum Debt
-	\$220	Car Payment
-	\$ 75	Personal Loan Payment
-	\$ 50	Revolving Charge Card Payment
	\$807	Maximum Mortgage PITI Payment

The maximum monthly mortgage payment Mary can qualify for is \$807. Remember, when both ratios are used, Mary must qualify under both ratios, so the lower figure is the most she can afford. Of course, if she could pay off some of her debts and reduce her total long-term monthly obligations, she would be able to qualify for a larger mortgage payment.

Completing the Uniform Residential Loan Application

Lenders expect the loans they make to be repaid in a timely manner without collection or foreclosure. Thus, employment stability, income potential, history of debt management, and assets are important considerations. A loan application is designed to elicit responses that detail the borrower's history, trends, and attitude as a means of trying to predict future loan repayment behavior.

The uniform residential loan application (Fannie Mae **Form 1003** or Freddie Mac **Form 65**) is a form lenders require potential borrowers to complete that allows them to collect pertinent information about the borrower and the property. An application may either be in writing or electronically submitted, including a written record of an oral application. The borrower typically completes a loan application during the initial consultation with the mortgage loan originator. There's a great deal of information asked; therefore, attention to detail when completing the application is advised. If the borrower doesn't provide all necessary data during the initial consultation, the missing information must be provided at a later date, which will delay the loan process.

WHEN IS AN APPLICATION AN "APPLICATION"?

According to the Real Estate Settlement Procedures Act (12 C.F.R. §1024.2(b)), an **application** is defined as the *submission of a borrower's financial information in anticipation of a credit decision* relating to a federally related mortgage loan that includes:

- Borrower's name, monthly income, and Social Security number to obtain a credit report
- Property address and an estimate of the value of the property
- Mortgage loan amount sought
- Any other information deemed necessary by the MLO

This triggers federal disclosure requirements, which are discussed in detail in the next chapter.

Uniform Residential Loan Application

This application is designed to be completed by the applicant(s) with the Lender's assistance. Applicants should complete this form as "Borrower" or "Co-Borrower," as applicable. Co-Borrower information must also be provided (and the appropriate box checked) when ☐ the income or assets of a person other than the Borrower (including the Borrower's spouse) will be used as a basis for loan qualification or ☐ the income or assets of the Borrower's spouse or other person who has community property rights pursuant to state law will not be used as a basis for loan qualification, but his or her liabilities must be considered because the spouse or other person has community property rights pursuant to applicable law and Borrower resides in a community property state, the security property is located in a community property state, or the Borrower is relying on other property located in a community property state as a basis for repayment of the loan.

If this is an application for joint credit, Borrower and Co-Borrower each agree that we intend to apply for joint credit (sign below):

Borrower		Co-Borrower	
I. TYPE OF MORTGAGE AND TERMS OF LOAN			
Mortgage Applied for: <input type="checkbox"/> VA <input type="checkbox"/> Conventional <input type="checkbox"/> Other (explain): <input type="checkbox"/> FHA <input type="checkbox"/> USDA/Rural Housing Service		Agency Case Number _____ Lender Case Number _____	
Amount \$ _____	Interest Rate % _____	No. of Months _____	Amortization Type: <input type="checkbox"/> Fixed Rate <input type="checkbox"/> Other (explain): <input type="checkbox"/> GPM <input type="checkbox"/> ARM (type): _____
II. PROPERTY INFORMATION AND PURPOSE OF LOAN			
Subject Property Address (street, city, state & ZIP)			No. of Units _____
Legal Description of Subject Property (attach description if necessary)			Year Built _____
Purpose of Loan <input type="checkbox"/> Purchase <input type="checkbox"/> Construction <input type="checkbox"/> Other (explain): <input type="checkbox"/> Refinance <input type="checkbox"/> Construction-Permanent		Property will be: <input type="checkbox"/> Primary Residence <input type="checkbox"/> Secondary Residence <input type="checkbox"/> Investment	
<i>Complete this line if construction or construction-permanent loan.</i>			
Year Lot Acquired	Original Cost \$ _____	Amount Existing Liens \$ _____	(a) Present Value of Lot \$ _____ (b) Cost of Improvements \$ _____ Total (a + b) \$ _____
<i>Complete this line if this is a refinance loan.</i>			
Year Acquired	Original Cost \$ _____	Amount Existing Liens \$ _____	Purpose of Refinance Describe Improvements <input type="checkbox"/> made <input type="checkbox"/> to be made Cost: \$ _____
Title will be held in what Name(s)		Manner in which Title will be held	Estate will be held in: <input type="checkbox"/> Fee Simple <input type="checkbox"/> Leasehold (show expiration date)
Source of Down Payment, Settlement Charges, and/or Subordinate Financing (explain)			
Borrower		Co-Borrower	
III. BORROWER INFORMATION			
Borrower's Name (include Jr. or Sr. if applicable)		Co-Borrower's Name (include Jr. or Sr. if applicable)	
Social Security Number	Home Phone (incl. area code)	DOB (mm/dd/yyyy)	Yrs. School
<input type="checkbox"/> Married <input type="checkbox"/> Unmarried (include single, divorced, widowed)	Dependents (not listed by Co-Borrower) no. _____ ages _____		<input type="checkbox"/> Married <input type="checkbox"/> Unmarried (include single, divorced, widowed)
Present Address (street, city, state, ZIP) <input type="checkbox"/> Own <input type="checkbox"/> Rent _____ No. Yrs.		Present Address (street, city, state, ZIP) <input type="checkbox"/> Own <input type="checkbox"/> Rent _____ No. Yrs.	
Mailing Address, if different from Present Address		Mailing Address, if different from Present Address	
<i>If residing at present address for less than two years, complete the following:</i>			
Former Address (street, city, state, ZIP) <input type="checkbox"/> Own <input type="checkbox"/> Rent _____ No. Yrs.		Former Address (street, city, state, ZIP) <input type="checkbox"/> Own <input type="checkbox"/> Rent _____ No. Yrs.	
Borrower		Co-Borrower	
IV. EMPLOYMENT INFORMATION			
Name & Address of Employer <input type="checkbox"/> Self Employed		Name & Address of Employer <input type="checkbox"/> Self Employed	
Yrs. on this job _____ Yrs. employed in this line of work/profession _____		Yrs. on this job _____ Yrs. employed in this line of work/profession _____	
Position/Title/Type of Business	Business Phone (incl. area code)	Position/Title/Type of Business	Business Phone (incl. area code)
<i>If employed in current position for less than two years or if currently employed in more than one position, complete the following:</i>			

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Borrower		IV. EMPLOYMENT INFORMATION (cont'd)		Co-Borrower	
Name & Address of Employer	<input type="checkbox"/> Self Employed	Dates (from – to)	Name & Address of Employer	<input type="checkbox"/> Self Employed	Dates (from – to)
		Monthly Income \$			Monthly Income \$
Position/Title/Type of Business		Business Phone (incl. area code)	Position/Title/Type of Business		Business Phone (incl. area code)
Name & Address of Employer	<input type="checkbox"/> Self Employed	Dates (from – to)	Name & Address of Employer	<input type="checkbox"/> Self Employed	Dates (from – to)
		Monthly Income \$			Monthly Income \$
Position/Title/Type of Business		Business Phone (incl. area code)	Position/Title/Type of Business		Business Phone (incl. area code)

V. MONTHLY INCOME AND COMBINED HOUSING EXPENSE INFORMATION						
Gross Monthly Income	Borrower	Co-Borrower	Total	Combined Monthly Housing Expense	Present	Proposed
Base Empl. Income*	\$	\$	\$	Rent	\$	
Overtime				First Mortgage (P&I)		\$
Bonuses				Other Financing (P&I)		
Commissions				Hazard Insurance		
Dividends/Interest				Real Estate Taxes		
Net Rental Income				Mortgage Insurance		
Other (before completing, see the notice in "describe other income," below)				Homeowner Assn. Dues		
				Other:		
Total	\$	\$	\$	Total	\$	\$

* Self Employed Borrower(s) may be required to provide additional documentation such as tax returns and financial statements.

Describe Other Income

Notice: Alimony, child support, or separate maintenance income need not be revealed if the Borrower (B) or Co-Borrower (C) does not choose to have it considered for repaying this loan.

B/C	Monthly Amount
	\$

VI. ASSETS AND LIABILITIES

This Statement and any applicable supporting schedules may be completed jointly by both married and unmarried Co-Borrowers if their assets and liabilities are sufficiently joined so that the Statement can be meaningfully and fairly presented on a combined basis; otherwise, separate Statements and Schedules are required. If the Co-Borrower section was completed about a non-applicant spouse or other person, this Statement and supporting schedules must be completed about that spouse or other person also.

Completed ☐ Jointly ☐ Not Jointly

ASSETS		Cash or Market Value	LIABILITIES		
Description			Liabilities and Pledged Assets. List the creditor's name, address, and account number for all outstanding debts, including automobile loans, revolving charge accounts, real estate loans, alimony, child support, stock pledges, etc. Use continuation sheet, if necessary. Indicate by (*) those liabilities, which will be satisfied upon sale of real estate owned or upon refinancing of the subject property.		
Cash deposit toward purchase held by:		\$			
List checking and savings accounts below					
Name and address of Bank, S&L, or Credit Union			Name and address of Company	\$ Payment/Months	\$
Acct. no.	\$		Acct. no.		
Name and address of Bank, S&L, or Credit Union			Name and address of Company	\$ Payment/Months	\$
Acct. no.	\$		Acct. no.		
Name and address of Bank, S&L, or Credit Union			Name and address of Company	\$ Payment/Months	\$
Acct. no.	\$		Acct. no.		

Mortgage Lending Principles & Practices

VI. ASSETS AND LIABILITIES (cont'd)					
Name and address of Bank, S&L, or Credit Union		Name and address of Company		\$ Payment/Months	\$
Acct. no.	\$	Acct. no.			
Stocks & Bonds (Company name/ number & description)	\$	Name and address of Company	\$ Payment/Months	\$	
		Acct. no.			
Life insurance net cash value	\$	Name and address of Company	\$ Payment/Months	\$	
Face amount: \$					
Subtotal Liquid Assets	\$				
Real estate owned (enter market value from schedule of real estate owned)	\$				
Vested interest in retirement fund	\$				
Net worth of business(es) owned (attach financial statement)	\$	Acct. no.			
Automobiles owned (make and year)	\$	Alimony/Child Support/Separate Maintenance Payments Owed to:	\$		
Other Assets (itemize)	\$	Job-Related Expense (child care, union dues, etc.)	\$		
		Total Monthly Payments	\$		
Total Assets a.	\$	Net Worth (a minus b)	\$	Total Liabilities b.	\$

Schedule of Real Estate Owned (If additional properties are owned, use continuation sheet.)

Property Address (enter S if sold, PS if pending sale or R if rental being held for income)	Type of Property	Present Market Value	Amount of Mortgages & Liens	Gross Rental Income	Mortgage Payments	Insurance, Maintenance, Taxes & Misc.	Net Rental Income
		\$	\$	\$	\$	\$	\$
Totals		\$	\$	\$	\$	\$	\$

List any additional names under which credit has previously been received and indicate appropriate creditor name(s) and account number(s):

Alternate Name	Creditor Name	Account Number

VII. DETAILS OF TRANSACTION		VIII. DECLARATIONS					
a. Purchase price	\$	If you answer "Yes" to any questions a through i, please use continuation sheet for explanation. a. Are there any outstanding judgments against you? b. Have you been declared bankrupt within the past 7 years? c. Have you had property foreclosed upon or given title or deed in lieu thereof in the last 7 years? d. Are you a party to a lawsuit? e. Have you directly or indirectly been obligated on any loan which resulted in foreclosure, transfer of title in lieu of foreclosure, or judgment? (This would include such loans as home mortgage loans, SBA loans, home improvement loans, educational loans, manufactured (mobile) home loans, any mortgage, financial obligation, bond, or loan guarantee. If "Yes," provide details, including date, name, and address of Lender, FHA or VA case number, if any, and reasons for the action.)		Borrower		Co-Borrower	
b. Alterations, improvements, repairs				Yes	No	Yes	No
c. Land (if acquired separately)				<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
d. Refinance (incl. debts to be paid off)				<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
e. Estimated prepaid items				<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
f. Estimated closing costs				<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
g. PMI, MIP, Funding Fee				<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
h. Discount (if Borrower will pay)				<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
i. Total costs (add items a through h)				<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

The Mortgage 3 Lending Process

VII. DETAILS OF TRANSACTION		VIII. DECLARATIONS				
j. Subordinate financing		If you answer "Yes" to any question a through I, please use continuation sheet for explanation. f. Are you presently delinquent or in default on any Federal debt or any other loan, mortgage, financial obligation, bond, or loan guarantee? g. Are you obligated to pay alimony, child support, or separate maintenance? h. Is any part of the down payment borrowed? i. Are you a co-maker or endorser on a note? ----- j. Are you a U.S. citizen? k. Are you a permanent resident alien? l. Do you intend to occupy the property as your primary residence? If "Yes," complete question m below. m. Have you had an ownership interest in a property in the last three years? (1) What type of property did you own—principal residence (PR), second home (SH), or investment property (IP)? _____ (2) How did you hold title to the home—by yourself (S), jointly with your spouse or jointly with another person (O)? _____	Borrower		Co-Borrower	
k. Borrower's closing costs paid by Seller			Yes	No	Yes	No
l. Other Credits (explain)			<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
m. Loan amount (exclude PMI, MIP, Funding Fee financed)			<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
n. PMI, MIP, Funding Fee financed			<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
o. Loan amount (add m & n)			<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
p. Cash from/to Borrower (subtract j, k, l & o from i)		<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

IX. ACKNOWLEDGEMENT AND AGREEMENT

Each of the undersigned specifically represents to Lender and to Lender's actual or potential agents, brokers, processors, attorneys, insurers, servicers, successors and assigns and agrees and acknowledges that: (1) the information provided in this application is true and correct as of the date set forth opposite my signature and that any intentional or negligent misrepresentation of this information contained in this application may result in civil liability, including monetary damages, to any person who may suffer any loss due to reliance upon any misrepresentation that I have made on this application, and/or in criminal penalties including, but not limited to, fine or imprisonment or both under the provisions of Title 18, United States Code, Sec. 1001, et seq.; (2) the loan requested pursuant to this application (the "Loan") will be secured by a mortgage or deed of trust on the property described in this application; (3) the property will not be used for any illegal or prohibited purpose or use; (4) all statements made in this application are made for the purpose of obtaining a residential mortgage loan; (5) the property will be occupied as indicated in this application; (6) the Lender, its servicers, successors or assigns may retain the original and/or an electronic record of this application, whether or not the Loan is approved; (7) the Lender and its agents, brokers, insurers, servicers, successors, and assigns may continuously rely on the information contained in the application, and I am obligated to amend and/or supplement the information provided in this application if any of the material facts that I have represented herein should change prior to closing of the Loan; (8) in the event that my payments on the Loan become delinquent, the Lender, its servicers, successors or assigns may, in addition to any other rights and remedies that it may have relating to such delinquency, report my name and account information to one or more consumer reporting agencies; (9) ownership of the Loan and/or administration of the Loan account may be transferred with such notice as may be required by law; (10) neither Lender nor its agents, brokers, insurers, servicers, successors or assigns has made any representation or warranty, express or implied, to me regarding the property or the condition or value of the property; and (11) my transmission of this application as an "electronic record" containing my "electronic signature," as those terms are defined in applicable federal and/or state laws (excluding audio and video recordings), or my facsimile transmission of this application containing a facsimile of my signature, shall be as effective, enforceable and valid as if a paper version of this application were delivered containing my original written signature.

Acknowledgement. Each of the undersigned hereby acknowledges that any owner of the Loan, its servicers, successors and assigns, may verify or reverify any information contained in this application or obtain any information or data relating to the Loan, for any legitimate business purpose through any source, including a source named in this application or a consumer reporting agency.

Borrower's Signature X	Date	Co-Borrower's Signature X	Date
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X. INFORMATION FOR GOVERNMENT MONITORING PURPOSES

The following information is requested by the Federal Government for certain types of loans related to a dwelling in order to monitor the lender's compliance with equal credit opportunity, fair housing and home mortgage disclosure laws. You are not required to furnish this information, but are encouraged to do so. The law provides that a lender may not discriminate either on the basis of this information, or on whether you choose to furnish it. If you furnish the information, please provide both ethnicity and race. For race, you may check more than one designation. If you do not furnish ethnicity, race, or sex, under Federal regulations, this lender is required to note the information on the basis of visual observation and surname if you have made this application in person. If you do not wish to furnish the information, please check the box below. (Lender must review the above material to assure that the disclosures satisfy all requirements to which the lender is subject under applicable state law for the particular type of loan applied for.)

BORROWER <input type="checkbox"/> I do not wish to furnish this information Ethnicity: <input type="checkbox"/> Hispanic or Latino <input type="checkbox"/> Not Hispanic or Latino Race: <input type="checkbox"/> American Indian or Alaska Native <input type="checkbox"/> Asian <input type="checkbox"/> Black or African American <input type="checkbox"/> Native Hawaiian or Other Pacific Islander <input type="checkbox"/> White Sex: <input type="checkbox"/> Female <input type="checkbox"/> Male	CO-BORROWER <input type="checkbox"/> I do not wish to furnish this information Ethnicity: <input type="checkbox"/> Hispanic or Latino <input type="checkbox"/> Not Hispanic or Latino Race: <input type="checkbox"/> American Indian or Alaska Native <input type="checkbox"/> Asian <input type="checkbox"/> Black or African American <input type="checkbox"/> Native Hawaiian or Other Pacific Islander <input type="checkbox"/> White Sex: <input type="checkbox"/> Female <input type="checkbox"/> Male
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To be Completed by Loan Originator: This information was provided: <input type="checkbox"/> In a face-to-face interview <input type="checkbox"/> In a telephone interview <input type="checkbox"/> By the applicant and submitted by fax or mail <input type="checkbox"/> By the applicant and submitted via e-mail or the Internet		
Loan Originator's Signature X	Date	
Loan Originator's Name (print or type)	Loan Originator Identifier	Loan Originator's Phone Number (including area code)
Loan Origination Company's Name	Loan Origination Company Identifier	Loan Origination Company's Address

Mortgage Lending Principles & Practices

CONTINUATION SHEET/RESIDENTIAL LOAN APPLICATION		
Use this continuation sheet if you need more space to complete the Residential Loan Application. Mark B for Borrower or C for Co-Borrower.	Borrower:	Agency Case Number:
	Co-Borrower:	Lender Case Number:

SAMPLE

I/We fully understand that it is a Federal crime punishable by fine or imprisonment, or both, to knowingly make any false statements concerning any of the above facts as applicable under the provisions of Title 18, United States Code, Section 1001, et seq.

Borrower's Signature	Date	Co-Borrower's Signature	Date
X		X	

Co-Borrowers

The first part of Form 1003 discusses requirements for borrowers and co-borrowers. A **co-borrower** is simply a person who signs a note along with another primary borrower and accepts a joint obligation to repay the loan. Co-borrowers have joint ownership interest in the security property as indicated on the title. A **co-signor**, on the other hand, is a credit applicant who does *not* have ownership interest in the security property as indicated on the title, but signs the note. The most common co-borrower is a spouse. Non-occupant parents may also be co-borrowers or co-signors, as they lend an established earnings pattern and financial status to their children who otherwise would be unable to purchase a home.

Co-borrowers must have credit history and assets acceptable to the underwriter. Furthermore, if the co-borrower does not reside in the collateral property, he or she must be able to support both his or her own housing expense *plus* a proportionate share, if not all, of the proposed housing expense for the applicant. Marginal co-borrowers, therefore, should not be relied on heavily, and may do more harm than good.

If there is a co-borrower, applicants must indicate whether the co-borrower's income or assets will be used for qualifying, in which case, the co-borrower's information must be included on the application. Generally, spouses have merged assets and credit and so would be able to use the same application. When you have two unmarried adults on a mortgage application, you need to determine whether their assets and liabilities are sufficiently joined so that the information can be meaningfully and fairly presented on a combined basis. If so, they too can complete a single application. If the co-borrowers do not have joint assets and liabilities, separate applications should be used. For privacy purposes, credit reports and information disclosed on the mortgage application should be handled separately in such cases.

Section I: Type of Mortgage and Terms of Loan

This section details the specific **mortgage option** that a borrower has chosen from among those offered by the lender, including loan amount, rate, and term. (Mortgage types and loan terms are covered in later chapters.)

Section II: Property Information and Purpose of Loan

This section asks for detailed information about the **subject property**. For a **purchase**, the MLO needs to see the sales contract for the home the borrower wants to buy. It's critical to complete as much information on this section as possible, paying particular attention to property address (to confirm that it agrees with the sales agreement/tax bill), number of units, and property type (owner occupied or investment). Also, it's necessary to document the source of the down payment, including any secondary financing being used to purchase the property. If this is a **refinance**, as much of the existing information as possible about the property must be completed to provide the lender with an idea of improvements that have been made which may increase value.

Title. Borrowers should indicate the manner in which title will be held and what name(s) will hold the title to the property. If unsure, they may need to ask an attorney. **Do not assume or advise.** (Ownership options are covered in a later chapter.)

Occupancy. Occupancy of the property will determine the interest rate, available programs, and overall risk of the loan. Generally, investment loans are a higher risk than owner-occupied loans.

Note: Loans insured by the Federal Housing Administration require that borrowers establish bona fide occupancy of the home as the borrower's principal residence within **60 days** of signing the security instrument, with continued occupancy for at least one year.

Section III: Borrower Information

This section requests **personal information** about the borrower and, if applicable, co-borrower: Name, address, phone number, Social Security number, age, schooling, marital status, etc. When inquiring about a borrower's marital status, MLOs must comply with the Equal Credit Opportunity Act (12 C.F.R. § 1002.2(u)) definitions:

- Married
- Unmarried (which includes persons who are single, divorced, or widowed)
- Separated

The application also asks how many dependents the borrower must support. If there are co-borrowers with joint dependents, it's necessary to indicate the number of dependents only for the primary borrower.

If the borrower has resided at his or her present address for two years or less, previous address information—and whether the borrower owned or rented—must also be provided. This information is also required from the co-borrower, if applicable. MLOs may ask for contact information for lenders, landlords, or rental agents.

Section IV: Employment Information

Borrowers must provide details about all current and previous **employment** over a **two-year period**, including years on the job, position, type of business, and contact information. Frequent job changes within the same field and with consistent or increasing income are *not* detrimental to the mortgage decision. Borrowers must be able to explain any gaps of employment over one month.

Borrowers must indicate if they are **self-employed**, which is defined as owning **25%** or more of the business. Employment information is also required from the co-borrower, if applicable.

Section V: Monthly Income and Combined Housing Expense Information

This section provides spaces for base **employment gross income**, overtime, bonuses, commissions, dividends, interest, net rental income, and income from any other sources. Income derived from alimony or child support does *not* need to be disclosed unless the borrower wants this considered as income to help qualify for a larger loan. Also, note that those who are self-employed may need to supply additional supporting documents, such as personal tax returns, corporate tax returns, or financial statements, to show income.

Monthly housing expenses, such as rent, mortgage payments, secondary financing, insurance, real estate taxes, etc., are included as well. The lender wants to see what the borrower is currently paying and what the proposed total payment would be for the new mortgage to gauge the potential extra burden of the new loan. This allows underwriters to evaluate the possibility that payment shock could result from a large increase in housing without accumulated assets to support it.

Section VI: Assets and Liabilities

Borrowers must list all assets and liabilities to determine net worth. **Assets** are *items of value*, such as cash on hand, checking or savings accounts, stocks, bonds, cash value of insurance policies, equity in real estate, retirement funds, automobiles, and personal property.

Liabilities are *financial obligations owed by a borrower*. Liabilities include the following:

- **Debts** are *any recurring monetary obligation that will not be cancelled* (e.g., monthly bills). Borrowers must list all debts—installment loans, credit cards, mortgages, collections, slow pays, judgments, student loans (even if currently deferred), etc. The lender generally will not consider installment loan debt with **less than ten monthly payments** remaining (except for leases, which always count regardless of how few payments remain) or unless the payments on those installment loans significantly affect the borrower's ability to meet credit obligations.
- While any equity in a pledged asset that may be collateral on another loan, such as real estate, would be considered an asset, the **amount owed** on the asset would be considered a liability against the borrower's net worth.

- Borrowers must also reveal **alimony** or **child support** required to be paid as a liability and should be prepared to produce a copy of a divorce decree for verification.

Lenders obtain a credit bureau report and compare liabilities listed on the application. If a liability is not listed on the credit report, the payment information needs to be verified.

Net worth is determined by *subtracting liabilities from total assets*. Most lenders feel that a borrower's net worth is a good indicator of credit worthiness. A high net worth shows an ability to manage money, and may help offset other marginal items on an application. Furthermore, liquid assets that can be sold in an emergency to make payments can give a lender an added feeling of security in making a loan.

Section VII: Details of the Transaction

Here the MLO estimates what **funds** are required by the borrower at closing by adding and subtracting items such as purchase price, prepaid items (e.g., escrows for taxes, insurance, etc.), estimated closing costs, mortgage insurance, loan amount, etc. The borrower also needs to reveal secondary financing, closing costs to be paid by the seller, and any other credits, such as equity from selling his or her current home and deposits being held by a broker or title company.

Section VIII: Declarations

The borrower (and any co-borrower) must respond to critical questions about: • Outstanding judgments, bankruptcies, foreclosures, lawsuits, etc.

- Delinquency or defaults on any federal debt or other loan.
- Obligations to pay alimony or child support.
- Borrowed funds used for any part of the down payment.
- Co-signers on any other debts.
- Citizenship or permanent residency status.
- Intentions to occupy the property as a primary residence.
- Ownership interest in other properties in the past three years.

Section IX: Acknowledgment and Agreement

The borrower and co-borrower, if applicable, must date and sign the application to acknowledge that they have answered everything truthfully. By signing the application, borrowers are acknowledging 11 disclosures, so they should take the time to read and understand this section. Both the MLO and the applicant(s) are responsible for ensuring the information contained in the application is truthful, accurate, and complete.

Section X: Information for Government Monitoring Purposes

This section is used by the government to monitor lender compliance with equal credit and equal housing laws. The Equal Credit Opportunity Act (ECOA) prohibits discrimination in granting credit based on age, sex, race, marital status, color, religion, national origin, and receipt of public assistance (12 C.F.R. § 1002.2(z)). When meeting with a borrower face-to-face, the MLO must complete this section if the applicant declines to supply the requested information. The MLO must note the applicant's ethnicity, race, and sex on the basis of visual observation and surname, to the extent possible.

The mortgage loan originator is required to sign the application. Contact information, as well as the MLO's NMLS unique identifier, must also be included.

SPECIAL NOTICE FOR BALLOON MORTGAGES

A balloon mortgage is a loan that has level monthly payments that would fully amortize over a stated term, but which provides for a lump-sum payment to be due at the end of an earlier specified term. Fannie Mae requires MLOs using the 1003 Uniform Residential Loan Application to insert a special notice regarding the nature of the balloon features on Form 1003 or in a separate attachment to the form if the loan includes this feature. If an attachment is used, the borrower(s) must sign the attachment. The following language must be inserted, using capital letters:

“THIS LOAN MUST EITHER BE PAID IN FULL AT MATURITY OR REFINANCED TO A MARKET LEVEL FIXED-RATE MORTGAGE. YOU MUST REPAY THE ENTIRE PRINCIPAL BALANCE OF THE LOAN AND UNPAID INTEREST THEN DUE IF YOU DO NOT QUALIFY FOR THE CONDITIONAL RIGHT TO REFINANCE AS SPECIFIED IN THE NOTE ADDENDUM AND MORTGAGE RIDER. THE LENDER IS UNDER NO OBLIGATION TO REFINANCE THE LOAN IF QUALIFICATION CONDITIONS ARE NOT MET. YOU WILL, THEREFORE, BE REQUIRED TO MAKE PAYMENT OUT OF OTHER ASSETS THAT YOU MAY OWN, OR YOU WILL HAVE TO FIND A LENDER, WHICH MAY BE THE LENDER YOU HAVE THIS LOAN WITH, WILLING TO LEND YOU THE MONEY. IF YOU REFINANCE THIS LOAN AT MATURITY, YOU MAY HAVE TO PAY SOME OR ALL OF THE CLOSING COSTS NORMALLY ASSOCIATED WITH A NEW LOAN EVEN IF YOU OBTAIN REFINANCING FROM THE SAME LENDER.”

See: <https://www.efanniemae.com/sf/formsdocs/forms/1003.jsp>

Processing the Loan Application

Once the application has been properly completed and the required Truth in Lending Statement and Good Faith Estimate disclosures have been delivered to and accepted by the borrower, the mortgage loan originator can begin gathering other pertinent information to validate the data. Some MLOs accept a borrower's check stubs or W-2 forms, copies of bank statements, and other documents; others use verification forms that are sent out to the borrower's employer, banks, other creditors, and any previous mortgage lender. A credit report is ordered and a preliminary title report prepared. An approved appraiser is also contacted to appraise the property.

A borrower's ability to qualify for a real estate loan depends on many factors related to income, credit history, and assets. There are guidelines for determining what sufficient income for a given housing expense is, but it would be wrong to apply these figures too rigidly. *All* aspects of the borrower's financial situation must be considered before a loan decision is made. Quality, quantity, and durability of income are important, but a borrower with a marginal income may still qualify for a loan if the borrower has substantial assets, indicating an ability to manage financial affairs.

Conversely, strong earnings and substantial assets may not be enough to offset the damage caused by poor credit paying habits. A borrower must be both able and willing to pay the housing expense.

Finally, keep in mind that a good property with a large down payment can offset marginal credit or income as well. Borrowers who make large investments in their property are far less likely to default than those with little or no equity.

Income

Before deciding if a borrower has sufficient income to qualify for a loan, the underwriter must decide what portion of the borrower's total verified earnings are acceptable as a part of the total monthly income. This is accomplished by studying the dependability of the income source(s) and the probability that the income will continue.

Stable monthly income, the *monthly income that can reasonably be expected to continue in the future*, is generally meant to include the **gross** base income of the borrower(s) from **primary** jobs.

Secondary Sources of Income

Predictable earnings from acceptable secondary sources are considered if a lender's thorough analysis determines they can be substantiated and are durable. Secondary sources of income include, but are not limited to, the following:

- Bonuses
- Commissions above base salary
- Part-time earnings
- Overtime
- Disability payments
- Social Security
- Pensions
- Retirement payments
- Interest-yielding investments
- Rental income
- Alimony
- Child support
- Maintenance
- Unemployment and welfare (if verifiable, continuous, and ongoing)

A **quality** source of income is one that is *reasonably reliable*, such as income from an established employer, government agency, interest-yielding investment account, etc. A **durable** source of income can be *expected to continue for a sustained period*. Permanent disability, retirement earnings, and interest on established investments clearly are enduring types of income. Temporary unemployment benefits are unlikely to be counted.

Bonuses, Commissions, and Part-Time Earnings

To be considered durable, these types of income must be shown to have been a consistent part of the borrower's earnings for two years. Less than two years is considered unstable, but may be used to justify a higher qualifying ratio. Proof of such consistency can be shown by submitting copies of W-2 forms, pay stubs, or federal income tax returns. Tax returns are reviewed for unreimbursed business expenses which is deducted from income. The lender may send the employer a request for verification of employment earnings and the likelihood of continuance for **at least three years**. If durable, a **two-year average** of these earnings is used.

Overtime

Overtime earnings technically are eligible to count as part of a borrower's qualifying monthly gross income, but many underwriters are reluctant to rely on such earnings because their durability is uncertain. When qualifying buyers, overtime earnings should not be counted unless they show a consistent pattern. If substantiated, a **two-year** average is used.

Disability Payments

Disability payments count as income if they are a permanent source of income, but the lender will use caution if they are only for a limited time. If the benefits have a defined expiration date, the remaining term should be at least **three years** from the date of the mortgage application.

Social Security

Social Security income counts as permanent income for a borrower who's reached retirement age. If these payments are the result of a disability or some other condition, the lender treats them like other disability payments and verifies a **three year** continuance.

Pensions and Retirement Benefits

Lenders generally consider pension and retirement benefits as stable income, although they may investigate the source to determine solvency.

Interest-Yielding Investments

If the investments are sound and interest payments have been consistent, lenders will consider this durable income. If investments are a source of down payment, income must be deducted in proportion to what is used for the loan closing.

Rental Income

Income from rental properties can be counted if a stable pattern of positive **cash flow** can be verified. Cash flow is money available to an individual on a regular basis after subtracting all expenses. Rents must cover all expenses and mortgage payments, while still leaving excess cash for the owner. Tax returns are used for verifying rental income and expenses. If rental income is not reported on current tax returns, rental leases and PITI documentation must be obtained.

To determine the amount of rental income that may be counted, deduct PITI from gross rental income then multiply by **75%** to reach **net income**.

Alimony, Child Support, and Maintenance

These sources of income can be considered part of the borrower's monthly qualifying income if it's determined they are likely to be made on a consistent basis. Such a determination is dependent on whether the payments are required by written agreement or court decree, the length of time the payments have been received, the age of the child (child support payments generally stop at age 18), the overall financial and credit status of the payer, and the ability of the borrower to compel payment if necessary (e.g., through a court order). Alimony, child support, and/or maintenance should be expected to continue for a **minimum of three years** in order to be used in income calculations. They do *not* need to be listed as sources of income if a borrower does not want them considered as income for the loan.

A copy of the **divorce decree** is generally sufficient to establish the amount and the enforceability of the required payments. To verify receipt of income, the borrower must verify child support payments either by 12 months of cancelled checks or bank statements showing deposits.

Child support income for dependent children is *not* taxed and, therefore, is not included on tax returns. Such non-taxable income may be grossed up by **125%**. Child support for non-dependent children *is* listed on tax returns, as is alimony income.

Unemployment and Welfare

When considering whether income from unemployment or welfare can be counted as stable income, you should ask these questions:

- Is it verifiable—can it be proven that the income was received?
- Is it continuous—has this income stream been regular for two years?
- Is it ongoing—is this income stream likely to continue for at least three more years?

Case in Point

Here are some examples. Borrower A has worked as a greens keeper for five years at a golf course. Every winter, he is laid off and receives unemployment, and he gets a W-2 from the unemployment office each year. His unemployment income should be considered. Borrower B has a six-year-old son and receives Aid for Dependent Children. This, too, should be considered if the borrower chooses to include it on the application.

Remember: MLOs may not discriminate against a borrower on the basis of receipt of public assistance.

Self-Employment Income

To be classified as self-employment income, the borrower must own **at least 25% of the business**. For this income to be used for qualifying, self-employed borrowers need to provide personal and entity (corporation, partnership, sole proprietorship) **tax returns** (all schedules) for a **minimum of two years**. The lender may also ask to see **financial statements**, which are *documents that show assets and liabilities for an individual or an entity, such as a company for a specific period or point in time*. Profit and loss statements and/or balance sheets may also be required.

Secondary market guidelines generally require a self-employed borrower to have operated the business profitably for at least **two years**. If a borrower has been self-employed for *less* than two years, it is difficult to qualify for a loan. However, someone with a shorter history of self-employment, one to two years, may be considered if the borrower's most recent signed federal income tax returns reflect income:

- At the same (or greater) level in a field providing the same products or services as the current business, or
- In an occupation in which the borrower had similar responsibilities to those undertaken in connection with the current business.

In such cases, the lender must give careful consideration to the nature of the borrower's level of experience and the amount of debt the business has.

CONSIDERING NONTAXABLE INCOME

If lenders can verify that a regular source of a borrower's income is nontaxable—such as child support payments, Social Security benefits, disability retirement payments, workers' compensation benefits, certain types of public assistance payments, and food stamps—and is likely to continue, they may develop an **adjusted gross income** for the borrower by **adding 25%** of the nontaxable income to the borrower's income, according to the Fannie Mae Selling Guide (Chapter B3-3.1-04). You may hear this process described as “grossing up.” The Selling Guide goes on to indicate the following:

If the actual amount of federal and state taxes that would generally be paid by a wage earner in a similar tax bracket is more than 25% of the borrower's nontaxable income, the lender may use that amount to develop the adjusted gross income, which should be used in calculating the borrower's qualifying ratio.

Evaluating Income

Keeping in mind a lender's general guidelines toward certain kinds of income, it's still important to remember that each type of income is evaluated *separately* by the underwriter. When deciding which income counts toward a home mortgage, the underwriter takes each income source and looks at employment history, advancement, and education/training in deciding the strength of each position—particularly for the borrower's primary job.

Employment History

When evaluating the elements of a borrower's income (quantity, quality, and durability), the underwriter analyzes the individual's employment **stability**. A borrower with a history of steady, full-time employment is given more favorable consideration than one who has changed employers frequently, unless the changes are properly explained.

As a general rule, a borrower should have continuous employment for at least **two years** in the same field. However, every borrower is unique and if there is not an established two-year work history, there may be explainable circumstances that would warrant loan approval, such as having recently finished college or being discharged from military service.

Advancement. Even if the borrower has changed employers frequently, if it was for the sake of advancement and/or the borrower can show a stable and reliable flow of predictable income, the underwriter will not likely view the changes negatively. On the other hand, persistent job hopping without maintaining income flow or showing some advancement usually signifies a problem of some kind, and an underwriter will tend to regard the individual's earnings as unstable.

Education and Training. Special education or training that prepares a person for a specific kind of work can strengthen a loan application. Such education or training can offset minor weaknesses with respect to earnings or job tenure, especially if the underwriter is convinced there's a continuing demand for people in this line of work, there's job stability in that particular field, or there's opportunity for advancement.

Computing Monthly Income

After deciding which income counts, all gross monthly income from those sources is added together to arrive at a total gross monthly income figure. If a borrower earns an hourly wage, it must be converted to a monthly figure. To convert a person's hourly wages to monthly earnings:

1. Multiply the hourly wage by the number of hours worked in a week
2. Multiply by 52 (weeks in a year)
3. Divide by 12 (months in a year)

Case in Point

Our borrower makes \$19.50 per hour. Assuming the borrower works 40 hours a week, to compute the monthly gross income:

Hourly Wage:	\$19.50
Weekly Income:	\$19.50 x 40 hours = \$780
Annual Income:	\$780 x 52 weeks = \$40,560
Monthly Income:	\$40,560 ÷ 12 months = \$3,380

Verifying Income

The borrower can substantiate employment and income by providing:

- **W-2 forms** for the previous **two years**.
- **Payroll stubs** for the previous **30-day** period.

Since federal labor regulations promulgated by the Department of Labor (29 C.F.R. § 516.5) and the Equal Employment Opportunity Commission (29 C.F.R. § 1627.3) require employers to keep payroll records for **three years**, if the borrower cannot locate pay stubs or W-2's, it may be possible to get copies directly from the employer.

Pay stubs must identify the borrower, employer, and the borrower's gross earnings for both the current pay period and year-to-date. Pay stubs may reveal other factors that could impact the mortgage application, such as garnishments or 401K loans.

Verbal employment confirmations are normally done on each borrower prior to closing. **Verification of Employment (VOE)** forms may also be used to verify income and employment history.

IRS Form 4506-T

Underwriters generally require the lender to obtain a completed and signed **Form 4506-T** from all borrowers at application. This form gives the lender permission to request electronic transcripts of federal tax returns from the IRS when documenting the borrower's income. Under current requirements, the lender determines if and when to submit the form to the IRS (or designee) to obtain the tax information. These transcripts are

used to validate the borrower's income against their W-2s with the intention of helping to reduce instances of mortgage fraud. Many lenders have some level of quality control audit procedures where a random number of loan files are pulled for review; sometimes this is done prior to close, and sometimes after close. Since the 4506-T form is valid for only 90 days, some MLOs also ask borrowers to sign a second form prior to closing so that tax information may be accessed as part of the quality assurance process if necessary.

Reasonable Ability to Repay

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173) includes provisions in §§ 1411, 1412, 1414 of Title XIV—designated as the Mortgage Reform and Anti-Predatory Lending Act—that amend the Truth in Lending Act (15 U.S.C. 1631 et seq.) by inserting a new § 129C. One provision requires mortgage lenders to determine—based on “verified and documented information”—that the borrower has a “reasonable ability to repay” the loan according to its terms (including all applicable taxes, insurance, and assessments). The Board of Governors of the Federal Reserve System promulgated a rule to amend Regulation Z (12 C.F.R. Part 1026) to implement this provision, effective as of April, 1, 2011. The rule applies to any consumer credit transaction secured by a dwelling (whether or not it is owner-occupied), with the following exceptions:

- Open-end credit plan
- Timeshare plan
- Reverse mortgage
- Temporary loan

The proposal establishes multiple options for complying with the ability-to-repay mandate. One option is to require a creditor to consider and verify the following information about the borrower:

- Current or reasonably expected income or assets,
- Current employment status,
- Monthly payment on the mortgage (with the calculation based on the fully indexed rate),
- Monthly payment on any simultaneous loan,
- Monthly payment for mortgage-related obligations,
- Current debt obligations,
- Monthly debt-to-income ratio, or residual income, and
- Credit history.

Qualified Mortgages

Another option for compliance with the ability-to-repay requirement, according to the proposed rule, is for the creditor to originate a “qualified mortgage.” The following alternative operates a legal safe harbor and defines a qualified mortgage as one for which:

- The loan does not contain negative amortization, interest-only payments, balloon payments, or a loan term exceeding 30 years.
- Total points and fees do not exceed 3% of the total loan amount.
- The borrower's income or assets are verified and documented.
- The underwriting is based on the maximum interest rate in the first five years, uses a payment that fully amortizes the loan over its term, and considers any mortgage-related obligations.

A second alternative to defining a qualified mortgage includes the criteria listed above as well as these additional underwriting requirements: Consumer's employment status, monthly payment for any simultaneous loan, consumer's current debt obligations, total debt-to-income ratio or residual income, and consumer's credit history.

Other Provisions of the Proposed Rule

The rule also implements provisions of the Dodd-Frank Act that:

- Limits prepayment penalties to prime qualified mortgages with a fixed rate, and also limits the amount.
- Lengthens the time creditors must retain records that evidence compliance with the ability-to-repay and prepayment penalty provisions (three years).
- Prohibits evasion of the rule by structuring a closed-end extension of credit as an open-end plan.

As of March 2012, rulemaking comes under the authority of the Consumer Financial Protection Bureau. All mortgage loan originators have a legal and ethical obligation to stay current with the applicable laws and regulations as they are implemented.

Mortgage Exercise 3-1

Two months ago, Lisa Zorn was honorably discharged from the Air Force, where she spent four years training as an airplane mechanic. After discharge, she moved to take a 40 hour/week apprentice mechanic job with a major airline company where she earns \$18/hour. Last month, her husband Dave, who has worked the past two years as registered nurse, found a nursing job with a local hospital making \$625 per week. They just bought a new car and pay \$400 each month on that loan. *See the Appendix for answers to check your work.*

1. What is the maximum mortgage payment (PITI) a lender would allow for a conventional loan based on the housing expense ratio?
2. What is the maximum total debt-to-income? What is the maximum mortgage amount (PITI) a lender would likely approve with the auto loan?
3. Can the Zorns get approved for a loan even though they've only been at their jobs a short time? Explain.

Credit History

Credit history is a *record of debt repayment, detailing how a person paid credit accounts in the past as a guide to whether he or she is likely to pay accounts on time and as agreed in the future*. A **debt** is simply money owed. When evaluating a borrower's credit history, however, a debt is generally considered *any secured or unsecured recurring monetary obligation that will not be cancelled until paid in full*. A car lease is considered a debt; so is a student loan or court-ordered child support. Utilities and insurance premiums are *not* considered debts because they can, in theory, be cancelled. Lenders assume borrowers would turn off their phones or cable service before losing their houses. Gray areas can include such things as doctor bills. These are generally not considered to be debt unless there is a payment schedule (e.g., for braces). Borrowers must inform a lender of *all* debts—even things that may not show up on a credit report.

As part of the loan evaluation, the underwriter analyzes the borrower's and any co-borrower's credit history by obtaining a credit report from a national credit reporting company—e.g., Experian (formerly TRW), Equifax, and TransUnion. If the credit history shows a slow payment record or other derogatory credit information (suit, judgment, repossession, collection, foreclosure, or bankruptcy), a loan application could be declined or the borrower put into a **high-risk** (B-C credit) category.

In some cases, derogatory ratings don't prevent a borrower from obtaining a loan if the credit problems can be explained. The underwriter must be satisfied that these problems don't represent the borrower's overall attitude toward credit obligations, and the circumstances were temporary and no longer exist.

REAL SUCCESS

If a borrower's credit report is laced with derogatory ratings over a period of years, there's probably little hope for loan approval through a traditional lender. Perpetual credit problems more likely reflect an attitude instead of a circumstance, and it's reasonable for lenders to presume that pattern will continue. All credit problems can be resolved with time, however, so never assume a borrower can't qualify for a loan eventually.

When evaluating a borrower's credit history, lenders use a number of methods, including objective evaluation methods, to ensure compliance with the **Equal Credit Opportunity Act** (ECOA). This Act prohibits discrimination in lending based on age (except minors under 18), sex, race, marital status, color, religion, national origin, or receipt of public assistance (12 C.F.R. § 1002.2(z)).

You must never discourage an applicant from submitting a mortgage application because of his or her membership in a protected class under ECOA.

Credit Scoring

Credit scoring is an *objective means of determining creditworthiness of potential borrowers based on a number system*. A credit score is a numeric representation of the borrower's credit profile compiled by assigning specified numerical values to different aspects of the borrower. These numbers are adjusted up and down based on the strengths and weaknesses of particular qualifications.

For example, a person with a large line of available credit that is hardly used would likely score higher than a person with lower credit limits but whose credit cards are all maxed out. The numbers are added from all the categories and a credit score based on these various criteria is assigned.

Credit scores also play an important role in automated underwriting since Fannie Mae and Freddie Mac have identified a strong correlation between mortgage performance and credit scores. The higher the credit score, the better credit risk a borrower is; the lower the score, the higher the risk of default.

Credit Scoring Systems

Credit scores are the result of very complex calculations carried out by a computer that takes into account every aspect of the borrower's credit file. There are many different names for credit scoring systems. The system that most consumers are likely to be familiar with is **FICO**, which was developed by Fair, Isaac & Co. Other common names for credit scoring systems include BEACON (used by Equifax) and EMERICA (used by TransUnion). Items considered by a credit scoring system include the following:

- Number of open accounts
- Total credit limit
- Types of credit (e.g., credit cards, installment loans)
- Length of credit history (e.g., when opened, latest activity)
- Total amount of debt outstanding
- Number of late payments in the past 30-60-90 days
- Presence of adverse public records (e.g., liens, judgments, or bankruptcies)
- Number of recent credit inquiries
- Re-establishment of positive credit history after past payment problems

Credit scoring systems do not consider items such as a consumer's race, sex, age, marital status, religion, national origin, salary, or employment history.

Each of these three main credit bureau scores is calculated a little differently. For example, FICO weighs payment history as 35% of the total score, amounts owed as 30%, length of credit history as 15%, and new credit and types of credit used as 10% each. Regardless of the actual calculation, all credit bureaus produce similar credit scores, which range from about **300 to 850**. While lenders can't tell you exactly how each credit score is computed, they will disclose what cutoff scores they use in qualifying borrowers for various mortgage loan programs.

Secondary Market

The secondary market has pricing adjustments to the interest rate depending upon credit score and LTV. Fannie Mae and Freddie Mac guidelines generally consider those with credit scores **above 720** to be an *acceptable* credit risk and therefore have little interest rate adjustment. Those with scores **between 620 and 660** are considered *marginal* and are held to a more comprehensive review. Fannie Mae and Freddie Mac do *not* accept loans with credit scores **below 620** except for certain products and programs. Before making decisions regarding qualification, lenders are encouraged to check the accuracy of credit information.

REAL SUCCESS

Credit scores also come into play with FHA loans. For example, in 2010, the Federal Housing Administration changed its policy so that the standard 3.5% down payment on an FHA-insured loan applies only to those borrowers who have a credit score of 580 or above. Other borrowers need to put at least 10% down, or may not qualify at all. Even so, it's important to understand that most lenders impose even stricter guidelines than these when underwriting an FHA-insured loan. Make sure that you stay current with the program guidelines of the loan products with which you deal, for example, by reading FHA's Mortgage Letters.

Explaining Derogatory Credit

Most people try to meet credit obligations on time; when they don't, there's usually a reason. Job loss, hospitalization, prolonged illness, death in the family, or divorce can create financial pressures that affect debt-paying habits. If a few derogatory items appear on a credit report, it may be possible to show that the

problems occurred during a specific period of time for understandable reasons, and that prior and subsequent credit ratings have been good.

If borrowers refuse to accept responsibility by explaining credit difficulties based on misunderstandings or on the creditors themselves, underwriters may not look favorably upon such explanations. Underwriters reason that a borrower's reluctance to take responsibility for prior credit problems is an indication of what can be expected in the future.

Borrowers may have questions regarding credit scores. The Fair Credit Reporting Act, as amended by Section 212(c) of the Fair and Accurate Credit Transactions Act of 2003 (16 C.F.R. Part 602), requires that a **Notice to the Home Loan Applicant Credit Score Information Disclosure** be provided to borrowers. This disclosure must include the score that a credit reporting agency distributed to the lender used in connection with a home loan and the key factors affecting the credit scores. This disclosure must include contact information for any credit agency used.

Bankruptcy

Bankruptcy, as established by Title 11 of the United States Code, is a court process that cancels debt and provides some relief for creditors. There are two basic proceedings for individuals:

- **Chapter 7.** Sometimes called a straight bankruptcy, it is a *liquidation proceeding*. The debtor turns over all non-exempt property to the bankruptcy trustee, who then converts it to cash for distribution to the creditors. The debtor receives a discharge of all dischargeable debts, usually within four months. Someone wishing to file Chapter 7 must meet certain tests related to income and debt.
- **Chapter 13.** This is filed by individuals who want to pay off their debts over a period of three to five years. This is preferable to those who have non-exempt property that they want to keep. It is only an option for individuals who have predictable income and whose income is sufficient to pay their reasonable expenses with some amount left over to pay off their debts.

According to the Fair Credit Reporting Act (15 U.S.C. 1681c § 605 (a)(1)), consumer reporting agencies may maintain bankruptcy information on a consumer's credit report for no more than 10 years from the date of entry of the order for relief or the date of adjudication, whichever the case may be. While credit reporting agencies do keep completed Chapter 7 bankruptcies on the credit report for the maximum 10 years, they often keep Chapter 13 bankruptcies on the credit report only for seven years after discharge date. This is an incentive for consumers to file under Chapter 13 and repay their debts.

Other Negative Information

According to FICO, in addition to Chapter 13 bankruptcies, the other types of negative information that remains on a consumer's credit report for **seven years** includes:

- Late payments
- Foreclosures
- Collections (generally, depending on the age of the debt being collected)

Also, information that is part of the public record may show for seven years, although unpaid tax liens can remain indefinitely.

Bill Consolidation and Refinancing

Even without derogatory ratings, lenders may find other concerns in a credit report that might indicate the borrower is a marginal credit risk. If an individual's credit pattern is one of continually increasing liabilities and periodically bailing out through bill consolidation (borrowing a larger sum of money to pay off many smaller debts) and refinancing, he or she may be classified as a marginal risk. This pattern suggests a tendency to live beyond a prudent level. It is a subjective consideration likely to influence the lender's decision if a borrower is weak in other areas, such as income or net worth.

REAL SUCCESS

Creditors who have a legitimate business need to access a potential borrower's credit report when a business transaction is initiated by the consumer may do so, as long as they have authorization from the borrower. While some MLOs require separate written consent from the borrower before obtaining a credit report, Block IX, the Acknowledgment and Agreement section of the Uniform Residential Loan Application, includes language that authorizes the creditor to access the borrower's credit information from any source named in the application or from a consumer reporting agency.

Although credit reports presented by borrowers would not likely be acceptable to lenders, the Fair Credit Reporting Act (15 U.S.C. 1681b § 604 (b) (2) (B) (IV)) does allow consumers to request one free credit report per year from each of the national credit bureaus—Experian, Equifax, and TransUnion—by visiting www.annualcreditreport.com. Borrowers should be encouraged to take advantage of this annually. They are also entitled to a free report if information in a credit report resulted in some sort of adverse action, if the consumer was a victim of identity theft and a fraud alert was inserted in a credit file, if the credit file contains inaccurate information as a result of fraud, or if the consumer is on public assistance or is unemployed.

Assets

Assets are simply *items of value*. The underwriter takes the necessary steps to verify the nature and value of assets held by a borrower. If a borrower has a marginal total debt-to-income ratio, above average assets can offset this deficiency. Underwriters know that assets, especially in liquid form such as savings or stocks and bonds, can be used to pay unexpected bills or to support a borrower when there's a temporary interruption in income.

Liquid versus Non-Liquid Assets

Liquid assets are cash and any other assets—such as stocks or bonds—that can *quickly be converted to cash*. Automated underwriting systems generally consider the following assets liquid and include their value when evaluating borrowers:

- Checking and savings accounts
- Gift funds
- Certificates of deposit
- Money market funds
- Mutual funds
- Stocks and bonds
- Secured borrowed funds
- Retirement accounts
- Trust funds, if the borrower is the beneficiary or settlor and the trust is irrevocable
- Expected cash from properties pending sale

Non-liquid assets include:

- Cash deposits on the sales contract
- Cash value of life insurance policies
- Net worth of businesses owned
- Automobiles

Evaluating Assets

There are three aspects of a borrower's assets in which lenders and underwriters are interested: Down payment, reserves, and other assets.

Down Payment

It must be determined that the borrower has **sufficient liquid assets** to make the cash down payment and pay the closing costs and other expenses incidental to the purchase of the property. Most loan programs require the borrowers to bring at least 5% of the down payment from their own personal savings history into the transaction. There are some programs that allow a smaller down payment—mostly government programs or those geared to first time home buyers. The lender also wants to know the **source** of the borrower's down payment. Savings or sale of a prior home are both acceptable sources of down payment.

Borrowed Funds. Borrowed funds must be secured and the debt considered in the total debt-to-income ratio.

Gifts. If an applicant lacks the necessary funds to close a transaction, a gift of the required amount is usually acceptable to the underwriter. The gift should be confirmed by means of a **gift letter** signed by the donor. The letter should clearly state that the money represents a gift and *does not have to be repaid*. The gift usually must be from an immediate family member, although rules can vary. In addition to the gift letter, lenders want to verify that the donor has the funds available to provide the gift by seeing a copy of the gift check and a copy of the deposit receipt showing funds have been deposited and are available for closing. In the past this has been an area of mortgage fraud, so it is important to validate the funds came from the account verified on the gift letter and bank statement provided by the donor.

Fannie Mae and Freddie Mac require borrowers to make at least a 5% down payment from their own funds in addition to the gift, unless the gift equals 20% or more of the purchase price. On conventional loans, borrowers can't use borrowed funds or gifts for the first 5%.

Reserves

Reserves are *cash on deposit or other highly liquid assets a borrower will have available after the loan funds*. Lenders would like to see enough to cover two months' PITI mortgage payments of principal, interest, taxes, and insurance (and assessments such as condominium association fees, if applicable) after the borrower makes the down payment and pays all closing costs, but in most cases this is not required. For investment properties, six months' PITI payments must be verified for loans on non-owner-occupied property. When borrowers convert a primary residence that they have occupied during the past 12 months into investment property, if the equity in the property is less than 30%, they are required to have six months reserves for **both properties**—the investment property and their own principal residence—for conventional loans.

Other Assets

Having assets in addition to cash and other liquid assets shows that the borrower is able to manage money and has resources, if needed, to handle emergencies and make mortgage payments.

Real estate equity is an important asset to consider. Equity is *the difference between the market value of the property and the sum of the mortgages and other liens against the property*. Equity, less all selling expenses, is what a buyer should receive from the sale of property. If the equity from the sale of a home is the source of money for the purchase of the subject property, the underwriter might require evidence that the sale closed and the borrower received the proceeds before making the new loan. If the loan is a construction loan and the borrower owns the lot, the underwriter treats the borrower's equity in that lot as cash or its equivalent when determining the down payment needed.

Other real estate also counts as an asset. But only the equity in the property—and not its total value—contributes to net worth, since only the equity can be converted to cash by selling an interest in or mortgaging the property. Real estate with little or no equity, or investment property with income that's equal to or below expenses, hurts a loan application more than it helps because the property may require cash from the borrower. Of course, a lender must be told of any financial obligations or expense shortfalls not covered by rents.

Verifying Deposits for Down Payment/Reserves

Documentation of assets includes **one to two months of bank statements** (all pages) to verify available funds. A **Verification of Deposit (VOD)** form may also be used to verify bank statement balances, both current balance and average balance. When the underwriter reviews the bank statements or receives the completed Verification of Deposit forms, four questions are considered:

- Does the verified information conform to statements in the loan application?
- Is there enough money in the bank to pay costs of buying the property?
- Has the bank account been opened recently (within the last few months)?
- Is the present balance notably higher than the average balance?

Lenders prefer to see **seasoned funds**, which means they have been in the account for the entire period covered by the bank statements. Recently opened accounts or higher-than-normal balances must be explained as these are strong indications the applicant may have borrowed the funds. Also, the source of any large and unusual deposit will need to be documented.

INSURANCE AND ESCROW REQUIREMENTS

Providing funds to a borrower to purchase or refinance a home carries with it a great deal of financial risk for the lender, who is said to have an **insurable interest** in the property. To protect that collateral, therefore, lenders normally require insurance.

Homeowner's Hazard Insurance. A policy that covers loss or damage to the home or property in the event of fire or other disaster such as tornado, snow, and hail damage. Lenders generally:

- Require the policy to be sufficient to replace the home or reimburse the mortgage amount with the lender being named on the actual policy.
- Have the right to place insurance on the property to cover its interest (the loan value) in the event of a loss if the borrower does not comply with the lender's insurance requirements.
- Require borrowers to pay the first year's insurance premium in full **prior** to closing.
- Incorporate the annual insurance cost (along with current property taxes) into an **escrow account**, which is prorated over the next 12 months to determine a monthly insurance and property tax payment amount. This is added to the monthly principal and interest due for loan repayment. Upon payment each month, the insurance and taxes are deposited into the borrower's escrow account. When property taxes and insurance become due, the lender/servicer forwards the payment to the respective recipients on behalf of the property owner.

Flood Insurance. Homeowner's hazard insurance does **not** cover damage caused by the peril of flood. When a property is located in a federally designated special flood hazard area (SFHA), the lender for federal loans will require a flood insurance policy for the life of the loan in addition to homeowner's hazard insurance. Flood insurance must be purchased from the **National Flood Insurance Program (NFIP)** or from an insurer participating in the Write Your Own program. In order to buy federal flood insurance, the property must be in a community that is voluntarily participating in the NFIP.

Mortgage Exercise 3-2

Sam Able wants to buy a home, and it's estimated that an 80% conventional loan will have a mortgage payment of \$878. He has an automobile payment of \$212 a month with 14 installments remaining. He earns \$700 per week. His down payment and closing costs are estimated at \$18,400. Sam is selling a home with equity of \$14,000. He has a checking and savings account with a local bank, and plans to draw on that account to close the transaction. The Verification of Deposit came back showing that Sam's savings account has an average monthly balance of \$1,000 and a current balance of \$3,600. *See the Appendix for answers to check your work.*

1. What is Sam's housing expense ratio?

2. What is Sam's total debt-to-income ratio?

3. Will Sam have any problems closing this transaction? Explain.

4. Do you see any problems with Sam's Verification of Deposit? Explain.

Underwriting

There are general steps all lenders take before deciding whether or not to make a real estate loan and on what terms. This evaluation process is called **loan underwriting**, where an underwriter evaluates the documentation, borrower information, and various risk factors associated with a loan in order to make a decision. According to Freddie Mac, "Underwriting mortgage loans is an art, not a science." The underwriting process can be automated, where all information is fed into an automated underwriting system (AUS), or manual, which is done by an individual who works for the lender. Both processes have various qualifying standards applied to the loan information. Regardless of whether underwriting process is manual or automated, the resulting final decision will be one of these three options:

1. Reject the loan as applied for (which may be because the borrower or collateral was not a good risk or because the loan application file was incomplete)
2. Make the loan on the terms applied for
3. Make the loan on different terms (for example, a higher interest rate, a different loan program, additional collateral, etc.)

Putting Together a Loan File

In order to make any decision, however, the underwriter must have all of the relevant data. Before submitting a loan file to underwriting, MLOs should review the application one last time before shipping it for the underwriter's review. A good mortgage loan originator takes ownership of the loan file, ensuring that the information in the submitted application is accurate, that all required documentation in the loan file is included and complete, and that all readily identifiable issues that an underwriter might raise have been addressed. If a loan processor misses something, it's the MLO's job to figure it out and fix it before it goes to the underwriter. The goal of the MLO should be to never have a loan file rejected as "incomplete."

When evaluating a loan file, the primary concern throughout the loan underwriting process is determining the degree of **risk** a loan represents. The underwriter attempts to answer two fundamental questions:

- Is there sufficient value in the property pledged as collateral to assure recovery of the loan amount in the event of default?
- Does the borrower's overall financial situation, which is comprised of credit, income, and assets, indicate a reasonable expectation of making the proposed monthly loan payments in a timely manner?

A complete and accurate loan file, therefore, allows the underwriter to make an informed decision.

Automated Underwriting Systems (AUS)

Automation is used in all facets of the lending process. The purpose of automated underwriting is to reduce the cost of examining a loan application and speed up mortgage approvals. An AUS is able to provide consistent underwriting decisions using statistical computer models based on traditional underwriting factors, and never considers factors such as race, ethnicity, age, or any other characteristic prohibited by law. And with large databases of statistics and information available, the secondary market has increased efforts to manage credit risk by improving loan criteria.

The AUS makes a recommendation to accept a loan for delivery, or refers it for an underwriter for further manual review and analysis. Even with an automated approval, an underwriter still must validate the information entered into the AUS, along with the supporting documentation. While lenders may rely on automated underwriting systems for a preliminary decision, it generally comes down to a human underwriter to make the final decision.

Both Fannie Mae and Freddie Mac have proprietary automated underwriting systems, and they charge lenders for the privilege of using them. Fannie Mae's automated underwriting system is **Desktop Underwriter®** (DU®). Freddie Mac has a similar direct AUS called **Loan Prospector®** (LP®).

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There's no standardized order in which to assemble the loan file, although particular lenders may have a preference. Submitting the loan file for final underwriting can usually be accomplished in an email or FAX. If it is an especially large loan file, you may choose to send it through the mail or overnight it. Also, it is a good practice to include a "Dear underwriter" letter on the top of the stack. If the loan application has some potential issues—for example, unusual circumstances, odd letters of explanation, strange income—use the letter to prepare the underwriter for what's coming. Let the underwriter know that you know where the issues are; if he finds something strange on his own, he may start doubting the whole package. Do anything you can do to make the process go smoothly.

Also, for the sake of your borrowers, find out how long the file will sit in the review queue and when they can expect a decision. It's stressful waiting to hear—keep them informed to alleviate their worry. Share with your borrowers that during busy times, it might take the underwriter several weeks to finish. The **Equal Credit Opportunity Act** (12 C.F.R. § 1002.9 (a)(i)), however, requires a lender to communicate a credit decision (approval, counteroffer to, or adverse action) within **30 days** of receiving a completed application.

Closing

After the loan is approved and all “prior to doc” conditions are met—for example, the lender may request to see a closing statement from the sale of the borrower’s previous home, a final inspection report, or property insurance policy—the lender issues a **clear to close** the loan and the necessary documents are prepared for closing. **Closing**, or **funding**, completes the process of granting a loan as funds are disbursed in accordance with the settlement statement. If the transaction involves the **sale** of real property, closing also involves *transfer of ownership of real property from seller to buyer, according to the terms and conditions in the sales contract or escrow agreement*. This is the final stage in a real estate transaction, when the seller receives value for property (cash, mortgage, etc.) and the buyer receives title.

Closing Procedures

You may also hear the closing process referred to as **settlement** or **loan consummation**. Generally speaking, the mechanics of closing are the responsibility of either an escrow/title agent or an attorney. This escrow agent may be the lender’s in-house escrow department, an independent escrow company, or a title insurance company.

With a sales transaction, the escrow agent simultaneously follows the instructions of both the borrower and seller, as per the sales contract, agreement, or a separate set of escrow instructions. A copy of the sales contract or escrow instructions must be provided to the escrow agent, the title company, and the lender.

The title agent gathers all necessary documents, calculates the various prorations, adjustments, and fees charged to each party, and also compares the Good Faith Estimate of closing costs to the HUD-1 settlement statement to verify the proper tolerance with disclosed fees. Each party receives a HUD-1 settlement statement that complies with the Real Estate Settlement Procedures Act (RESPA).

The lender wants to ensure that there are no unforeseen problems during closing, see that the loan papers (e.g., promissory note, mortgage, deed, etc.) are signed, and be available to make one final check to be sure that everything is in order. Once the necessary documents have been recorded, loan funds may then be disbursed to the proper parties, according to the sales contract or escrow instructions.

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Closing procedures may be different from state to state—or even from one part of a state to another. For example, in some states, an attorney is required to close the loan. Other states allow a title agent to perform the loan closing. Closings may be conducted in escrow, which means they are handled by a disinterested third party, or roundtable, where all parties are present. A borrower who cannot attend a closing may be able to use a power of attorney if one exists specific to the property being transferred.

Another important thing to keep in mind is that settlement costs may also differ from region to region. For example, in some areas, the seller traditionally pays fees related to title, while in other areas, the buyer pays title fees. Regardless of local practices, however, the determination of who pays certain fees may be negotiated during the sales process and documented in the purchase contract.

If you are taking an application from a state with which you are unfamiliar, research the mortgage regulations and laws from that state. Licensing requirements may also be different; however, note that not only must an individual MLO be licensed to do business in that state, but the MLO’s employing company must also generally be licensed in that state.

Settlement Statement Reconciliation

The **Real Estate Settlement Procedures Act (RESPA)** is the federal law dealing with real estate closings that sets forth procedures and guidelines for disclosing settlement costs using a standard settlement statement. Provisions of RESPA, including a look at the HUD-1 settlement statement, are covered in detail in the following chapter.

To understand the final distribution of money involved in a transaction as detailed on the settlement statement, however, one must be familiar with the concept of **debits** and **credits**.

- **Debits** (like debts) are *sums of money owed*. A debit is charged to a particular party on a balance sheet to represent money that must be paid out. The settlement statement reflects the total costs the seller and the buyer must pay.
- **Credits** are *sums of money received*. A credit is given to a particular party on a balance sheet to represent money that is paid by another party or that has already been paid. The settlement statement also reflects the total amounts credited to the seller and the buyer.

Debits and credits work together when **reconciling** the settlement statement. All debits owed by the borrower are totaled and added to the loan amount/purchase price. Then the credits are totaled and subtracted from the total debits to determine *how much money the borrower must bring to closing*. The mortgage amount shows up as a **credit** to the borrower, since it is the lender who brings that money to closing. The details on a settlement statement allow a buyer to see the **acquisition cost**, which is a total of the amount of money necessary to purchase the property, since it shows the sales price as well as the charges necessary to close the loan.

A similar process occurs on the seller's side. All credits due to the seller are totaled and added to the purchase price. All debits owed are totaled and subtracted from the total money due to determine how much money the seller receives at closing.

Proration

Proration is *the division of expenses between buyer and seller in proportion to the actual usage of the item represented by a particular expense as of the day the loan is funded*. In order to adjust a cost shared by both buyer and seller, it's necessary to determine whether the expense is accrued or prepaid. **Accrued expenses** are the items on a settlement statement for which *the cost has been incurred, but the expense has not yet been paid*; for example, mortgage interest. Accrued expenses are prorated on the settlement statement as a debit to the seller and a credit to the buyer. **Prepaid expenses** are the *items on a settlement statement the seller has already paid*; for example, condominium association fees or property tax in counties where it is paid in advance. Prepaid expenses are prorated on the settlement statement as a credit to the seller and a debit to the buyer.

When performing proration calculations, expenses may be prorated using:

- A 360-day year, 12 months of 30 days each.
- A 365-day year, counting the exact number of days in each month (taking leap years into account).

Often, local custom dictates which factor is used. Either way, the steps to calculate the adjustment are similar:

1. Determine if the expense is accrued or prepaid.
2. Divide the expense by the appropriate period to find a monthly (daily) rate.
3. Determine how many months (days) are affected by the expense.
4. Multiply the monthly (daily) rate by the number of affected months (days).
5. Determine which party is credited and which is debited.

Chapter 3 Summary

1. The common areas of work for a mortgage professional are mortgage loan originator, loan processor, underwriter, and servicer. A mortgage loan **originator** takes applications, pulls credit reports, orders appraisals, and assembles documents for mortgage loans. A loan **processor** works on the file assembled by the originator, verifying the information in the file and coordinating other aspects of the loan and closing. The **underwriter** is responsible for reviewing the file and arriving at a credit decision for the lender or investor, based on the credit risk associated with a particular loan. If there are conditions on the loan, they must be satisfied prior to closing. A **servicer** oversees the collection of mortgage payments and pursues late payments on behalf of the mortgagee.
2. **Lender's return** is the total amount a lender or broker makes on a loan, such as from loan fees, discount points. **Points** are 1% of loan amount; increase lender's yield, and are paid for many reasons. **Discount points** are used to buy down the interest rate. **Yield spread premium** is a tool mortgage loan originators can use to reduce a borrower's settlement costs.
3. Borrowers can get pre-qualified or pre-approved. **Pre-qualification** is when a mortgage broker or lender reviews a borrower's history to determine if they're likely to get approved for a loan, and the approximate amount. Pre-qualification is *not* binding on the lender. **Pre-approval** is when a lender uses an application to determine that potential borrowers can be financed for a certain amount for a specific property. A mortgage broker cannot give a borrower a pre-approval; only a lender can.
4. The loan process consists of four steps: 1. **Consulting** with a MLO; 2. Completing the **application**; 3. **Processing** the application; 4. **Analyzing** the borrower and the property. Common fees include credit report, appraisal, title work, inspections, etc. The loan application asks a number of personal and financial questions, along with information about the property the borrower wishes to purchase. MLO must document that a borrower is reasonably able to repay the loan.
5. Address and **employment** information must go back two to three years. **Income** should be stable and verifiable. Alimony/child support may be excluded as income if borrower chooses (if included, may be grossed up 125%). Those who are self-employed (at least 25% ownership) may need personal and company tax returns and financial statements. **Assets** and **liabilities** must all be disclosed, including alimony and child support, if it's an obligation. **Liquid assets** can be quickly and easily converted to cash. **Net worth** is assets minus liabilities. Borrowers must answer all declarations truthfully.
6. **Bankruptcy** is a court process that cancels debt and provides some relief for creditors. Chapter 7 bankruptcy is a liquidation proceeding where the debtor receives a discharge of all dischargeable debts. Chapter 13 bankruptcy is filed by individuals who want to pay off their debts over a period of three to five years. Chapter 13 bankruptcy usually appears on a credit report for 7 years.
7. The **underwriting** process may evaluate: Capacity (ability to pay), collateral (down payment, home value), credit (good payment history), character (job stability, reserves), and conditions (health of job market, economy). Some elements of the mortgage process may be automated to reduce time and costs for lenders. Automated underwriting systems (AUSs) offer computerized analysis to recommend accepting the loan or refer it to a human underwriter for further consideration. Fannie Mae's AUS is **Desktop Underwriter**® (DU®); Freddie Mac's system is called Loan Prospector®.
8. Monthly **income** must show stability, quality, and durability. Bonuses, commission, part-time earnings, and overtime all count if shown to be a consistent part of the borrower's income for the past few years. Lenders do not usually count temporary unemployment, welfare, and other income. **Credit history** is a record of debt repayment. **Credit scoring** is an objective means of evaluating credit. Lenders verify assets and may require financial statements. The three main credit bureaus produce similar credit scores, which range from about **300 to 850**. A **gift letter** can show part of the down payment/closing costs are a non-repayable gift.

9. Conforming loans sold on the secondary market (e.g., Fannie Mae and Freddie Mac) require income ratios of **28%** for housing expense and **36%** for debt-to-income (DTI). The housing expense ratio is the relationship of the borrower's total monthly housing expense, or PITI (Principal, Interest, Taxes, Insurance or PITI), to gross monthly income (stable), expressed as a percentage. PITI must also consider required homeowners association fees. Total debt-to-income ratio is the relationship of the borrower's total monthly debt obligations (including housing and debts that will not be cancelled and that have ten or more payments remaining) to gross monthly income, expressed as a percentage. A borrower must qualify under **both** ratios. Fannie Mae, however, focuses on the back-end ratio (DTI).
10. **Closing**, also called settlement, is the culmination of the loan process where papers are signed and funds disbursed. In a real estate sales transaction, it's also the transfer of ownership of real estate from a seller to a buyer, per terms of the sales contract (seller receives value for property—cash, mortgage, etc.—and buyer gets title). **Proration** is the division of expenses between buyer and seller in proportion to the actual usage of the item represented by a particular expense as of the day the loan is funded.

Chapter 3 Quiz

1. ***Bob is buying a house. It was appraised at \$236,000, the sales price is \$228,000, and the loan amount is \$216,800. In order to buy down his interest rate, Bob is willing to pay 2 points in addition to the 1 point in loan origination fees. What is the price of Bob's discount points?***
 - A. \$4,336
 - B. \$4,720
 - C. \$6,840
 - D. \$7,080
2. ***Non-taxable child support income***
 - A. cannot be considered as stable income.
 - B. may be counted at 75%.
 - C. may be counted at 100%.
 - D. may be counted at 125%.
3. ***If the borrower is self-employed, he or she should provide***
 - A. average monthly income amount earned over the previous two years.
 - B. employment verification from the last employer.
 - C. profit and loss statements for the previous six years.
 - D. tax returns for the previous two or three years.
4. ***A gift letter***
 - A. can come from a borrower's parent or guardian only.
 - B. cannot be used for part of the down payment.
 - C. must be signed by the donor.
 - D. must state when the gift is to be repaid.
5. ***To be classified as self-employment income, the borrower must own at least what percent of the business used for qualifying?***
 - A. 5%
 - B. 10%
 - C. 25%
 - D. 50%
6. ***Conforming loans follow guidelines of***
 - A. ECOA.
 - B. Fannie Mae and Freddie Mac.
 - C. the FHA.
 - D. RESPA.
7. ***When qualifying for a conventional loan, stable gross monthly income can include***
 - A. alimony received (that a borrower chooses to reveal).
 - B. bonus received for the first time last year.
 - C. erratic unemployment earnings.
 - D. income from other family members.
8. ***If the lender wants the borrower's permission to get copies of his income tax returns, the borrower must sign what form?***
 - A. 1003
 - B. 4506-T
 - C. 95-IRS
 - D. URAR
9. ***Joe wants to get a loan to buy a house. When evaluating his credit obligations, which would LEAST LIKELY be considered as debt?***
 - A. car loan payment
 - B. cell phone service payment
 - C. child support payments
 - D. credit card payments
10. ***A borrower has a stable monthly gross income of \$3,200 and recurring monthly debts of \$370. What is the maximum amount of money available to him for monthly housing expenses in order to qualify for a conforming loan?***
 - A. \$782
 - B. \$896
 - C. \$928
 - D. \$1,152

