What is a Mortgage?

Likely the largest debt you'll ever take on, a mortgage is a loan to finance the purchase of your home. Your home is collateral for the loan, which is also a legal contract you sign to promise that you'll pay the debt, with interest and other costs, typically over 15 to 30 years.
If you don't pay the debt, the lender has the right to take back the property and sell it to cover the debt. To repay the debt, you make monthly installments or payments that typically include the principal, interest, taxes and insurance, together known as PITI.

Principal: The principal is simply the sum of money you borrowed to buy your home. Before the principal is financed you can give the lender a sum of cash called a down payment to reduce the amount of money that will be financed.

Interest: Usually expressed as a percentage called the interest rate, interest is what the lender charges you to use the money you borrowed. As well as the given rate, the lender could also charge you points, and additional loan costs. Each point is one percent of the financed amount and is financed along with the principal.

Principal and interest comprise the bulk of your monthly payments in a process called amortization, which reduces your debt over a fixed period of time. With amortization, your monthly payments are largely interest during the early years and principal later.
In addition to your principal and interest, your mortgage payment could include money that's deposited in an escrow or trust account to pay certain taxes and insurance.
Generally, if your down payment is less than 20 percent, your lender considers your loan riskier than those with larger down payments. To offset that risk, the lender sets up the escrow account to collect those additional expenses, which are rolled into your monthly mortgage payment.

Taxes: The taxes are property taxes your community levies based on a percentage of the value of your home. The tax is generally used to help finance the cost of running your community, say to build schools, roads, infrastructure and other needs. You must pay property taxes even if you don't need an escrow account and even after your mortgage is paid off.

Insurance: Lenders won't let you close the deal on your home purchase if you don't have home insurance, which covers your home and your personal property against losses from fire, theft, bad weather and other causes. Even if you pay cash for your home, you should buy home insurance unless you can afford to repair or rebuild your home if it's damaged or destroyed.
If your home is in a federally designated high flood risk zone within a flood plain and you are signing for a federally insured loan, federal law mandates that you must buy flood insurance. If you are not in a high flood risk zone, you still may buy the coverage.
If you put less than 20 percent down on your home purchase, most lenders will also charge you private mortgage insurance (PMI) premiums. The coverage doesn't protect you, it protects the lender from you defaulting on the mortgage. Without the coverage, many buyers could not otherwise afford to buy a home. Effective for loans written on or after July 29, 1999, lenders must automatically cancel PMI when your mortgage balance shrinks to 78 percent of the home's original purchase price.

Common Types of Home Mortgages

Fixed rate and adjustable rate mortgages are the two main types of mortgages, but there is a wide variety of other mortgage products available. Below are pros and cons of just a few of the mortgage products you may want to consider.

Type of Mortgage	Pros	Cons
Fixed-rate mortgage	No surprises The interest rate stays the same over the entire term, usually 15, 20 or 30 years.	If interest rates fall, you could be stuck paying a higher rate.
Adjustable-rate (ARM) or variable-rate mortgage	Usually offers a lower initial rate of interest than fixed-rate loans.	After an initial period, rates fluctuate over the life of the loan When interest rates rise, generally so do your loan payments.
FHA (Federal Housing Administration) loan	Allows buyers who may not qualify for a home loan to obtain one Low down payment.	The size of your loan may be limited.
VA loan	Guaranteed loans for eligible veterans, active duty personnel and surviving spouses Offers competitive rates, low or no down payments.	The size of your loan may be limited.
Balloon mortgage	Usually a fixed rate loan with relatively low payments for a fixed period.	After an initial period, the entire balance of the loan is due immediately This type of loan may be risky for some borrowers.
Interest-only	Borrower pays only the interest on the loan, in monthly payments, for a fixed term.	After an initial period, the balance of the loan is due. This could mean much higher payments, paying a lump sum or refinancing.
Reverse mortgage	Allows seniors to convert equity in their homes to cash; you don't have to pay back the loan and interest as long as you live in the house.	Subject to aggressive lending practices and false advertising promises, particularly by lenders that prey on seniors. Check to make sure the loan is Federally insured.

Abstract of title
A summary of recorded transactions concerning a particular property.

Acceleration clause
Condition in a mortgage that gives the lender the right to require immediate repayment of the loan balance if regular mortgage payments are not made or for breach of other conditions of the mortgage.

Accrued interest
Interest earned but not yet paid.

Adjustable rate
An interest rate that changes periodically according to an index.

Adjustable-rate mortgage (ARM)
A mortgage with an interest rate that adjusts periodically based on a preselected index, causing interest rates and payments to rise and fall with the market.

Adjustment interval
The time between changes in the interest rate and monthly payments on an ARM.

Agent
One that acts for or represents another.

Agreement of sale
Also known as a "sales contract," a written document in which a purchaser agrees to buy property under certain given conditions, and the seller agrees to sell under certain given conditions.

Alternative documentation
A method of documenting a loan file that relies on information the borrower is likely to be able to provide, instead of waiting on verification sent to third parties for confirmation of statements made in the application.

Amortization
A monthly repayment schedule in which a loan is repaid in fixed payments of principal and interest.

Annual percentage rate (APR)
The annual cost of a loan, expressed as a yearly rate. APR takes into account interest, discount points, lender fees and mortgage insurance, so it will be slightly higher than the interest rate on the loan.

Application
Often referred to as a 1003, an initial statement of personal and financial information required to approve your loan.

Application fee
A fee charged by a lender to cover initial costs of processing a loan application, often including charges for property appraisal and a credit report.

Appraisal

A written estimate of a property's current market value, based on recent sales information for similar properties, the current condition of the property and how the neighborhood might affect future property value.

Appraisal fee
A fee charged by a licensed, certified appraiser to render an opinion of market value as of a specific date.

APR
See Annual Percentage Rate.

ARM
See Adjustable-Rate Mortgage.

ARM assumbility
Some ARM products feature "assumability" to a qualified applicant. The assumability of an ARM loan may make it more attractive to an applicant who envisions selling their home at a later date. By incorporating an assumable mortgage product, they may be able to make their home more attractive to potential buyers.

ARM disclosure
An additional disclosure specific to adjustable-rate mortgages that must be prepared and presented to the consumer within three days of application whenever an adjustable-rate mortgage transaction is contemplated (Note: home equity lines have their own unique disclosure).

ARM handbook
The Consumer Handbook to Adjustable-Rate Mortgages ("CHARM" booklet) must be presented to the consumer within three days of applying for an ARM loan (in addition to the ARM disclosure referenced above).

Amortization re-cast period
Pre-determined period of time (expressed either in a number of months and/or a percent of increase from original principal balance) after which any/all accumulated "negative amortization" (aka "deferred interest") is accounted for in a re-amortization of the loan balance over the remaining term of the mortgage at the then prevailing rate of interest. Amortization is also re-casted at each adjustment even if no negative amortization. Typically, any payment cap that would otherwise factor in is disregarded in the event of re-casting.

Amortization re-cast limitation
Amortization is most often "capped" at 110 or 125 percent of the original principal balance. Re-amortization typically occurs every 60 months and/or at such time as the balance reaches the pre-determined "cap."

Assessment
A local tax levied against properties that have benefited from civil improvements such as road or sidewalk construction, a sewer or street lights.

Asset
Anything of monetary value that a person owns. Assets include real property, personal property and enforceable claims against others (including bank accounts, stocks, mutual funds and so on).

Assignment

The transfer of property rights from one person to another.

Assumability
A feature of a loan allowing it to be transferred to the new purchaser of a home. Assumable mortgages can help attract buyers because assumption of a loan requires lower fees and/or qualifying standards than a new loan.

Assumption
Agreement between buyer and seller for the buyer to take over the payments on an existing mortgage.

Balance sheet
A document showing the financial situation-assets, liabilities and net worth of a person at a specific point in time.

Bank check
See cashier's check.

Bankruptcy
Proclamation by a court of an individual's (or organization's) state of insolvency, or inability, to pay debts. Petition may be brought by an individual or his creditors, with a goal of orderly and equitable settlement of obligations.

Basis point
A unit of measure: 1/100th of one percent. For example, the difference between a 9.0 percent loan and a 9.5 percent loan is 50 basis points.

Bearer
The legal owner of a piece of property.

Bequest
A gift of personal property by will.

Bill of sale
A document that transfers ownership of goods from one person to another.

Biweekly mortgage
A payment plan under which one pays one-half of a monthly payment every two weeks, saving interest substantially over the life of the loan.

Bona fide
In good faith.

Bond
A document representing a right to certain payments on underlying collateral.

Borrower (Mortgagor)

An individual who applies for and receives a loan in the form of a mortgage with the intention of repaying the loan in full.

Broker
An individual who assists in arranging funding or negotiating contracts for a client, but does not loan money himself.

Buy-down
A situation in which the seller contributes money that allows the lender to give the buyer a lower rate and payment, usually in exchange for an increase in sales price. With a refinance, this could be paid by the borrower.

Buyer's broker
An agent hired by a buyer to locate a property for purchase and to represent the buyer in negotiations with the seller's broker for the best possible deal for the buyer.

Buyer's market
Market conditions that favor buyers. With more sellers than buyers in the market, buyers have ample choice of properties and can negotiate lower prices.

Call option
A provision in the mortgage that gives the mortgagee the right to call the mortgage due and payable at the end of a specified period for whatever reason.

Caps
Limits on changes in ARM interest rates or monthly payments, either in an adjustment period or over the life of the loan.

Caps (Payment)
Consumer safeguards may limit the amount monthly payments on an adjustable-rate mortgage may change. Because they do not limit the amount of interest the lender is earning, they may cause negative amortization.

Cash-out
A refinance for more than the balance of the original mortgage, with the extra money is taken out of the equity in the property.

Cashier's check (or bank check)
A check whose payment is guaranteed because it was paid for in advance and is drawn on the bank's account instead of the customer's.

CC&Rs
See Covenants, Conditions and Restrictions.

Ceiling
The maximum allowable interest rate of an adjustable-rate mortgage.

Certificate of eligibility
Document issued by the Veterans' Administration to qualified veterans that entitles them to VA guaranteed loans. This certificate can be obtained through local VA office by submitting form DD-214 (Separation Papers) and VA form 1880 (request for Certificate of Eligibility).

Certificate of occupancy
Document issued by local government agency stating that a property meets the requirements of health and building codes.

Certificate of reasonable value (CRV)
A property appraisal performed by a VA-approved appraiser that establishes the limit on the principal of the VA loan.

Certificate of title
Written opinion of the status of title to a property, given by an attorney or title company. This certificate does not offer the protection given by title insurance.

Certificate of veteran status
Document given to veterans or reservists who have served 90 days of continuous active duty (including training time) which enables them to obtain lower down payments on certain FHA-insured loans. Obtainable through local VA office by submitting form DD-214 (Separation Paper) with form 26-8261A (request for Certificate of Veteran Status).

Certified check
A check drawn on the issuer's account for funds that have been segregated by the bank, guaranteeing payment.

CFPB
See Consumer Financial Protection Bureau.

Chain of title
The chronological order of conveyance of a property from the original owner to the present owner.

Clear title
A marketable title, free of clouds and disputes.

Closing (or settlement)
Meeting between the buyer, seller and lender or their agents at which property and funds legally change hands.

Closing costs
Fees incurred in a real estate or mortgage transaction and paid by borrower and/or seller during a mortgage loan closing. These typically include a loan origination fee, discount points, attorney's fees, title insurance, appraisal, survey and any items that must be prepaid, such as taxes and insurance escrow payments. The cost of closing is usually about 3 to 6 percent of the mortgage amount.

Closing statement
A financial disclosure statement that lists the funds received and expected at the closing.

Cloud on title

An outstanding claim or encumbrance that, if valid, would affect or impair the owner's title.

CLTV
See Combined loan-to-value.

COFI
See Cost of funds index.

Collateral
Assets that back a mortgage loan.

Combined loan-to-value (CLTV)
The ratio of the total mortgage liens against the subject property to the lesser of either the appraised value or the sales price.

Commission
Money paid to a real estate agent or broker by the seller (usually 6 to 7 percent of a home's sale price).

Commitment
A formal offer by a lender to make a loan under certain terms or conditions to a borrower.

Condominium
A form of property ownership in which the homeowner holds title to an individual dwelling unit and an interest in common areas and facilities of a multi-unit project.

Conforming loan
A mortgage loan under the maximum amount of loans that FNMA and FHLMC are legally allowed to buy. Maximum loan amount varies by county.

Consumer Financial Protection Bureau (CFPB)
A federal agency that enforces laws that protect consumers of financial products and services such as mortgages, credit cards and deposit accounts.

Contingency
A condition that must be satisfied before a contract is legally binding before a sale can close.

Contract of sale
The agreement between the buyer and seller on the purchase price, terms and conditions of a sale.

Conventional loan
A mortgage not insured by the FHA or guaranteed by the VA.

Conversion clause
A provision in some ARMs allowing you to change an ARM to a fixed-rate loan, usually after the first adjustment period. The new fixed rate is set at current rates, and there may be a charge for the conversion feature.

Conversion option
Many "short-term" ARM products feature a conversion option. This option allows a consumer, subject to certain restrictions, to convert the loan from an adjustable to a fixed-rate mortgage.

Convertible ARMs
ARMs with the option of conversion to a fixed loan during a given time period.

Conveyance
The transfer of a deed or possibly a lease or mortgage.

Cost of funds index (COFI)
An index of the weighted-average interest rate paid by savings institutions for sources of funds, usually by members of the 11th Federal Home Loan Bank District.

Covenants, conditions and restrictions (CC&Rs)
A document defining the use, requirements and restrictions of a property.

Credit report
A report detailing the credit history of a prospective borrower, used when determining creditworthiness.

Credit risk
The possibility that the borrower may default on financial obligations.

CRV
See Certificate of reasonable value.

Debt-to-income ratio
The ratio, expressed as a percentage, that results when a borrower's monthly payment obligation on long-term debts is divided by monthly income.

Deed
A legal document that transfers a property from one owner to another. The deed contains a description of the property, and is signed, witnessed and delivered to the buyer at closing.

Deed of trust
Agreement to pledge property as security for a loan, used in many states in place of a mortgage. In this arrangement, the borrower transfers legal title to a trustee who holds the property in trust as security for the repayment of the debt. The deed of trust becomes void if the debt is repaid, but if the borrower defaults on the loan, the trustee may sell the property to pay the debt.

Default
Failure to meet legal obligations in a contract, including failure to make payments on a loan. A mortgage is generally considered to be in default when a payment is 30 or more days past due.

Deferred interest
Interest added to the balance of a loan when monthly payments are not sufficient to cover it. (See Negative amortization.)

Delinquency
Failure to make payments on time.

Deposit
Cash paid when a formal sales contract is signed. The deposit is usually held by a third party until the sale is complete.

Depreciation
When the value of property declines.

Discount points (or Points)
Money paid to a lender at closing in exchange for lower interest rates. Each point is equal to 1 percent of the loan amount.

Documentary stamps
A state tax, in the forms of stamps, required on deeds and mortgages when a real estate title passes from one owner to another.

Down payment
Money paid for a house from one's own funds at closing. The down payment will be the difference between the purchase price and mortgage amount.

Due-on-sale clause
Provision in a mortgage or deed of trust allowing the lender to demand immediate payment of the loan balance upon sale of the property.

Earnest money
Deposit made by a buyer in evidence of good faith when the purchase agreement is signed.

ECOA
See Equal Credit Opportunity Act.

Effective interest rate
The cost of a mortgage expressed as a yearly rate, usually higher than the interest rate on the mortgage since this figure includes up-front costs.

Encumbrance

A legal right or interest in a property that affects title and lessens the property value. Encumbrances can take the form of claims, liens, unpaid taxes and so on. These will usually have to be taken care of before a buyer may purchase a property.

Equal Credit Opportunity Act (ECOA)
Federal law requiring creditors to make credit equally available without discrimination based on race, color, religion, national origin, age, sex, marital status, or receipt of income from public assistance programs.

Equity
The percentage of property value held by the owner; the difference between the current market value of a property and the outstanding mortgage balance.

Equity loan
A loan based on the borrower's equity in his home.

Escrow
The neutral third party that holds money and/or documents until the escrow instructions are fulfilled and escrow can be a title company or an attorney, depending on state regulations.

Escrow account
Account held by a lender containing funds collected as part of mortgage payments for annual expenses such as taxes and insurance, so that the homeowner does not have to pay a large sum when these fall due.

Escrow waiver
Escrow Waiver is waiver of the requirement to fund an escrow account with lender and instead pay insurance and taxes separately. This waiver may require a fee and is not available with all loan programs.

Fannie Mae
See Federal National Mortgage Association.

FHAct
See Fair Housing Act

Fair Housing Act (FHAct)
Prohibits discrimination in real estate transactions because of race, color, religion, sex, handicap, familial status (families with children), or national origin. It applies to mortgage lending as well as other aspects of real estate transcations, including sales and rentals, real estate brokerage, and appraisals.

Farmer's Home Administration (FMHA)
An agency within the U.S. Department of Agricultur that provides financing for homes and farms in small towns and rural areas.

Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac)

Quasi-governmental agency that purchases conventional mortgages from insured depository institutions and HUD-approved mortgage bankers.

Federal Housing Administration (FHA)
A government agency, division of the Department of Housing and Urban Development, that insures residential mortgage loans made by private lenders and sets standards for underwriting mortgage loans.

Federal National Mortgage Association (FNMA or Fannie Mae)
A quasi government agency created by Congress that buys and sells residential loans.

Federal Reserve
The central bank of the United States and major regulatory agency for many commercial banks.

Fee simple
Absolute ownership of real property.

FHA
See Federal Housing Administration.

FHA Loan
A loan insured by the FHA open to all qualified home purchasers.

FHLMC
See Federal Home Loan Mortgage Corporation.

FIAR
Fully Indexed Accrual Rate (Index + Margin).

First mortgage
A mortgage that is in first lien position, taking priority over all other liens. In the case of foreclosure, the first mortgage will be repaid before any other mortgages.

Fixed rate
An interest rate that is fixed for the term of the loan.

Fixed-rate mortgage
A mortgage with an interest rate that doesn't change for the life of the loan, guaranteeing fixed payments.

Flood insurance
A form of hazard insurance required by lenders to cover properties in flood zones.

Floor
The minimum rate of interest payable on an adjustable-rate mortgage.

Floor (Interest - ARM)

A pre-determined amount that establishes the minimum interest rate life of a loan. This can be expressed as a percentage below the start rate, as a rate of interest independent of the start rate, or, quite typically, the "Floor" may be established as being equal to the Margin.

FMHA
See Farmer's Home Administration.

FNMA
See Federal National Mortgage Association.

Forbearance
Grace period given when a lender postpones foreclosure to give the borrower time to catch up on overdue payments.

Foreclosure (or repossession)
Legal process by which the lender forces the sale of a property because the borrower has not met the mortgage terms.

Freddie Mac
See Federal Home Loan Mortgage Corporation.

Ginnie Mae
See Government National Mortgage Association.

GNMA
See Government National Mortgage Association.

Good faith estimate
This document sets out the costs associated with a mortgage, including the interest rate, lender fees, title charges, pre-paid interest and insurance. The government requires that your lender give you a GFE within three days of receiving your loan application. The GFE is only an estimate; some fees can change before closing. Lender fees and the interest rate (if you have locked your rate) may not increase, and certain other costs may not increase by more than 10 percent.

Government National Mortgage Association (GNMA or Ginnie Mae)
A government agency that provides funds for VA and FHA loans.

GPM
See Graduated Payment mortgage.

Graduated Payment Mortgage (GPM)
A mortgage with initial low payments (with potential negative amortization) that increase regularly for several years and then level off.

Grace period
Period of time during which a loan payment may be made after its due date without incurring a late penalty.

Gross
Before taxes.

Gross income
Total income before taxes or expenses are deducted.

Gross monthly income
The total amount earned by a borrower each month.

Guarantee
To assume liability for another's debts in the event of default.

Guaranty
A promise by one party to pay a debt or perform an obligation contracted by another in case of that person's default.

Hazard insurance
Protects the insured against loss due to fire or other natural disaster in exchange for a premium paid to the insurer.

Home equity loan
A loan secured by equity in a property. These are sought for a variety of purposes, including home improvements, major purchases or expenses and debt consolidation. Interest paid is usually tax-deductible.

Homeowners warranty
A type of insurance that covers repairs to specified parts of a house for a specific period of time.

Housing and Urban Development (HUD)
A U.S. government agency established to implement federal housing and community development programs; oversees the Federal Housing Administration.

Housing code
Local government ordinance that sets minimum standards of safety and sanitation for existing residential buildings.

Housing expense-to-income ratio
The ratio, expressed as a percentage, that results when a borrower's housing expenses are divided by his/her monthly income.

HUD
See Housing and Urban Development.

HUD-I settlement statement

A form that itemizes the closing costs associated with purchasing a home.

Impound (or reserves)
A portion of a borrower's monthly payments held by the lender to pay for taxes, insurance and other items as they become due.

Impound account
Savings account for accumulating that portion of a borrowers monthly payments designated for future payments of taxes and insurance. (Required by certain lenders or with certain types of financing.)

Index
A published rate used by lenders to calculate interest adjustments on ARMs (Index + Margin = Interest Rate). Some indexes are more volatile than others.

Index (ARM)
Established at loan origination, the index is a widely published financial indicator that, combined with the Margin, works to establish the effective rate of an adjustable-rate mortgage ("Index + Margin = Rate").

Initial rate
The rate charged during the first interval of an ARM.

Insolvency
Condition of a person who is unable to pay his debts as they fall due.

Interest
Charge paid for borrowing money, calculated as a percentage of the amount borrowed.

Interest rate
The periodic charge, expressed as a percentage, for use of credit.

Interest rate cap
A safeguard built into ARMs to prevent drastic changes in interest rates.

Interest rate change date
Dates upon which the rate of interest is subject to change. Initial change date and subsequent change dates may feature different terms.

Joint liability
Liability shared among two or more people, each of whom is liable for the full debt.

Joint tenancy
The ownership of property by two or more persons with the survivor taking the share of the deceased.

Jumbo loan
A mortgage larger than the limits set by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. Because jumbo loans cannot be funded by these two agencies, they usually carry a higher interest rate.

Late charge
Penalty paid by a borrower when a payment is made after the due date.

Lender
The bank, mortgage company or mortgage broker offering a loan.

LIBOR (London Interbank Offered Rate)
The interest rate charged among banks for short-term Eurodollar loans, and a common index for ARMs.

Lien
A claim by one person on the property of another for payment of a debt.

Life cap (Interest)
A pre-determined amount that establishes the maximum interest rate life of loan. This can be expressed as a percentage above the start rate or as a rate of interest independent of the start rate.

Loan administration
The collection of mortgage payments from borrowers and related responsibilities (such as handling escrows for property tax and insurance, foreclosing on defaulted loans and remitting payments to investors).

Loan application
A document required by lenders prior to loan approval containing detailed information about the borrower and property.

Loan application fee
A fee a prospective buyer pays a lender when applying for a mortgage.

Loan origination fee
A fee a lender charges to process a mortgage, usually expressed as a percentage of the loan (or points), which pays for the work in evaluating and processing the loan.

Loan servicing
See Loan administration.

Loan to value ratio (LTV)

The percentage of the property value borrowed. (Loan amount/property value=LTV)

Lock or lock-in

A lender's guarantee of an interest rate for a set period of time, usually between loan application and loan closing. This protects borrowers against rate increases during that time.

LTV

See Loan to Value Ratio.

Margin

The number of percentage points added to an index to calculate the interest rate on an ARM at each adjustment.

Marketable title

A title free and clear of liens, clouds or other defects that would prevent the sale of the property.

Market rate

The average rate charged by lenders for a loan.

Market value

The highest price that a buyer would pay for a property and the lowest price a seller would accept.

Monthly housing expense

Total monthly expense of principal, interest, taxes and insurance.

Mortgage

A document that creates a lien on a property as security for the payment of a debt.

Mortgage banker

A professional that originates mortgage loans, funding them with his own money.

Mortgage broker

A specialist that arranges financing for borrowers, but places loans with lenders rather than funding them with their own money.

Mortgagee

The lender in a mortgage loan transaction.

MIP (Mortgage insurance premium)

Insurance purchased by borrower to insure against default on a FHA loans.

Mortgage loan

A loan for which real estate serves as collateral to provide for repayment in case of default.

Mortgage note
A legal document that obligates a borrower to repay a loan at a stated interest rate during a specified period of time. The agreement is secured by a mortgage.

Mortgagor
The borrower in a mortgage loan transaction.

Negative amortization
An increase in principal balance that occurs when monthly payments are not large enough to pay all interest due on a loan, usually caused when payment caps prevent sufficient payment increases. Unpaid deferred interest is added to the loan balance, causing the borrower to owe more than the loan's original amount.

Net
After taxes.

Net effective income
Gross income minus estimated federal income tax.

Non-assumption clause
A statement in a mortgage contract forbidding the assumption of the mortgage by another borrower without the prior approval of the lender.

Non-conforming loan
A conventional loan that can not be sold to Fannie and Freddie Mac. Often, these loans are larger than the conforming loan amount.

Non-dischargeable debt
Debt, such as taxes, that cannot be forgiven in a bankruptcy liquidation.

Note
Legal document stating the terms of a debt and a promise to repay it.

Notice of default
Written notice to a borrower that a default has occurred and that legal action may be taken.

Office of Comptroller Currency
The federal financial regulatory body that oversees the nation's federally chartered banks and savings institutions.

Origination fee

A fee that a lender charges, usually expressed as a percentage of the loan (or points) for evaluating and processing the loan.

Owner financing
A purchase in which the seller provides all or part of the financing.

Payment cap
Limit on the amount by which a borrower's ARM payments may increase, regardless of rise in interest rates. This may result in negative amortization.

Payment cap (ARM)
A pre-determined amount that establishes the maximum by which the payment can increase, irrespective of increases to the interest rate.

Payment change date
Dates upon which the payment amount is subject to change. Products featuring "negative amortization" typically will include a payment change date which differs from the interest rate change date in frequency.

Per diem interest
Interest calculated per day. Depending on the day of the month on which closing takes place, you'll have to pay interest from the date of closing to the end of the month.

Periodic interest cap
An interest cap that restricts how much adjustable-rate mortgage rates may increase or decrease on pre-determined change dates.

Permanent loan
A long-term mortgage of 10 years or more.

PITI
Also called "monthly housing expenses," principal, interest, taxes and insurance are the components of a monthly mortgage payment.

PMI
See Private Mortgage Insurance.

Points (or Discount points)
Interest prepaid to the lender at closing. Each point is equal to 1 percent of the loan amount. Paying more points at closing generally reduces a loan's interest rate and monthly payments..

Power of attorney
Legal document authorizing one person to act on behalf of another.

Prepaid expenses
Taxes, insurance and assessments paid in advance of their due dates, including at closing.

Prepaid interest
Charged to a borrower at closing to cover interest on the loan between the closing date and the end of that month.

Prepayment
A full or partial payment of the principal before the due date. This might occur if the borrower makes extra payments, sells the property or refinances the existing loan.

Pre-payment penalty
Some ARM loans contain a provision against pre-payment without penalty. Terms of pre-payment penalty clauses vary from product to product, investor to investor, and state to state. Many states and even local municipalities have, or are contemplating, enacting legislation against pre-payment penalties.

Prequalification
The process of determining how much money a prospective homebuyer may borrow, prior to application for a loan.

Primary mortgage market
Includes banks, savings and loans, credit unions, and mortgage bankers who make mortgage loans directly to borrowers. These lenders sometimes sell their mortgages to lenders such as FNMA in the secondary mortgage market.

Prime rate
Lowest commercial interest rate charged by a bank on short-term loans to its most credit-worthy customers.

Principal
The amount of debt, not counting interest, left on a loan.

Private Mortgage Insurance (PMI)
Insurance purchased by a buyer on a conventional loan when a down payment is less than 20 percent of the purchase price to protect the lender against default.

Profit and loss statement
A financial statement showing revenue, expenses and profits over a period of time.

Property tax
A government tax based on the market value of a property.

Purchase agreement
A contract signed by buyer and seller stating the terms and conditions of a home sale.

Qualifying rate

Adjustable-rate mortgages often employ a "qualifying fate" that differs from the "start rate." The qualifying rate may be a pre-determined percentage of interest (i.e. "8 percent"), expressed as the "highest possible rate of interest at the beginning of the 2nd year", based on the start rate (i.e. "start rate + 2 percent), expressed as the "Fully Indexed Accrual Rate" ("FIAR") or another amount.

Qualifying ratio

A comparison of a borrower's expenses (housing or total debt) to his income.

Real Estate Agent

A real estate professional who is a member of the National Association of Realtors.

Real estate broker

An agent representing a buyer or seller in a real estate transaction.

Real Estate Settlement Procedures Act

A law that governs acceptable practices and fees in real estate transactions.

Real property

Land and everything that is permanently affixed to it.

Reclamation

The right of the person with title to a property to recover it from the debtor in case of a bankruptcy.

Reconveyance

The transfer of property back to the owner when a mortgage is fully repaid.

Recording

The act of entering documents concerning title to a property into public records.

Recording fee

Money paid to an agent for entering the sale of a property into the public records.

Refinancing

The process of paying off one loan with the proceeds from a new loan secured by the same property.

Rent with option to buy

See Lease-purchase mortgage loan.

Repossession (or foreclosure)

Legal process by which the lender forces the sale of a property because the borrower has not met the mortgage terms.

Rescission

The cancellation of a contract, permitted by law within three days of signing a mortgage not used to purchase a home.

Reserves
See Impound.

RESPA
See Real Estate Settlement Procedures Act.

Sale agreement
A contract signed by buyer and seller stating the terms and conditions under which a property will be sold.

Satisfaction
The payment of a debt that satisfies an obligation.

Secondary mortgage market
The market into which primary mortgage lenders sell the mortgages they make to obtain funds to originate more new loans. This includes investors such as Fannie Mae and Freddie Mac.

Second mortgage
A subordinate mortgage made in addition to a first mortgage.

Seller's broker
An agent hired by a seller to represent him/her in negotiations to sell property.

Seller's market
Market conditions that favor sellers. With more buyers than sellers in the market, sellers have the negotiating power as demand exceeds supply.

Servicing (or Loan administration)
The collection of mortgage payments from borrowers and related responsibilities (such as handling escrows for property tax and insurance, foreclosing on defaulted loans and remitting payments to investors).

Settlement (or Closing)
A meeting between the buyer, seller and lender (or their agents) where property and funds legally change hands.

Settlement cost (HUD guide)
A booklet given to consumers after applying for a loan that provides an overview of the lending process.

Settlement costs
See Closing costs.

Settlement sheet (HUD-1)

The computation of costs payable at closing that determines the seller's net proceeds and the buyer's net payment.

Simple interest
Interest that is computed only on the principal balance.

Start rate
A pre-determined rate of interest that will be applied to the loan until the date of the first interest rate change.

Subsidized second mortgage
Alternative financing option for low- and moderate-income households that also includes a down payment and a first mortgage, with funds for the second mortgage provided by city, county or state housing agencies, foundations or nonprofit corporations. Payment on the second mortgage is often deferred and carries low interest rates (if any). Part of the debt may be forgiven for each year the family remains in the home.

Survey
A measurement of land, prepared by a licensed surveyor, showing a property's boundaries, elevations, improvements and relationship to surrounding tracts.

Sweat equity
Value added to a property by improvements made by the owner.

Tax impound
Money paid to and held by a lender for annual tax payments. See Impound Account.

Tax lien
Claim against a property for unpaid taxes.

Tax sale
Public sale of property by a government authority as a result of nonpayment of taxes.

Term
The number of years until a loan is due to be paid in full.

Title
A document that gives evidence of ownership of a property, as well as rights of ownership and possession.

Title company
A company that insures the title to a property.

Title insurance
Insurance that protects the lender (lender's policy) or buyer (owner's policy) against loss due to disputes over property ownership.

Title search
Examination of municipal records to ensure that the seller is the legal owner of a property and that there are no liens other claims against the property.

Transfer tax
Tax paid when a title passes from one owner to another.

Trust account
An account maintained by a broker or escrow company to handle all money collected for clients.

Trustee
Someone given legal responsibility to hold property in the best interest of another.

Truth-in-Lending Act
A federal law requiring written disclosure of the terms of a mortgage (including APR and other charges) by a lender to a borrower after application.

Underwriting
The process of verifying data and evaluating a loan application. The underwriter gives the final loan approval.

VA Loan
A home loan available to veterans with little or no down payment and guaranteed by the U.S. Veterans' Administration.

Variable rate mortgage
See Adjustable-rate mortgage.

Variable rate
An interest rate that changes periodically in relation to an index.

Verification of deposit (VOD)
A document signed by the borrower's bank or other financial institution that verifies the borrower's account balance and history.

Verification of employment (VOE)
A document signed by the borrower's employer that verifies the borrower's position and salary.

VOD
See Verification of deposit.

VOE
See Verification of employment.

Waiver
Voluntary relinquishment or surrender of some right or privilege.

Walk-through
A final inspection of a home to check for problems that may need to be corrected before closing.

Warehouse fee
Mortgage firms often borrow funds from a warehouse lender on a short-term basis in order to originate loans that will later be sold to investors in the secondary mortgage market. Lenders may charge a warehouse fee to cover an expense charged by the warehouse lender.

Zoning ordinances
Local laws that establish building codes and usage regulations for properties in a specified area. This creation of districts specifies different types of property uses, such as commercial or residential.

Different Types of Income in the US

Types of Income	Proof of Month	Annual Proof
Wage Earner / Salaried	**Paystubs & BS**	**W2 & 1040**
Business Income	**Profit & Loss & BS**	**1040 WITH Applicable Schedules**
Social Security Benefits	**Award Letter & BS**	**1040 WITH Applicable Schedules**
Disability Benefits	**Letter & BS**	**1040 WITH Applicable Schedules**
Pension Income	**Letter & BS**	**1040 WITH Applicable Schedules**
Unemployment Claims	**Letter & BS**	**1040 WITH Applicable Schedules**
Rental Income	**Lease Agreements & BS**	**1040 WITH Applicable Schedules**
Contribution	**Contribution Letter**	**{All the documents for Above categories}**

BS stands for Bank Statements

Formulas for Calculating Income in Monthly numbers

How to calculate incomplete earned income documentation

1. A weekly gross income must be multiplied by 4.333 to total one month's income.

$550 weekly X 4.333 = $2,383.15 monthly income

2. Bi-weekly gross income should be multiplied by 2.167 to calculate one month's income.

$1,200 bi-weekly X 2.167 = $2,600.40 monthly income

3. Bi-monthly gross income should be multiplied by 2

$1,200 bi-monthly X 2 = $2,400.00 monthly income

4. Quarterly gross income (including any interest and dividends) should be divided by 3 to arrive at a monthly average.

$4,000 quarterly divide by 3 = $1333.33 monthly income

MORTGAGE LOAN ORIGINATION ACTIVITIES

Learning Objectives

This chapter was created based on the Mortgage Loan Origination Activities section of the NMLS National Test Content Outline. The topics found in this chapter could likely appear on the NMLS national test in multiple choice question format. In this chapter, students will:

- Review the key players and steps in the loan origination process
- Achieve insight into the origination process and obtain tips on effective loan application communication
- Gain perspective on what underwriters look for in loan files in order to anticipate and avoid problems
- Practice some of the important financial calculations associated with the origination process
- Review the importance of borrower communication and how it can make or break successful loan origination
- Investigate each step of the loan cycle from origination through funding and servicing and learn about the roles of various individuals involved in the loan process
- Explore the Uniform Residential Loan Application in detail to ensure compliance
- Discover how to meet underwriter requirements and avoid underwriting pitfalls
- Learn about the responsibilities of the title company and information on the post-closing process
- Understand the critical elements of borrower qualification: credit capacity, credit character and collateral
- Review the fundamentals of property ownership
- Explore the property appraisal process
- Review calculations as they pertain to debt ratios, borrower income and loan amount
- Examine the components of a credit report

Introduction

The operational procedures for mortgage professionals align with federal and state laws, customer service best practices, mathematical concepts and documentation. In this course, students will review the importance of the loan application, qualification, processing, underwriting, qualifying ratios, specific program guidelines, closing and more.

Application Information and Requirements

Application Accuracy (Truthfulness) and Required Information (e.g. 1003)

Loan applicants must complete a mortgage loan application and provide documentation to show the veracity of the information provided in the application. In order to complete an application, it is also necessary to obtain documentation on the value of the property used to secure the loan.

Customer

Form 1003, the Uniform Residential Loan Application, is the standard application that applicants complete when applying for a mortgage. Fannie Mae created the form and posts a downloadable copy on the Internet. Form 65 is a similar form created by Freddie Mac.

The 1003 contains an Acknowledgement and Agreement section which includes the borrower's (and co-borrower's) signature. This section is where the borrower is attesting to the truthfulness of the information contained in the application. While honest mistakes can always be corrected, it is important that all parties involved in a loan transaction understand the importance of truthfulness and accuracy in completing the loan application.

In conjunction with the loan application, the borrower should be made aware of the FBI Mortgage Fraud Warning Notice, which includes the following language:

> *Mortgage Fraud is investigated by the Federal Bureau of Investigation and is punishable by up to 30 years in federal prison or $1,000,000, or both. It is illegal for a person to make any false statement regarding income, assets, debt, or matters of identification, or to willfully overvalue any land or property, in a loan and credit application for the purpose of influencing in any way the action of a financial institution.*

The Warning Notice was issued in March 2007 as a joint effort of the Mortgage Bankers Association and the FBI in combating mortgage fraud.

Loan Originator

Completing the Loan Application

The purpose of the application interview with the potential borrower is to capture information to complete the loan application. This may take place in a face-to-face meeting, over the phone or even over the internet.

The 1003 is a fairly extensive document and is used to obtain a broad range of personal information about a potential borrower and the loan for which he or she is applying. Sections of the 1003 include:

Section I

Section I of the 1003 is the **“Mortgage and Terms of Loan”** section. This section allows borrowers to choose the type of loan for which they are applying. There are specific boxes on the loan application for each loan type that must be checked. Borrowers will also fill out the loan amount that they are requesting.

The agency case number box is designated for the Federal Housing Administration (FHA), the Veterans Administration (VA) or Farmer’s Home Administration (FmHA) case numbers. There is also a section for the lender’s case numbers.

After discussing with the applicant and while completing the application, the loan originator will fill out the interest rate the lender is charging the borrower and the length of time – also known as the term – that the borrower will have to repay the loan. The amortization type (fixed-rate, graduated payment, adjustable-rate) is also set forth in this section.

I. TYPE OF MORTGAGE AND TERMS OF LOAN					
Mortgage Applied for:	☐ VA ☐ FHA	☐ Conventional ☐ USDA/Rural Housing Service	☐ Other (explain):	Agency Case Number	Lender Case Number
Amount $	Interest Rate %	No. of Months	**Amortization Type:**	☐ Fixed Rate ☐ GPM	☐ Other (explain): ☐ ARM (type):

Section II

Section II of the 1003 – **“Property Information and Purpose of Loan”** - is used to designate information concerning the property address and how the loan proceeds will be used. The property address for the loan collateral is the address that will be connected to the loan. The address may be different from the applicant’s primary address. The property address must include the city, state and zip code. Designation of the property type – a single-family home or a multi-unit – is disclosed here.

Section II requires that the legal description of the property is provided. If the transaction is a purchase transaction (in which case it will be listed on the sales contract), the applicant may not know this information until the title work is returned. At that point, the legal description can be added. This section also requires the applicant to state:

- The year of construction of the property
- The purpose of the loan (how the borrower plans to use the loan proceeds)
- The type of property (primary residence, second home, investment property)
- Year of acquisition (when was the borrower added to the title)
- Original cost
- Existing loan amounts
- Value of the property
- Names currently on title

- How the title will be held (joint tenancy, tenancy in common or single tenancy)

If the property is a lot that is currently vacant, the borrower must fill out the construction-permanent section. This will let the lender know that the property is currently vacant but that a dwelling will be constructed on the lot.

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 ☐ Purchase ☐ Construction ☐ Other (explain): ☐ Refinance ☐ Construction-Permanent			Property will be: ☐ Primary Residence ☐ Secondary Residence ☐ Investment		
Complete this line if construction or construction-permanent loan.					
Year Lot Acquired	Original Cost $	Amount Existing Liens $	(a) Present Value of Lot $	(b) Cost of Improvements $	Total (a + b) $
Complete this line if this is a refinance loan.					
Year Acquired	Original Cost $	Amount Existing Liens $	Purpose of Refinance	Describe Improvements ☐ made ☐ to be made Cost: $	
Title will be held in what Name(s)			Manner in which Title will be held		Estate will be held in: ☐ Fee Simple ☐ Leasehold (show expiration date)
Source of Down Payment, Settlement Charges, and/or Subordinate Financing (explain)					

Section III

Section III of the loan application **– "Borrower Information" –** asks for the applicant's personal information. If the applicant has lived in his/her home for less than two years, residency information must be provided for the past two years. Contact information for the applicant is also necessary.

The applicant must provide personal information including social security number, age and number of dependents. Even though the age and number of dependents of the applicant is requested, the information cannot be used to discriminate in the mortgage transaction. Age is requested because the applicant must be of age to execute a contract.

Borrower				III. BORROWER INFORMATION			Co-Borrower
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	Social Security Number	Home Phone (incl. area code)	DOB (mm/dd/yyyy)	Yrs. School
☐ Married ☐ Unmarried (include ☐ Separated single, divorced, widowed)	Dependents (not listed by Co-Borrower) no.	ages		☐ Married ☐ Unmarried (include ☐ Separated single, divorced, widowed)	Dependents (not listed by Borrower) no.	ages	
Present Address (street, city, state, ZIP) ☐ Own ☐ Rent ____No. Yrs.				Present Address (street, city, state, ZIP) ☐ Own ☐ Rent ____No. Yrs.			
Mailing Address, if different from Present Address				Mailing Address, if different from Present Address			
If residing at present address for less than two years, complete the following:							
Former Address (street, city, state, ZIP) ☐ Own ☐ Rent ____No. Yrs.				Former Address (street, city, state, ZIP) ☐ Own ☐ Rent ____No. Yrs.			

Section IV

Section IV of the loan application – **"Employment Information"** – is for the applicant's current and/or two-year employment history. Current employer's information must be provided; if the applicant has more than one employer, all must be listed. If the applicant has not been at his/her current job for two years or more, he/she must provide information on employment for the past two years. If the applicant is self-employed, this must also be specified.

Borrower		IV. EMPLOYMENT INFORMATION		Co-Borrower	
Name & Address of Employer	☐ Self Employed	Yrs. on this job Yrs. employed in this line of work/profession	Name & Address of Employer	☐ Self Employed	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)	

If employed in current position for less than two years or if currently employed in more than one position, complete the following:

Borrower		IV. EMPLOYMENT INFORMATION (cont'd)		Co-Borrower	
Name & Address of Employer	☐ Self Employed	Dates (from – to) Monthly Income $	Name & Address of Employer	☐ Self Employed	Dates (from – to) 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	☐ Self Employed	Dates (from – to) Monthly Income $	Name & Address of Employer	☐ Self Employed	Dates (from – to) Monthly Income $
Position/Title/Type of Business	Business Phone (incl. area code)		Position/Title/Type of Business	Business Phone (incl. area code)	

Section V

Section V – **"Monthly Income and Combined Housing Expense Information"** – covers the information required to calculate an applicant's front and back debt-to-income ratios. When the applicant is asked for his/her income information, all income should be listed. Income may come from sources other than regular or full-time employment that is identified in IV. Other sources of income, which must be documented if they are used for qualification, may include:

- Regular full-time and part-time employment, including second jobs
- Social security
- Child support
- Alimony
- Investment/Rental property income

Housing expenses are also addressed in this section. The calculation for housing expenses should include mortgage payments, property taxes, association or condominium fees, mortgage insurance and hazard insurance payments.

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
		$

Section VI

Section VI – **"Assets and Liabilities"** – addresses the applicant's assets and liabilities.

Assets, which may consist of liquid and non-liquid types, include:

- Cash
- Checking accounts
- Savings accounts
- Retirement accounts (such as IRAs, 401Ks, etc.)
- Stocks
- Bonds
- Cash value of life insurance policies

Liabilities include:

- Debts for medical bills
- Credit cards
- Mortgages
- Judgments
- Consumer loans
- Student loans (unless deferred for more than two years)
- Alimony payments
- Child support payments

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 Description	Cash or Market Value	**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		**LIABILITIES**	**Monthly Payment & Months Left to Pay**	**Unpaid Balance**
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.		

Section VII

Section VII – **"Details of Transaction"** – is for specific information about the proposed transaction. The transaction information section is used to display how much money the borrower will need in order to get the loan to closing. The following information is detailed in this section:

- **Purchase Price –** The purchase price is the sale price of the property outlined in the sales contract.
- **Alterations, Improvement and Repairs –** Estimated cost for alterations, improvements and repairs are identified.
- **Land –** The cost of land, if purchased separately, from the cost noted in the purchase price.
- **Refinance –** Debts to be paid off in a refinance transaction.
- **Pre-paids –** These are items paid in advance. Examples of prepaid items are homeowner's insurance, escrows, interest and tax payments.
- **Estimated Closing Costs –** Costs charged in a loan transaction such as origination fees, processing fees, appraisal fees, title fees and recording fees.
- **Private Mortgage Insurance (PMI), Mortgage Insurance Premiums (MIP), Funding Fee –** This is the upfront private mortgage insurance fee, upfront mortgage insurance premium or VA funding fee that is charged to the borrower as a part of the loan transaction.
- **Discount –** The discount fee is a charge paid by the borrower to reduce the interest rate on the mortgage. It is generally expressed in percentages or points. A point is 1% of the loan amount.

- **Total Cost –** The above items are added together to get the estimated total cost of the loan.
- **Subordinate Financing –** Financing that a borrower will receive in addition to the loan amount identified in Section I of the 1003. Subordinate financing may include a second mortgage or a Home Equity Line of Credit (HELOC).
- **Borrower Closing Costs Paid by Seller –** This will identify contributions that will be made by the seller to the borrower at time of closing. It generally appears on the HUD-1 Settlement Statement as a seller's contribution or a seller's credit.
- **Other Credits** – May appear as a grant, a gift, a broker's credit or lender's credit.
- **PMI, MIP, Funding Fee Financed-** For the purpose of calculating cost, the PMI, MIP or Funding Fee can either be paid by the borrower out of pocket, or it can be financed as a part of the loan. This line identifies whether the PMI, MIP or funding fee will be financed.
- **Loan Amount** – The amount identified in Section I of the 1003.
- **Cash From/To Borrower –** The cash from or to the borrower is identified by subtracting the cost of the loan from the credits. The result is what needs to be communicated to the borrower prior to closing, after preparing the final 1003. The amount may vary slightly, but it will serve as a good estimate.

VII. DETAILS OF TRANSACTION		
a.	Purchase price	$
b.	Alterations, improvements, repairs	
c.	Land (if acquired separately)	
d.	Refinance (incl. debts to be paid off)	
e.	Estimated prepaid items	
f.	Estimated closing costs	
g.	PMI, MIP, Funding Fee	
h.	Discount (if Borrower will pay)	
i.	Total costs (add items a through h)	

Section VIII

Section VIII – **"Declarations" –** contains questions regarding judgments, citizenship, default status, occupancy status and other questions that may affect the underwriting of the loan and may result in additional conditions or immediate rejection of the loan. It is important to remind the borrower that the questions must be answered truthfully and completely and that untruthful responses may be considered fraud.

The lender may ultimately verify the responses through a third party verification process. If the verification reveals something contrary to the applicant's response, the applicant should be notified and the 1003 should be adjusted accordingly. The underwriter may request additional information or mitigating information pursuant to underwriting guidelines.

VIII. DECLARATIONS				
If you answer "Yes" to any questions a through i, please use continuation sheet for explanation.	**Borrower**		**Co-Borrower**	
	Yes	**No**	**Yes**	**No**
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.)	☐	☐	☐	☐

Section IX

Section IX **– "Acknowledgment and Agreement" –** allows applicants to affirm that they understand the purpose of the loan application and that it is a binding agreement. Applicants are required to sign this section and certify that all information contained in the 1003 is true and correct to the best of their knowledge. The applicant should be made aware that his/her failure to truthfully complete the application could result in civil liability or criminal prosecution for mortgage fraud.

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

Section X

The final section on the 1003 – "**Information for Government Reporting Purposes**" **–** is related to government statistics. The section is referred to as the Home Mortgage Disclosure Act (HMDA) Section. It requests information regarding race, sex and national origin. None of this information can be used to discriminate against the borrower, and it is at the applicant's discretion whether he/she completes this section. If the applicant decides not to furnish this information, it will be up to the loan originator to make an “educated guess” concerning the demographic information to report to the government (only in regards to face-to-face applications; not internet, mail, or telephone).

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 ☐ I do not wish to furnish this information	**CO-BORROWER** ☐ I do not wish to furnish this information
Ethnicity: ☐ Hispanic or Latino ☐ Not Hispanic or Latino	**Ethnicity:** ☐ Hispanic or Latino ☐ Not Hispanic or Latino
Race: ☐ American Indian or Alaska Native ☐ Asian ☐ Black or African American ☐ Native Hawaiian or Other Pacific Islander ☐ White	**Race:** ☐ American Indian or Alaska Native ☐ Asian ☐ Black or African American ☐ Native Hawaiian or Other Pacific Islander ☐ White
Sex: ☐ Female ☐ Male	**Sex:** ☐ Female ☐ Male

To be Completed by Interviewer This application was taken by: ☐ Face-to-face interview ☐ Mail ☐ Telephone ☐ Internet	Interviewer’s Name (print or type) Interviewer’s Signature Date Interviewer’s Phone Number (incl. area code)	Name and Address of Interviewer’s Employer

If information is missing from the application, the loan originator should make an effort to notify the applicant immediately and allow him/her a reasonable amount of time in which to furnish it. Applicants must be made aware of the status of their loan application in writing within 30 days of the date of application. Evidence of this notification must be kept in the loan file.

Verification and Documentation

After completing a loan application, an applicant must provide documentation to support the information disclosed in the application. These documents include:

- **Requests for Verification of Employment:** If the applicant is salaried and is not self-employed, he/she will sign a VOE, which the lender will forward to the applicant’s employer for verification of employment and income. If the applicant has not held his/her current employment for two years, the lender will also send a VOE to the previous employer. Lenders may also request W-2 forms, pay stubs, and tax forms.

  Lenders are not likely to consider overtime and bonus pay as part of a loan applicant’s income unless the applicant can show that he/she has received the additional income consistently for at least two years, and the employer indicates that the overtime or bonus pay is likely to continue.

- **Requests of Verification of Deposit:** A Verification of Deposit (VOD) is a document signed by the loan applicant’s bank or other depository institution verifying the applicant’s balance in the account and the account history.

- **Special Considerations for Applicants with Commission Income or Self-Employment:** Lenders ask for additional documentation when calculating the income of loan applicants who earn commission income and when calculating the income of self-employed loan applicants.

- **Commission Income:** Lenders will require copies of income tax returns for the past two years and information on current income if commissions represent 25% or more of an applicant's annual income. In order to account for the variability of an applicant's commissions, lenders will average the past two years of income.
- **Income of Self-Employed Applicants**: A self-employed applicant must show that he/she has maintained an income for two years in order to qualify for a mortgage loan. Lenders will not rely on a verification of employment from a self-employed applicant. Lenders will request additional documentation to verify income. These documents may include:
  - Tax returns for the past two years
  - A year-to-date profit and loss statement
  - Balance sheets for the past two years
  - A self-employed income analysis

Suitability of Products and Programs

As a result of the rising number of defaults on subprime mortgages and nontraditional mortgages, there is a trend towards requiring loan originators to meet loan suitability standards. "Loan suitability" is a term that refers to the diligent matching of loan programs with the current financial circumstances of each customer. Revisions to some state laws have made loan suitability a legal standard that originators are required to meet when they help customers to secure mortgage loans.

In testimony before Congress, representatives for mortgage industry professional organizations have argued that borrowers must ultimately bear the responsibility for deciding what type of loan product is best suited to meet their individual needs. Although there are many who support this argument, state and federal legislators are debating bills that would create obligations for loan originators to:

- Conduct a more rigorous analysis of the borrower's repayment ability
- Consider whether a refinance creates a tangible net benefit for the borrower
- Work diligently to find a loan that is suitable for the borrower's circumstances

To some extent, these requirements are reflected in 2008 revisions to Regulation Z that address Section 32 loans and higher-cost home loans (loans that do not meet the criteria for Section 32 loans, but which are more expensive than prime mortgages). Under the new provisions, loan originators must:

- Complete an analysis of repayment ability that includes a determination of the ability of the borrower to pay mortgage-related taxes and insurance when originating Section 32 loans
- Verify income and employment for borrowers who accept Section 32 loans using **reasonably reliable evidence** such as IRS W-2 forms, tax returns, and payroll receipts

- Complete and verify an analysis of repayment ability that includes a determination of the ability of the borrower to pay mortgage-related taxes and insurance when originating higher-cost mortgages

Some states have adopted the CSBS/AARMR *Guidance on Nontraditional Mortgage Product Risks for State-Licensed Entities.* The Guidance demands a more thorough analysis of borrower circumstances when originating nontraditional loans such as interest-only loans and payment-option loans. The Guidance states that a rigorous analysis is critical if the loan applicant is:

- Seeking a reduced documentation loan or a simultaneous second-lien loan
- Applying for a loan as a subprime borrower
- Financing the purchase of a non-owner-occupied investment property

The Guidance strongly discourages originators from offering nontraditional mortgages to loan applicants whose financial circumstances will force them to sell or refinance the property when the amortizing payment schedule begins. Under the Guidance, the offering of a "collateral dependent" loan to a borrower with no assets would constitute the misalignment of a loan program with customer circumstances.

The Guidance and the new regulations have limited relevance in the 2009 mortgage lending market where neither nontraditional nor subprime products are readily available. The primary challenge that many originators will face is finding any loan program for a customer whose circumstances categorize him/her as a subprime borrower.

Financial and Homeownership Counseling

Homeownership counseling is rarely a prerequisite for obtaining a home loan. A home equity conversion mortgage is one of the few mortgage products that requires counseling in order to obtain loan approval. Other exceptions exist in states that have adopted predatory lending laws that require loan applicants to complete counseling prior to closing on a high-cost home loan. Congress has debated a number of bills to revise the Home Ownership and Equity Protection Act to require loan applicants to participate in counseling before obtaining high-cost home loans. However, none of the bills proposing this change has ever passed.

Although there are few laws that require financial and homeownership counseling, guidances created by the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) strongly encourage loan originators to offer counseling to loan applicants who are considering nontraditional mortgages or subprime mortgage products. HUD has always encouraged counseling for borrowers who consider an adjustable-rate mortgage (ARM) instead of a fixed-rate loan. As discussed below, resources are readily available that can help loan originators to counsel customers on the advisability of accepting these riskier mortgage products.

Counseling for ARMs

When adjustable-rate mortgages became increasingly popular mortgage products in the 1980s, the Federal Reserve Board created the *Consumer Handbook on Adjustable-Rate Mortgages* (the

CHARM booklet) to ensure that consumers would not enter lending agreements for ARMs without considering their risks as well as their advantages. The Federal Reserve updated the CHARM booklet in 2006 to address the risks of new types of ARMs such as interest-only ARMs and payment-option ARMs. A copy of the CHARM booklet is available online at the Federal Reserve website.[1]

Use of the CHARM booklet is mandatory under TILA. When loan originators give the booklet to customers, they should strongly encourage them to read the contents and to ask any questions that arise after completing a review of the brochure.

Disclosures

As a consumer protection measure, the timing and accuracy of disclosures is an important component of loan origination. In some cases, the term "disclosure" refers to an actual document used to inform or educate a borrower. In other cases, "disclosure" refers to the clear representation of a specific piece of information or data – most often done in writing.

Lending laws and regulations create long lists of obligatory disclosures. The disclosures are intended to:

- Educate consumers
- Provide consumers with information on loan costs
- Notify consumers of risky lending terms
- Notify consumers of their rights under federal lending laws
- Ensure that consumers know the status of their loan applications
- Give notice to consumers about changes in the servicing of their loans

Following is a list of the requisite disclosures, grouped according to their purpose.

Informational Disclosures to Educate the Consumer

The reason for requiring informational disclosures, such as the CHARM booklet, is that the information contained in the disclosures can educate consumers, and educated consumers may make better decisions when choosing between different mortgage products.

- **Settlement Cost Information Booklet:** Required by RESPA and due three business days after the completion of a loan application for a purchase transaction
- **CHARM Booklet:** Required by TILA within three business days of application for all ARMs
- **Information on All Variable-Rate Programs in Which the Loan Application Expresses an Interest (Adjustable-Rate Disclosures):** Required by TILA and due within three business days of application – must include specific terms of the

[1] http://www.federalreserve.gov/pubs/arms/arms_english.htm#types

adjustable/variable-rate program including a clear notice that payment or loan terms can change

- **When Your Home is On the Line: What You Should Know About Home Equity Lines of Credit:** This booklet is required by TILA for loan applicants who are considering home equity loans

<u>Disclosures to Inform the Consumer about the Costs of a Loan</u>

Disclosures regarding the cost of a loan and the fees associated with its closing are intended to provide the consumer with information that he/she can use to shop competitively for a mortgage loan and for settlement service providers.

- **Good Faith Estimate:** Required by RESPA and due within three business days after the submission of a loan application
- **HUD-1 Settlement Statement:** Required by RESPA and due at the time of closing, unless the borrower requests a copy one business day prior to settlement. Copies of the HUD-1 are prepared for both the buyer and seller at closing. The HUD-1A is used in refinance transactions where there is no seller.
- **Initial Escrow Statement:** Required by RESPA and due 45 days after closing, although it is often provided at the time of closing. The initial escrow statement provides an estimate of escrow payments (taxes, insurance, etc.) that will be required in the first 12 months of the loan
- **Annual Escrow Statement:** Required by RESPA and due annually
- **Affiliated Business Arrangement Disclosure:** Required by RESPA and due at the time of referring a loan applicant to a settlement service provider
- **Truth-in-Lending Disclosure Statement (TIL):** Required by TILA and due within three business days after the receipt of a completed loan application
- **Re-disclosure of APR:** Required by TILA at closing as part of the TIL Disclosure Statement. New regulations require the TIL Disclosure at least seven business days prior to closing. Additionally, re-disclosure is required at least three business days prior to closing anytime the APR on a regular loan varies by more than $1/8^{th}$ of 1%.

<u>Disclosures to Advise Consumer of Risky Lending Terms Agreements</u>

Some disclosures are offered to consumers to make certain that they understand the risks associated with specific types of lending terms:

- **Balloon Payment Notice:** Required by HOEPA, and due at least three business days prior to closing
- **Notice that Completion of Loan Application and Receipt of Disclosure Does Not Obligate Borrower to Complete Transaction:** Required by HOEPA, and due at least three business days prior to closing

Disclosures to Alert Consumers of Their Rights

The purpose of some disclosures is to alert consumers that they have legal rights that they are entitled to exercise within a particulate time frame.

- **Notice of Right to Receive Appraisal Report:** Required by ECOA and due at the time that the creditor provides a Notice of Action Taken
- **Notice Regarding Monitoring Programs:** Required by ECOA and due when obtaining information on race, ethnicity, sex, marriage, and age
- **Notice of Right to Rescind:** Required by TILA and due at the time of closing
- **Notice of Right to Cancel PMI:** Required by Homeowner's Protection Act at the time of closing and required in annual disclosures
- **Notice of Right to Receive Credit Score and to Dispute Its Accuracy:** Required by FACTA and due during the loan transaction
- **Notice of Right to Financial Privacy and Right to Opt-out of the Sharing of Personal Information:** Required by GLB Act at the time of establishing a customer relationship

Disclosures to Alert Consumers about the Status of a Loan Application

- **Notice of Action Taken:** Required by ECOA and due 30 days after the receipt of a loan application
- **Notice of Adverse Action:** Required by ECOA and due 30 days after the receipt of a loan application
- **Notice of Incomplete Application:** Required by ECOA and due 30 days after the receipt of an application

Disclosures Relating to Loan Servicing

RESPA creates a set of disclosures to ensure that borrowers receive notification if there are any changes related to the servicing of their loans.

- **Mortgage Servicing Disclosure Statement:** Required by RESPA and due three business days after completion of a loan application
- **Servicing Transfer Statement:** Required by RESPA and due 15 days prior to the effective date of the transfer

In addition to the disclosures that loan originators make to loan applicants, there are disclosures that licensed entities, such as mortgage brokers and mortgage bankers, must make to their state licensing agencies. It is important to note that if certain circumstances change during the processing period of a loan application, the loan applicant must be provided with new disclosures.

For instance, TILA requires re-disclosure of the APR on a regular loan if it varies by more than one-eighth of 1% at least three business days prior to closing. Another important example would be if the potential borrower decides to switch from a fixed-rate to an adjustable-rate loan. In this scenario, the potential borrower would need to receive an updated GFE and TIL Disclosure, as well as the CHARM booklet and the program disclosures related to adjustable-rate loans. Additionally, the new GFE must be provided within three business days of the MLO's knowledge of the change.

Discussion Scenario: Application and Income Documents

Larry Loanbranch is a licensed mortgage loan originator and designated branch manager for one of EZ-Mortgages' branch offices. EZ-Mortgages has seven loan officers and a number of clerical and administrative staff members under Larry's supervision.

Mr. Worthington was a potential borrower who submitted a loan application under which Larry Loanbranch was listed as the loan originator. His qualifying income was listed as $86,545. Mr. Worthington was a small business owner who had his eye on a modest home with a manicured lawn in a popular section of town. His business was booming and his projected revenue for next year looked promising.

Prior to submission of the loan package to USA-National Lender, an affiliate of a federally regulated depository institution and Fannie Mae lender who also had FHA endorsement, Mr. Worthington's W-2 was revised to reflect the projected revenue – it showed an increase of about $50,000 in earnings over the original version he provided. The final loan application included in the package listed Johnny B. Goode, a former employee, as the loan originator .

Around the same time as Mr. Worthington's loan application, Dr. and Mr. Hokie submitted a loan application to EZ-Mortgages. Their income documentation and employer verification listed Dr. Hokie's income as $25,000 per month and Mr. Hokie's income as $5,000. The final loan application which was submitted to USA-National Lender for underwriting retained the Hokie's income at $30,000/month but attributed all of the income to Dr. Hokie. Sally Mustang, a current EZ-Mortgages processor, was listed as the loan originator on the application package.

Discussion Questions

- *Based on the facts presented, what are the problems that occurred with these particular loan applications?*
- *What was Larry Loanbranch's role in these scenarios? Was there anything he failed to do which could result in disciplinary action by the state regulator?*

Discussion Feedback

There are a number of concerns presented in the scenario. Fraudulent documents were generated and submitted to a federally regulated lender. Additionally, non-licensed and former employees were listed on the loan documents – this is a violation of virtually all state licensing laws for the mortgage industry. It also appears that Larry Loanbranch was not exercising diligence in the supervision of the branch office employees. If he was not actively involved in the compliance issues, he should have been aware of them.

Submission of fraudulent documents to a federally regulated lender constitutes mortgage fraud and can result in extensive fines and possibly incarceration. This is considered a violation of federal banking laws. Loan origination by unlicensed individuals and failure of a branch manager to carefully supervise branch office staff generally violates most state laws and regulations pertaining to loan origination.

In order to be compliant, EZ-Mortgages should ensure the following occur:

- Loan application packages should be reviewed for accuracy prior to submission for underwriting
- Loan application documentation should include only un-altered and non-fraudulent information
- Branch managers should ensure they are properly supervising loan originators and other office staff. Examples of diligent supervision might include spot checking application packages before they are submitted to the lender and reviewing office policies and procedures on a regular basis.

Qualification: Processing and Underwriting

Borrower Analysis

Assets and Liabilities

Financial statements list an applicant's assets and liabilities side by side to facilitate the lender's assessment of the applicant's financial situation. The Uniform Residential Loan Application includes a table for the itemization of assets and liabilities.

Acceptable Assets Include:

- Significant cash reserves, which are an applicant's most valuable asset because lenders perceive cash reserves as a strong indication that a loan applicant is financially responsible.
- Gifts documented with a gift letter that includes the name and address of the person who is providing funds to the applicant to purchase a home. The letter must include a contact number for the donor and an indication that he/she does not anticipate that the applicant will reimburse the gift money.
- Stocks and bonds
- IRA/401 K
- Accounts receivable
- Other real estate owned by the applicant
- The cash surrender value of life insurance policies

- The value of automobiles owned by the applicant

Liabilities Include:

- Notes payable to banks
- Notes payable to others
- Accounts with an outstanding balance
- Unpaid income tax and interest
- Alimony/child support
- Previous bankruptcies

Income

Borrower income is an important consideration for almost all loan types. In the past, loan programs which did not consider income or programs which did not verify the borrower's income were available. These types of loans have all but disappeared due to rampant misuse and the occurrence of fraud.

Today, lenders take a close look at a borrower's ability to repay a loan. The amount of income the borrower makes in a month is analyzed against the total amount of debt he/she currently has as well as the prospective mortgage payment. This is called the debt ratio. Conventional/ conforming loans and government loans have different standards as to what constitutes an acceptable ratio.

In addition to documentation and verification of current/past employment, income analysis can also takes a number of other factors into consideration. Analysis of factors such as economic stability of a profession, potential increases in income due to education and training, relocation, etc. can all be used to help a borrower determine the appropriate loan product for his/her circumstances.

Examples of income documentation include:

- Standard income documentation for salaried and hourly individuals typically includes paystubs for the most recent 30-day period and W-2s for the most recent two-year period
- Individuals earning more than 25% of their income in commission must provide up to two years' tax returns. Their tax returns must document receipt of commission payments for a period of up to 12 months.
- Individuals who own more than 25% of a business are required to provide up to two years' tax returns
- Income documentation for all borrowers includes verification of employment. Employers are asked for an affirmation that income – whether it is salary, overtime or commission – is likely to continue.
- Individuals who earn non-taxed income such as Social Security, public assistance or disability must provide comprehensive documentation relevant to the type of income.

However, they are permitted to “gross up” their earnings by 25% (i.e. multiply the income by 125%).

- Individuals with special income, such as real estate investors, may not be permitted to use all of their income for qualification. For instance, a person who has rental income from an investment property is only permitted to use 75% of the rental income as qualifying income.

Due to the prevalence of over stated income and the potential for tampering with income documents, many lenders require authorization from a loan applicant to conduct an independent verification of tax records. This independent verification is often performed for self-employed borrowers but is becoming more common with other types of borrowers. The IRS form 4506-T is used to obtain a transcript of tax returns. IRS form 8821 is used to authorize the release of other tax information.

Income Calculations

The first calculations an originator typically makes during the loan interview regard income. Most applicants are paid on either an hourly basis or a salary. The salary might be given on an annual, monthly, or bi-weekly basis. Applicants who are self-employed or commissioned sales people require special considerations. This discussion will follow standard conforming guidelines in the consideration of income. A pay stub will provide most of the needed information. However, the originator will need to ask questions about the frequency of any overtime pay, how the employer handles vacation time, and when the potential buyer last received a raise. Once these questions are answered, the rest is just basic math!

Hourly

To compute the income of an hourly worker, you need to know the base hourly rate of pay, the number of hours worked in a typical week, the number of overtime hours received on average, and the number of weeks worked each year.

The formula is as follows:

{base rate} x {hours} = {weekly base income}

{OT rate} x {OT hours} = {OT weekly income}

{weekly base} + {OT income} = {weekly income}

{weekly income} x {weeks worked} = {annual income}

{annual income} ÷ 12 = {monthly income}

Overtime income can only be used to qualify for a loan if the applicant can show a history of receiving overtime and the employer verifies that overtime is likely to continue. Two continuous years typically constitutes a history of overtime. Annual vacation days are included at the base rate.

Bi-weekly Salary
To compute a bi-weekly salary, all you need to know is the applicant's salary and how the applicant's vacation time is treated. If the applicant receives a paid vacation (as most do), the calculation is simple. Remember that there are 26 bi-weekly pay periods in a year.

The formula is as follows:

{bi-weekly salary} x 26 = {annual income}

{annual income} ÷ 12 = {monthly income}

If the applicant does not receive a paid vacation, determine the typical amount of days that he or she takes off each year and subtract that income from the annual income before calculating the monthly income.

Annual Salaries
An applicant's income will occasionally be reported as an annual salary. This is common for educators and business executives.

If this is the case, the formula is as follows:

{annual income} ÷ 12 = {monthly income}

Self-Employed, Commissioned, and Trade Workers
Self-employed, commissioned, and trade workers are treated in much the same way. Their income is usually averaged over a two-year period. For the self-employed, the originator uses the income shown on the individual's tax return. For commissioned and trade workers, the originator uses the income shown on their W-2 form. In both cases, the calculation begins with adding the income from the previous two years and dividing it by 24.

The formula is as follows:

{year one income} + {year two income} = {income base}

{income base} ÷ 24 = {monthly income}

This more restrictive standard is used because the income of these workers is less stable than the income of hourly or salaried workers. Therefore, a lender must be more cautious when evaluating the capacity of these prospective borrowers' ability to repay a loan. When evaluating a person's tax returns, remember to add back into the annual income those expenses that will not recur and any depreciation taken on capital expenditures.

For example, a person might have relocated his or her office, which would be expensed and lower the net income. However, this expense is unlikely to recur, so the originator can add those costs back into the net income when determining the applicant's annual income.

Other Income
Annual bonuses, summer income, or other recurring additional income may be averaged over a two-year period and included in an applicant's annual income prior to calculating the monthly

income. Child support and alimony may be used if it is court ordered and if the applicant can show a stable history of receiving the payments.

Credit History

Will the prospective borrower repay the debt? Creditors also look at potential borrowers' credit history: how much they owe, how often they borrow, whether they pay bills on time, and whether they live within their means. Creditors also look for signs of stability: how long they have lived at their present address, whether they rent or own their home, and the length of their present employment.

Creditors use different combinations of these facts to reach their decisions. Some rely strictly on their own instinct and experience. Others use a "credit-scoring" or statistical system to predict whether an applicant will be a credit risk. Creditors may reach different conclusions based on the same set of facts. One may find the applicant an acceptable risk, whereas another may deny the same applicant a loan.

Credit and Creditworthiness

The creditworthiness of the customer will determine qualification for loan products, rates, and terms. The originator must learn what products are available through his or her company to serve each niche market. Specialization may limit what customers an originator or company may decide to serve. The broad range of products available in the mortgage marketplace has made the distinctions of the traditional definitions less valid.

How is Credit Identified? – The Credit Report

Consumer Reporting Agencies (CRAs) gather and sell information regarding an applicant's credit in the form of credit reports. The information is available to individuals, creditors, employers, insurers, banks, lenders, and similar entities. Further, the report evaluates the financial responsibility of the prospective borrower by comparing different types and sizes of loans. Presenting the prospective borrower with accurate information is the responsibility of the originator. The applicant's credit report contains information with different levels of detail and specificity depending on the type of report requested. The highest level and most detailed report, called a tri-merged report, uses data from the three major repositories: Experian, Equifax, and TransUnion, otherwise known as the Big Three.

Scores are developed through a statistically validated system designed to evaluate any available information about an individual's loan payment history. The score assigns a number to this objective analysis. The report also contains relevant information beyond the score that is supportive of the loan origination and underwriting process. The ability to cross verify information that the repositories report with the information the customer provides is key to loan integrity and fraud prevention.

The credit report will provide the following:

- Applicant information

- Content summary of the report
- Credit scores
- All known public records
- Filed collections actions data
- Derogatory trade lines information
- Credit inquiries
- Fraud verification alert information

It is important for applicants to realize that having negative information on their credit report does not mean they are doomed forever. Despite late payments—or even bankruptcy—they can still make credit their friend. In general, account information, including late payments and other adverse information reported by creditors, is kept on a credit report for no longer than seven years. However, there are certain exceptions to this rule:

- Bankruptcy information remains on credit reports for 10 years
- Unpaid tax liens might, depending on where the applicant lives, remain on credit reports indefinitely
- Certain states require that adverse credit information remain on credit reports no longer than five years

The purpose of this course is to make the originator conversant in and knowledgeable of all aspects of the credit report, its contents, and its utility in the loan decision process. The importance of a prospective borrower's credit score should not be underestimated. Successful originators never end their analysis of a loan's viability based on score alone. Scores only help them determine what avenues to pursue in making a loan application culminate in a settled loan. An originator's challenge is to understand an applicant's financial situation and, with the strengths and weaknesses of the three C's, find the perfect-fit mortgage program for him or her.

Getting Permission to Access Credit Information

By making a credit inquiry, the originator has instant access to a powerful tool that can determine the direction of the loan application process and has, in hand, critical information to determine what loan would suit the applicant's needs. To make a credit inquiry, a loan originator must have a "permissible purpose" identified under the federal Fair Credit Reporting Act (FCRA).

A loan offer begins with an accurate assessment of the applicant's credit capability and capacity. Mortgage ethics and federal regulation encumber the originator with the task of accurately assessing what type of loan would meet the applicant's needs. An originator's misrepresentation of the applicant's credit situation to "steer" the customer into disadvantageous loan programs is unethical, illegal, and a form of predatory lending. The originator must provide accurate information to the prospective borrower that is substantiated by the credit report, the prospective borrower's capacity (income and assets), and underwriting guidelines.

The Credit Report

How is the Information Formatted and Provided?

Each repository presents personal identification and credit information in a different format. In addition, most mortgage lenders, mortgage brokers, and banks use repository information consolidators that provide the information in the formats required by the originators. CRAs provide a varied menu of services.

These include the following:

- **Credit Reporting:** Provides credit information instantly with an automated system for retrieving and printing reports.
- **Merged Infile Credit Reports:** Pulls information from TransUnion, Experian, and Equifax databases and combines it into an easy-to-read format.
- **Full Factual Reports:** Residential Mortgage Credit Reports (RMCR's)
    - Copies of reports to applicant
    - Customized consumer letters
    - 90-day trade updates
    - Meets all Fannie Mae and FHLMC guidelines
    - Verification of employment information
- **Decision Reports:** Reports that provide you an instantaneous decision based on your lending criteria. Customize the system to review the credit report and return a decision based on credit data and your lending requirements. Decision reports can be returned electronically. Decision reports and credit reports are also in easy-to-read report format.
- **Credit Scoring:**
    - Designed by Fair Isaac (i.e. FICO Score)
    - Faster loan processing
    - Scores available on both merged infiles and full factual
    - Must be statistically developed and pass a validity test in order to meet fair lending requirements

How Do You Evaluate a Credit Report?

The first step of an evaluation is to carefully check all the identifying information. Multiple name spellings, addresses, or Social Security Numbers suggest errors in the report or possible identity theft. Each discrepancy should be addressed by the applicant. Next, the public records section should be checked to see if bankruptcies or outstanding judgments are reported. Then, review the mortgages, first and seconds or liens against the property by any other name. Next, review all open and closed lines of credit. Check each account for payment history and balances compared to opening balances. Note any discrepancies between the report and what the applicant has discussed with you.

Tax Liens and the Credit Score
Many consumers do not think about the impact their taxes have on their credit and are actually not aware that an impact even exists. When taxes go unpaid, the IRS can place a lien on a consumer's assets. If tax liens go unpaid, they will remain on a credit report for 15 years or more. Paid tax liens remain on a credit report for seven years.

Credit Accounts
There are variations in how each of the CRAs release information and how third party credit services may collate and document the information. However, credit accounts greatly impact a consumer's credit score and provide insight into credit character for loan qualification. The following areas are typically found in the credit accounts section of a credit report:

- **Company Name:** the name of the creditor
- **Account Owner:** will indicate whether the consumer is a joint account owner, authorized user, co-signor, etc.
- **Date Opened:** the month and year the credit account was established
- **Date Reported:** the date the last report was made to the CRA on the account – this can be an area of importance if there hasn't been a recent report establishing up to date payments
- **Months Reviewed and Date of Last Activity:** the number of months that have been reported and the last time any activity (including payment) occurred on the account
- **High Credit:** usually means the credit limit on the account
- **Balance and Past Due Amounts:** the amount the consumer owes on the credit account and any amount that has been reported past due
- **Type of Account:** such as open (for utilities), revolving (credit cards), installment (car loans), etc.
- **Timeliness of Payment:** the consumer's payment history regarding the account. As a rule, the following codes correspond to timelines:

  0 = Credit is open but has not been used (or reported)

  1 = Paid on time

  2 = 30+ days past due

  3 = 60+ days past due

  4 = 90+ days past due

  5 = 120+ days past due and/or referred to collections

  7 = Making payments via wage garnishment

  8 = Repossession

  9 = Charged off bad debt

Identifying Problems in the Credit Report and Fraud Alert
Examining the credit report is the originator's first line of defense to identify potential discrepancies and fraud. The Federal Trade Commission's Red Flags Rule requires financial industry professionals to identify and mitigate instances of identity theft as they pertain to credit reports. Some standard underwriting red flags, as well as red flags established by the FTC, include:

- Recently opened accounts
- All balances in round numbers
- Changes of addresses, especially recent
- P.O. Box addresses
- Recent payoff of a large number of accounts
- Misspellings and errors
- Large numbers of recent credit inquiries
- Uncharacteristic use of credit or sudden increase in use of credit
- A credit history that doesn't match the consumer's age

The originator and the processor, through verification of assets, employment, and the veracity of information provided on the application, are the first to sense that either the application is accurate or that fraud may be present. Under current federal law, all participants in the application and submission of a fraudulent loan are liable regardless of when the fraud was subsequently discovered. It is better to be cautious.

The Credit Score and Credit Risk

The Big Three
Industry consolidation has whittled what used to be scores of local and regional credit bureaus down to the three that we know of today: Equifax, Experian, and TransUnion. Over the past two decades, the "big three" gobbled up all of the smaller credit bureaus in an effort to become truly national in their coverage. A national credit bureau is beneficial because consumers will not lose any of their solid credit history simply because they have moved to another part of the country. Likewise, moving will not rid them of a negative credit history. Even if they were to move from the U.S. to Canada (or vice versa), their credit history would still follow them.

Equifax, Experian, and TransUnion are three separate and competitive companies. As such, they do not share information. It is very unlikely that a potential borrower's credit report is the same at all three credit bureaus because:

- **Not all lenders report to all three of the CRAs:** Lenders are not required to report to all three CRAs. Therefore, there will usually be omissions in an applicant's credit history at one or more of the credit bureaus.
- **Even if every lender DID report to all three CRAs, the information would probably be different:** Lenders that do report to all three credit bureaus do so by sending data tapes to them each month. Credit bureaus do not receive or "run" the tapes at the same

time. As such, account information may be different at each CRA depending on the time of the month.

- **Not all lenders pull a credit report from all three credit bureaus when they are processing a credit application:** A lender will likely pull only one credit report when an applicant applies for a credit card or auto loan. This means that the "inquiry" is only going to show up on one of the three credit reports. The exception to this rule is a mortgage application. Most mortgage lenders will pull all three credit reports during their loan processing practices.

Traditional vs. Nontraditional Credit

Loan qualification is typically based on credit capacity and character that a consumer has established through use of credit cards, previous mortgages, car loans, etc. While underwriting guidelines have become more stringent in recent years, it is worth mentioning that some loan programs permit applicants to document creditworthiness using nontraditional credit.

Particularly for first time homebuyers and recipients of government backed loans, nontraditional credit can make the difference in establishing the ability to repay a loan. Traditional credit generally means secured loans and credit cards. Nontraditional credit includes payments such as rent and utilities.

Discussion Scenario: Income Calculations

Determine the qualifying income for the borrower in each of the following scenarios.

Borrower 1: Steve Stephens is a draftsman for a local architectural firm. He works 40 hours each week and is paid an hourly wage of $16.85 with no history of overtime. He receives a two-week paid vacation each year and has been with the company for six years. ***What is his monthly qualifying income?***

Borrower 2: Jamie James is a mid-level executive with a local utility company. She is paid bi-weekly. Her pay stub shows a base rate of $2,307.89 per pay period. It also shows a discretionary bonus income with a year-to-date total of $4,500. ***What is her monthly qualifying income?***

Borrower 3: Tommy Thomas is a maintenance worker for a local sign company. He is paid a weekly salary of $765 and works an average of 46 weeks each year. ***What is his qualifying income?***

Borrower 4: Cassie Cassidy is a self-employed graphic artist. Her tax returns show net taxable earnings of $67,890 for 2009 and $59,540 for 2008. The returns also show she is depreciating her studio, which she owns at a level annual rate of $6,700. ***What is her qualifying income?***

<u>**Discussion Feedback**</u>

Borrower 1: The calculation for Mr. Stephens' income is fairly straight forward. In the example, it is fine to use 52 weeks per year since we know his vacation is paid.

The basic calculation is as follows:

(Hourly Rate × Hours Worked Per Week) × Weeks Worked Per Year = Annual Income
Annual Income ÷ 12 = Monthly Qualifying Income

Mr. Stephens' calculation:

($16.85 × 40) × 52 = $35,048
$35,048 ÷ 12 = $2,920.67

Steve Stephens' monthly qualifying income is: **$2,920.67**

Borrower 2: In the calculation for Ms. James, it's important to note that she is paid bi-weekly. This means she receives 26 paychecks per year. (Alternately, someone who is paid semi-monthly receives 24 paychecks per year.) With regard to her bonus, it would not be used for qualifying income since it is noted that it is "discretionary" (meaning the amount can change or she may not receive it at all), and we do not have evidence that there is a two-year history of receiving the bonus.

The calculation is as follows:

Bi-weekly Pay Amount × 26 = Annual Salary
Annual Salary ÷ 12 = Monthly Qualifying Income

Mrs. James' calculation:

$2,307.89 × 26 = $60,005.14
$60,005.14 ÷ 12 = $5,000.43

Jamie James' monthly qualifying income is: **$5,000.43**

Borrower 3: Mr. Thomas' calculation is fairly straightforward. However, it's important to remember that we have been told he works 46 weeks per year. It's easy to forget and perform the calculation based on 52 weeks.

The basic calculation is as follows:

Weekly Salary × Weeks Worked Per Year = Annual Salary
Annual Salary ÷ 12 = Monthly Qualifying Income

Mr. Thomas' calculation:

$765 × 46 = $35,190
$35,190 ÷ 12 = Monthly Qualifying Income

Tommy Thomas' monthly qualifying income is: **$2,932.50**

Borrower 4: Ms. Cassidy's calculation has a twist – you are dealing with annual salaries based on tax documents along with self-employment expenses, versus straightforward payroll documents.

The basic calculation is as follows:

(Year One Net Income + Year Two Net Income) ÷ 24 Months = Monthly Income

If we assume that the studio depreciation can be applied to both years, it would be added to the Net Income:

((Year One Net Income + Depreciation) + (Year Two Net Income + Depreciation)) ÷ 24 Months = Monthly Income

Ms. Cassidy's calculation:

(($59,540 + $6,700) + ($67,890 + $6,700)) ÷ 24 Months = $5,867.92

Cassie Cassidy's monthly qualifying income is: **$5,867.92**

Qualifying Ratios

The evaluation of an applicant's ability to qualify for a loan involves the consideration of his/her income, credit history, credit scores, assets, and liabilities. Lenders require documentation and verification in order to verify that a loan applicant has accurately represented his/her qualifications. After this information is assembled, the lender applies mortgage industry formulas, such as debt-to-income ratios, to determine the size of the loan for which a loan applicant may qualify. Other numerical assessments, such as credit scores, help lenders to determine whether the loan applicant is likely to repay the loan in accordance with the terms in the lending agreement, and this determination directly impacts the interest rate charged on the loan.

Evaluating Applicants Using the Front End Ratio

The Front End Ratio, which is also known as the ***Housing Ratio***, is a calculation that allows lenders to compare the monthly housing expense that a loan applicant will assume with a new mortgage to his/her income. The lender calculates the ratio by dividing the monthly housing expense by gross monthly income. In order to accurately calculate the monthly housing expense, the lender adds the following expenses, which are collectively referred to as ***PITI***: **P**rincipal, **I**nterest, **T**axes and **I**nsurance.

For conventional mortgage loans that conform to Fannie Mae and Freddie Mac guidelines, the maximum front end ratio has traditionally been 28%. Front end ratios for FHA loans and VA loans are less difficult to meet. Applicants for FHA loans must meet a front end ratio of 31%. Lenders who make VA loans look primarily at the back end ratio.

Evaluating Applicants Using the Back End Ratio

The Back End Ratio, which is also known as the ***Total Debt Ratio***, compares the total monthly obligations to gross monthly income. Lenders calculate total monthly obligations by adding monthly housing expenses and all recurring debt such as car payments, credit card payments, child support, and student loans. Lenders who make conventional loans that conform to Fannie Mae and Freddie Mac guidelines have traditionally used a maximum back end ratio of 36%.

The back end ratios for FHA loans and VA loans are less difficult to meet. Applicants for FHA loans must meet a back end ratio of 43%. The back end ratio for VA loans is 41%. Some lenders of nonconforming loans have allowed the back end ratio to be as high as 55%.

Using the Appraisal to Calculate the LTV Ratio

After obtaining an accurate appraisal from a licensed appraiser, the loan originator uses formulas, such as the ***Loan-To-Value Ratio (LTV)*** to determine the type of loan for which the loan applicant will qualify.

The LTV ratio is calculated by dividing the amount of the mortgage by the appraised value or the purchase price of the home, whichever is less. For example:

A loan applicant applies for a mortgage to purchase a home which the seller has agreed to sell for $350,000. The purchase price is $5,000 less than the home's appraised value of $355,000. The loan applicant has savings of $70,000 to use for a down payment. The lender performs the following calculations:

{Purchase Price} – {Down Payment} = **{Mortgage Amount}**

{$350,000} **–** {$70,000} = **{$280,000}**

{Amount of Mortgage} ÷ {Purchase Price} = **{LTV}**

{$280,000} ÷ {$350,000} = **{80%}**

It's important to note, however, if the appraisal is less than the purchase price, the borrower will have to increase his/her down payment or obtain mortgage insurance.

Most lenders that offer conventional conforming mortgages will not allow the LTV to exceed 80% because Fannie Mae and Freddie Mac will not purchase a mortgage with an LTV over 80%. However, Fannie Mae and Freddie Mac will purchase a mortgage with an LTV that exceeds 80% if the borrower purchases ***mortgage insurance*** in the amount prescribed by these agencies' guidelines. For example:

If the loan applicant in the preceding example had a down payment of only $35,000, the lender would make the following calculations:

{Purchase Price} – {Down Payment} = **{Mortgage Amount}**

{$350,000} –{$35,000} = **{$315,000}**

{Amount of Mortgage} ÷ {Purchase Price} = **{LTV}**

{$315,000} ÷ {$350,000} = **{90%}**

With an LTV of 90%, the lender would not be likely to make the loan unless the borrower purchased private mortgage insurance. With mortgage insurance, the lender knows that it is possible to sell the mortgage in the secondary market and insurance will mitigate additional risks that the lender incurs when making a loan with a high LTV. The amount of mortgage insurance that the borrower must purchase depends on the LTV; a higher LTV will require more insurance.

The LTV for FHA loans and VA loans is higher than the LTV for conventional mortgages. The LTV for FHA loans can be as high as 96.5% and the LTV for some VA loans is 100%. Two additional ratios that compare the loan amount to the value of the property are the Combined Loan-to-Value Ratio and the High Loan-to-Value Ratio.

Combined Loan-to-Value Ratio (CLTV): The CLTV is a ratio which lenders use when an applicant requests a second mortgage. Lenders calculate the CLTV by combining the cost of all mortgages on a home and comparing the combined cost to the value of the home securing the loans.

A loan applicant applies for a second mortgage for $40,000. He has a $200,000 mortgage on a home with an appraised value of $300,000. The lender will perform the following calculation**:**

{(First mortgage + Second mortgage)} ÷ {Appraised value of home} = **{CLTV}**

{($200,000 + $40,000)} ÷ {$300,000} = **{80%}**

With a CLTV of more than 80% the interest rate on the second mortgage is likely to be higher.

High Loan-to-Value Ratio (HLTV): An HLTV usually occurs when the borrower secures a second mortgage to consolidate consumer debt, and the combined amount of the first and second mortgages exceeds the value of the home used to secure the loans.

Studies show that the default rate is higher on high LTV, CLTV, and HLTV loans. Furthermore, a lender may not be able to fully recoup the losses associated with a default on a loan with a high loan to value ratio. For example, if the LTV is over 90%, the net sales proceeds may not be sufficient to cover the costs associated with the foreclosure, repair, and resale of the property. Due to the additional risks associated with a high LTV mortgage and knowing that a borrower with little equity to protect is more likely to default, lenders will scrutinize the loan application with a high loan-to-value ratio to determine if the additional risk is acceptable and at what increased rate.

Commitments and Underwriting Conditions

Lock-in and Float Agreements: Lock-in agreements, which are also known as ***rate-lock agreements*** or rate commitments are agreements made by a lender to hold an interest rate and a specified number of points while processing an applicant's loan. Lock-in agreements should be made in writing. True lock-in agreements lock in the interest rate and the points. Other types of lock-in agreements, known as float agreements, allow the interest rate or points to rise and fall with the market.

Lenders may charge a fee for a lock-in. The fee may be a flat fee or a percentage of the mortgage amount, payable upfront or at the time of closing. Some lenders may finance the fee by adding a fraction of a percentage of a point to the interest rate. The fees for long lock-in periods are higher than the fees for a lock-in that is effective for only a short period of time. Lock-in fees may not be refundable. Therefore, loan applicants whose applications are denied, and approved applicants who choose not to accept a loan, risk the loss of the fees that they paid for a lock-in.

Expiration date for lock-in agreements: Lock-in agreements may be effective for as little as seven days from the date of loan approval up to 120 days. Most agreements are effective for 30 to 60 days. If an applicant's loan is not settled and funded within the period of time that the agreement is effective, he/she will obtain a loan at the current rate. However, it is usually to the advantage of the borrower for the originator to request an extension to the agreement. Lock-in extensions must be approved by the lender, and a fee is charged for the extension, but it is usually worth the effort and cost so that the applicant is guaranteed the interest rate he/she agreed to.

Float Agreements: Lenders may allow loan applicants to lock in an interest rate without locking in the points. This type of float agreement, which is known as ***floating points***, benefits the loan applicant if points fall. However, if interest rates also fall, the lender may charge extra points to make more money from the mortgage transaction.

Lenders may agree to float both the interest rate and the points, allowing the loan applicant to lock in the rate and points between the time of the loan application and the date of closing. The applicant can choose to lock in the rate and points at the time that appears most advantageous.

It is important to note that the decision to lock or float the interest rate is up to the borrower. It is an ethical issue if an originator does not act upon a borrower's request to lock a rate. Additionally, some states have strict rules governing rate lock agreements – an originator may face legal or regulatory ramifications for failing to honor such an agreement.

Underwriting

An underwriter's principal responsibility is to assure that the proposed loan meets the requirements set forth by the investor who will purchase the mortgage. This includes assessing a borrower's ability and willingness to repay the mortgage debt and examining the property being offered as security for the mortgage. It must be determined that the prospective borrower not only has the ability to pay but has also proven a willingness to repay their debts, thus limiting the probability of default and collection difficulties.

The underwriter's job is to confirm that potential borrowers have sufficient cash assets available to close the mortgage. The property must also be examined to see that it is sufficient collateral for the mortgage and that it meets the investor's minimum acceptable guidelines.

The underwriter must follow guidelines as to what incomes are allowed. The liabilities that must be considered are what the applicant's debt-to-income ratios are and whether they are within acceptable guidelines for loan approval. Much of the underwriter's decision-making has now been taken over by an Automated Underwriting System (AUS). These underwriting systems are known by many names, but they all play the same role. They make an automated underwriting decision based on information entered into the AUS system.

If loans are submitted via the AUS system, it is then the underwriter's responsibility to make sure that the information entered into the AUS is indeed the information provided on the URLA and that all information is documented and accurate. It is the originator's responsibility to ensure that the loan file includes all information and documentation necessary to aid the underwriter in accomplishing this task.

An underwriter looks for complete and accurate information on the loan application and loan package and addresses any questions raised by lack of documentation or information in order to make an underwriting decision. The major areas that an underwriter examines are credit, income, assets, and collateral.

Prospective Borrower's Credit History and Explanations of Derogatory Credit

Past credit performance serves as the most useful guide in determining a potential borrower's attitude toward credit obligations and in predicting his or her future actions. A borrower who has made payments on previous and current obligations in a timely manner represents reduced risk. Conversely, if the credit history shows continuous slow payments, judgments, and delinquent accounts, despite an adequate income to pay off those obligations, then strong compensating factors will be necessary to approve the loan.

An underwriter examines the overall pattern of credit behavior and isolated occurrences of derogatory credit. If the prospective borrower's history reflects a bankruptcy, the underwriter will be looking to see what items on the credit report might be included in the bankruptcy, when the bankruptcy occurred, the reason for bankruptcy, and the type of credit history the borrower has had since the bankruptcy.

When derogatory credit is revealed, the underwriter will be looking for explanations for the derogatory credit, which the originator must document. The applicant's explanation must make sense and be consistent with the other credit information in the file. The underwriter will also check for items not listed on the credit report but disclosed on other documents, such as automatic deductions for loan payments on paycheck stubs or on bank statements. The originator and applicant must address these items.

If there are recent inquiries that could result in new credit, the applicant must address this. Many originators fail to ask the applicant about a credit inquiry that may turn into a debt. For example, an applicant purchased a new car shortly before closing escrow. The sales agent told him that the inquiry would not show on his credit report for at least 30 days.

As part of a quality control check, the lender ran another credit report. The new credit report showed a credit inquiry by the car dealership and the car manufacturer's lending subsidiary. Upon the lender's request to the credit-reporting agency, the lender confirmed that a loan had been authorized for the applicant. Further investigation resulted in the applicant being denied the loan as his new car payment put his ratios over guideline limits.

Income Analysis

All income must be supported with the proper documentation except for “no documentation” loans. The underwriter must develop an average of income and bonuses or overtime for the past two years, and then evaluate the probability of its future continuance to be used in calculating income. The underwriter will verify the calculations used to confirm the applicant’s income. This area seems to be of particular concern as many times the income is calculated incorrectly. It is the underwriter’s responsibility to verify that the income used when calculating the debt-to-income ratio is accurate.

The underwriter looks not only at the length of time that the prospective borrower has been working but also how long he/she has been with the same employer. The originator must address any job-hopping, job gaps, and any change in the line of work. The originator should document the reason for any job gaps or lack in length of time on the job. This could be due to the borrower being in school, the military, or a seasonal worker. The originator should document this in the file so that it leaves no questions for the underwriter.

The underwriter will review W-2s and 1040s to evaluate income consistency. This is particularly important when calculating commission and self-employed applicants. If the applicant is self-employed or commissioned, the underwriter will be looking at the 1040s for the non-reimbursed employee expenses or Schedule C and the adjusted gross income.

Any substantial increase or decrease in income must be addressed. The underwriter may even ask for current profit and loss statements. This is all required to provide evidence that the income is consistent with the previous year’s earnings. If the income shows considerably greater or lower than what is supported by the previous year’s tax returns, the underwriter will ask for an explanation as to the increase or decrease. This may be due to a large one-time investment for the business or it may be due to additional product lines or clients that the business recently acquired. Whatever the reason, explanations are in order. Also, if the applicant must pay quarterly taxes, then the originator must be sure to include proof that estimated taxes were paid as required.

The underwriter will calculate other non-taxable income and confirm that the correct adjustments have been used. One area that originators must pay attention to is the term “grossing up.” The originator should be careful that the correct grossing up percentages are used. The underwriter will look for documentation to support income. This includes, but is not limited to, W-2s, paycheck stubs, 1040s, retirement statements, social security awards benefit letters, divorce decrees, and settlements.

The underwriter will also review the 1040s for other income or expenses not documented in the loan file. This may include rental income (Schedule E), self-employment tax and income (Schedule C), farming expenses and income (Schedule F), and corporate or partnership returns. If an originator reviews the tax returns before submission, he or she should address any items that may become concerns of the underwriter in the loan file.

For rent received for properties owned by the prospective borrower, the originator must include documentation to support the rental amount. Documentation may include a current lease or rental agreement. As a standard rule, the underwriter will use 75% of rental income stated on the rental or lease agreement unless otherwise documented by 1040s. If 1040s are provided and the underwriter verifies less than 75% adjusted rental income, then the lower amount must be used for qualification purposes. If there is a negative rental income, the negative income will be considered a liability and treated as a debt.

Assets—Cash to Close the Transaction

The cash investment in the property must equal the difference between the amount of the mortgage and the total cost to acquire the property. All funds for the applicant's investment must be verified and documented. If the applicant has placed an earnest money deposit, the underwriter may ask to see a receipt from the escrow company holding the funds. This is to verify that the monies are in escrow and that these funds have or have not already been removed from any bank statements that are being submitted as evidence of funds available to close the transaction.

An underwriter is going to examine the asset documents to verify that there are enough funds available to close the transaction. During the underwriter's examination, an applicant's saving history and use of funds will also be reviewed. The underwriter will be looking for non-sufficient funds, use of credit lines, undisclosed loans, large deposits, and debits that may suggest undisclosed debts. Any of these areas need to be addressed by the applicant and originator in the loan file.

If funds are proceeds from the sale of a home, the underwriter may ask to see evidence in the form of a HUD-1 Settlement Statement. If the property has not sold at the time of underwriting, loan approval may be conditioned upon verifying that the applicant has actually received the proceeds.

Stocks, bonds, 401Ks, and retirement accounts are only to be counted at 60% of their face value. If any of these accounts are to be used for the purchase of the home, the underwriter may ask for the current statements along with proof of liquidating the account, stock, or bond. If the applicant intends to sell personal property items (cars, RVs, etc.) to obtain funds to close the transaction, the applicant must provide satisfactory evidence of the actual cash value of the property being sold. This estimated cash value must be realistic and at the current market value. If the estimated value of an item being sold seems unrealistic, the underwriter may ask to see an appraisal of the item or further documentation to provide evidence of the higher value.

If the prospective borrower is using rent credit (a portion of monthly paid rent credited towards his/her down payment by the seller), it must be documented. The underwriter may ask for verification of rent paid and applied towards the credit. If credit has been for a specific term, the underwriter may ask the prospective borrower to provide proof of residency in the form of utility bills or other documents such as bank statements for the term of the credit given.

The Subject Property Collateral

The underwriter must ensure that the property is eligible and meets lender guidelines for collateral. To do this, the underwriter relies on the appraisal report, preliminary title report, and any inspections requested by the prospective borrower or required by the lender. The underwriter must determine that the appraiser is properly licensed and has E&O (Error and Omission) insurance and that his or her resume substantiates competence to appraise this type of property.

The Sales Contract

While reviewing the sales contract the underwriter will look for credits or personal property included in the sales contract that will affect the value of the collateral. All personal property should be excluded from the sales contract or notated that it is be sold with no value. However, if the item being sold with property is such that value must be considered, it will affect the value and the loan amount.

The Underwriting Review of the Appraisal

The appraisal report is used to determine the value of the property being mortgaged and to advise of deficiencies that affect the continued marketability of the property should the lender need to foreclose on it. The underwriter looks to confirm that the names, address, and property description are accurate. The loan agent should check these areas before submitting to underwriting. Errors caught upfront will eliminate problems during underwriting.

The underwriter will be looking at the location of the subject property and any possible hazards or deficiencies that may affect the marketability of the property if the lender should have to foreclose. They will also compare the location of the subject property with the location of the comparable properties (comps) used. If the underwriter feels that they are too far from the subject property or that there should be more comps near the subject property, the underwriter may ask for additional comps to validate the value given by the appraiser. A review appraisal may also be required.

If there are any contract issues that affect the sales price or value of the home, the appraisal will note that. An underwriter will look at the floor plan (footprint) to check for functional obsolescence of the property. Photos will also be carefully examined. The underwriter is looking for any visible signs of health and safety hazards or damage to or near property that may affect the lender's collateral. Check for addresses in photos. Be sure that the subject property in the photo is the same as described in the appraisal.

The effective age will be reviewed. The last thing that a lender wants is economic life less than the term of the loan. This would mean that the property would not be there when the loan matures. The underwriter will also verify that an approved appraiser has completed the appraisal and that it is correctly signed and dated by the appraiser.

The Title Report

The underwriter will check to see if the subject property is a condominium or planned unit development, which would affect the loan documents and what title policy endorsements will be required. The underwriter may ask for the Home Owners Association (HOA) documentation, Consumer Confidence Report (CCR) on the drinking water, and Deed Restrictions.

The underwriter will be looking at other items that may cloud the title or affect the marketability of the property. Those items might be easements, land locks, vesting, and leaseholds. An originator must be cautious on leaseholds, as the term of the loan cannot be more than the remaining term of the leasehold.

Safety Issues
If the property is a manufactured home, the underwriter will check to make sure that the manufactured home tags required by HUD are notated on the appraisal. Additionally, evidence is required to prove that the manufactured home is titled as real property and not personal property. A structural engineer's certificate may also be required. The originator needs to make sure that he/she knows the lender's guidelines regarding manufactured homes prior to submitting the loan file to underwriting to avoid any suspensions or delays in approval.

If the property being financed is a new home under construction, the underwriter will require a completion notice from the appraiser. The underwriter may also require proof or evidence by the local building authority. The originator should be aware of this, plan ahead and order these items before the scheduled closing date. This will avoid last minute delays.

Flood Zone Verification
The underwriter will also verify the flood zone. This is necessary to assure that if the property is in a flood prone area, that the proper flood insurance is required to protect the lender's collateral and the prospective borrower's purchase. The appraiser is responsible for determining if a property is located in a flood zone.

Other Required Inspections
After reviewing the contract and appraisal, the underwriter may ask for verification that repairs were done or require further inspections to be performed. This is all to ensure the collateral of the lender or to meet program guidelines, such as those in an FHA or VA loan. This may include termite, well, septic, roof, or other inspections notated on the appraisal.

Documentation and Verification

The underwriter has a difficult job of ensuring that the loan application is properly documented and substantiated. An underwriter does not try to find ways to deny loans, but rather looks to see what loans meet the guidelines and have sufficient documentation to support the information provided by the applicant. Many times an underwriter is left to guess what the originator is trying to submit.

Questions will arise out of incomplete information either on the URLA or documentation provided in the loan file. The better information and documentation the originator can provide in the loan package, the better chance there is of having their loan sail through underwriting smoothly and efficiently.

The URLA captures most of the information needed to obtain a risk assessment from an AUS or manual underwriting decision. It is crucial that all information provided on the URLA for an underwriting decision is accurate. It is the underwriter's role to verify the accuracy of the information that is entered. The loan originator plays a big part in underwriting by ensuring information gathered and submitted to the lender has been reviewed for accuracy and comprehensiveness. Looking for discrepancies against the URLA and documentation is a key way of finding inaccurate or false information.

Faxed and internet documents must be verified. The originator should look at the heading on the top of a faxed document. Does it have the sender's name and phone number? Is it from the company that should be sending it? Does the internet document have the URL? If it's not a secured website, this might be a sign of a fraudulent document, especially if it is being provided as evidence of employment, income, or assets.

Common Underwriting Pitfalls

Some Underwriting Quicksand and Common Pitfalls to Avoid

- Incomplete files with no documents to back up what is stated on the URLA
- Inaccurate data. Many times these are just calculation errors in income or not using proper percentages for rental income, non-taxable income, or stocks, bonds, and retirement statements.
- Cash out refinance loans submitted as no-cash out
- Property is not the applicant's principal residence
- Qualifying ratios exceeded without compensating factors given
- Obligations of all applicants; non-purchasing spouse not included, inaccurate or unreported borrower debt
- Insufficient assets to close transaction
- Assets not documented
- Applicant's income not calculated correctly
- Applicant's income not substantially documented, such as self-employment
- Loan program not provided
- New construction documentation not provided. This can result in delays in closing.
- Sales contract not fully executed by all buyers and sellers
- Major repairs needed and not addressed in loan file
- Repair or compliance clearances not provided according to sales contract or lender guidelines
- Alimony or child support not included in debts.
- Secondary financing not disclosed

- Real estate obligations not disclosed
- Delinquent federal debts that showed up on title report but not credit report
- Incorrectly calculated loan amounts

The importance of having a complete and accurate URLA and sufficient documentation in loan files cannot be overstated.

Appraisals

Evaluation of Property Used to Secure the Loan

In addition to evaluating a loan applicant, it is necessary to evaluate the property used to secure a loan. Lenders rely on appraisals to ensure that the value of the property is adequate to serve as security, or collateral, for the loan. A licensed appraiser must prepare the appraisal.

Accurate appraisals are of great importance. The overvaluation of real property used to secure home loans is an issue of great concern. Critics point to overvaluation as a factor contributing to the meltdown of the real estate market. Overvaluation is also at the root of many predatory lending transactions and mortgage fraud schemes, allowing many unscrupulous mortgage professionals to profit at the expense of borrowers and lending institutions.

Overvaluation can also result from pressure exerted by sellers who hope to sell high, or from borrowers in refinance transactions who hope to secure a generous line of credit based on the equity in their homes. These demands from consumers are often directed towards loan originators who may feel pressured to pass their clients' demands for a favorable appraisal on to appraisers.

URAR/1004

There are a number of forms used by appraisers, and it is important to be able to identify them. The lender's underwriting guidelines for the specific property type is the driving force behind what forms must be included in the appraisal order. Credit and valuation models will also affect what is required of the appraiser.

The **Uniform Residential Appraisal Report** (URAR), or 1004, is the most common and comprehensive appraisal form. It is generally used on all single family homes and may also be used for row homes and townhouses if the property is situated on a fee simple lot.

Other appraisal forms include:

- **1070:** A condensed version of the 1004; often used with rate/term refinances
- **1073:** Used for condominiums, PUDs and row homes/townhouses situated on common ground
- **1007:** Used for single family properties which are intended as investment properties

- **1025:** Used for two- to four-unit properties which are intended as investment properties

A **property inspection waiver** is occasionally permitted instead of a full appraisal for certain refinances. The waiver would be granted for a borrower who is refinancing his or her property within a specified time after a previous loan transaction. Under these circumstances, a conventional lender may permit an abbreviated or “drive by” appraisal if it is comfortable with existing data on the subject property.

Appraisal Approaches

There a number of approaches an appraiser may use to determine the value of a property. The most common method of conforming loans is the **Sales Comparison Approach**, or Market Approach. This is based on a comparison with similar, recent property sales in the same vicinity as the subject property. The **Cost Approach** is another method. It is commonly used to appraise new home construction. Finally, the **Income Approach** is used for investment properties.

Sales Comparison Approach

This approach is an analysis of recent sales that are the most comparable to the subject property. An appraiser must analyze a minimum of three comparable sales that were settled or closed within the last 12 months. An appraiser must comment on sales that are more than six months old.

Adjustments to Comparable Sales
The appraiser’s analysis must take into consideration all factors that have an impact on value, recognizing that a well-informed buyer will not pay more for this property than the price he/she would pay for a similar property of equal desirability and utility. To accomplish this, the appraiser must analyze all closed and settled sales, contract sales, and current listings of properties that are the most comparable to the subject property.

Because the appraiser’s estimate of market value is no better than the reliability of the comparable data that is utilized, the appraiser must exercise diligence to ensure that the comparable sales data is reliable. The appraiser must report each comparable sale on the appropriate appraisal report form and must report a minimum of three comparable sales as part of the sales comparison approach.

Each comparable sale that is utilized must be analyzed for differences and similarities between it and the property being appraised. The appraiser must make appropriate adjustments for location, terms, and conditions of the sale, date of sale, and physical characteristics.

Specific guidelines have been set for adjustments regarding proximity to subject, date of sale, and net or gross adjustments:

- **Proximity to the Subject Property:** Sales should be located within one mile of the subject.

- **Date of Sale:** Comparable sales should have closed within 12 months of an appraisal's effective date.
- **Net & Gross Adjustments:** Adjustments are changes in the value of a comparable property made when comparing the features of the comparable property to the subject property. A net adjustment is the positive or negative value assigned to each feature. The gross adjustment is the sum of those values for each property. The dollar amount of the net adjustments for each comparable sale should not exceed 15% of the sales price of the comparable. The dollar amount of the gross adjustment for each comparable sale should not exceed 25% of the sales price of the comparable.
- **Sales or Financing Concessions:** The dollar amount of sales or financing concessions paid by the seller. Examples of sales or financing concessions include interest rate buy downs, loan discount points, loan origination fees, and closing costs customarily paid by the buyer. The appraiser must obtain this information from the individual who is a party to the concessions. The dollar amount of the concessions is adjusted negatively in the sales grid. Sales concessions are limited on conforming loans based on loan-to-value (LTV). Transactions with LTV over 90% are limited to 3% seller concessions. Concessions on loans with LTV under 90% are limited to 6%.

Rural Properties

Because rural properties are often situated on large lots, and rural neighborhoods can be relatively underdeveloped, there may be a shortage or absence of recent comparable sales in the immediate vicinity of the subject property. This means that the appraiser will often need to select comparable sales that are located a considerable distance from the subject property.

In such cases, the appraiser must use his or her knowledge of the area and apply good judgment in selecting comparable sales that are the best indicators of value for the subject property. The appraiser should include an explanation in his or her report of why the particular comparables were selected in his or her analysis.

What is considered a good comparable sale?

Your subject property is a 1,200 square foot rancher built in 1990. It is situated on a 10,000 square foot lot in an established residential sub-division. You run a comparable sales search through the local data bank and multiple-listing service you subscribe to. You find ten comparable sales situated in the subject sub-division ranging in gross living area from 1,000 square feet to 1,400 square feet, ranging in age from 10–20 years old, and situated on lot sizes ranging from 5,000 square feet to 15,000 square feet. All sales closed within the past six months.

From the database of ten comparable sales, the appraiser will analyze the properties and choose three that best represent the subject in lot size, room count, gross living area, and amenities. Remember, the adjustments made in the sales grid must fall within the net and gross percentage adjustment guidelines. Lower net and gross adjustments are the best indicators of the most reliable comparable sales.

Cost Approach

This approach assumes that a potential purchaser would consider building a substitute residence that has the same utility and use as the subject property being appraised. The appraiser arrives at the indicated value of the property by estimating the reproduction cost of improvements, subtracting the amount of depreciation by all causes, and adding the estimated value of the site as if it were vacant. The appraiser estimates land value by analyzing comparable sized land sales.

Income Approach

Normally this approach is not applicable to single-family properties. However, if a single-family home is being utilized as an investment property, the appraiser must prepare a single-family comparable rental schedule in addition to the appropriate appraisal report.

Title and Insurance

Title Report

Reasons for Title Insurance

When a lender decides to lend money to a borrower, the lender must be satisfied that there are no liens, judgments or other mortgages on the property which could take a priority interest over that of the lender's security interest. It is likewise important for the borrower to be satisfied that the property is unencumbered at the time of the transfer of title. If the borrower is purchasing a home, he/she will want to be assured that there aren't any pre-existing liens, encumbrances or defects affecting the property. It must also be ascertained that the borrower is obtaining the title from the correct individuals.

Lenders require title insurance in order to protect themselves from risks that arise when securing a loan with a property. There are two main differences between title insurance and other types of insurance. First, title insurance protects against events that may have happened in the past, while other insurances protect from future events. Second, with title insurance, there is only a one-time insurance premium paid at the loan closing, while other insurance types typically require on-going premiums. Title insurance is regulated by state agencies and the Department of Housing and Urban Development.

Types of Title Insurance

Lender's insurance and homeowner's title insurance policies are the two types of title insurance available. Homeowners or "owners" insurance provides protection for the borrowers against many potential liabilities, including mechanics liens, un-released mortgages, improper subdivisions and other third party rights affected on the property over the course of its prior ownership.

Lender's policies provide protection against lender loss from title defects or liens that should have been cleared up prior to the policy being issued. To perfect a lien, the borrower executes a deed of trust or mortgage which is subsequently recorded among the land records in the jurisdiction where the property is located. Deed of trust laws and theories vary among the states and U.S. territories.

Key Elements of Title

In order to understand title, it is important to know the key components. The title history of a property is composed of recorded instruments on the land records on each property and other statutory interests, i.e. tax liens or mechanics liens. Each record tells a story on the property, such as, when the property was acquired, the amount it was sold for etc. It is the job of the title company to review this information on the history of the property and to identify any defects that are in the title history of the property. These defects must be cured prior to closing, or the title company may elect to insure over them. A defect on title can be anything from a lien or judgment to a break in the chain of title.

Real Property vs. Personal Property

There is a major difference between real property and personal property. Real property is comprised of land and anything that is affixed to the land. Personal property is anything that is transitory and can be moved. Title to real property is maintained at local county courthouses and recorders offices. These courthouses have collected information on every property in the United States since the early 1800s.

There may be a question as to whether a mobile home is considered real property or personal property. If the mobile home is affixed to the land in a permanent fashion, it may be considered an improvement and would be considered real property. It is important to note that the mobile home must also be properly converted from personal property to real property. If the mobile home is not affixed to the land, it is considered personal property.

Steps in the Title Process

Just as the loan process has different steps to get to closing, so does the title process. The steps are as follows:

- **Order Title Search**: Originator should provide to the title company the subject property address and borrower's name (in the case of a refinance) or the seller's name (in the case of a purchase transaction). Based on this information, the abstractor or attorney will conduct a search of the county records to determine the status of the property, including ownership, liens and judgments.
- **Legal Review**: The chain of title is prepared by the abstractor (or attorney) and examined by a title attorney. The attorney certifies any areas of concern to the title company to determine ownership, open liens, open judgments, exceptions and requirements that must be satisfied in order to issue a title commitment.
- **Issue Binder/Commitment:** Once all open liens, judgments and ownership are determined, the title company will issue a title binder to the lender. The title binder will identify ownership, open liens, open judgments, exceptions and items that must be

satisfied in order for the title company to issue a title policy. When the title commitment is submitted to the lender, it usually comes in a package that includes the insured closing letter, the preliminary HUD-1 settlement statement, payoffs and wiring instructions for funding.

- **Closing:** Occurs when the parties meet to execute documents related to the loan transaction. In the case of a purchase, the parties may include the borrower, seller, real estate agents and a title company representative. In the case of a refinance, the parties may only be the borrower and the title company representative. In some instances, the loan originator may attend settlement to assist the borrower with any questions.
- **Funding:** Once all documents are executed and loan conditions are met. The title company receives funds for disbursement.
- **Issue Short Form Policy:** A short form policy is an abbreviated version of a long form title policy that does not require the recording of the deed or deed of trust prior to issuance. Many lenders request that a short form policy is issued at the time that the loan disburses. The title company will later provide an addendum to the lender showing the recording information
- **Recording:** Recording is when the deed, deed of trust or other recordable documents are submitted to the courthouse for filing. It is customary for title companies to record documents immediately after closing to ensure priority of lien.
- **Issue Long Form Policy:** If a short form policy is not issued at the time that the loan disbursed, a long form policy will be issued once the documents that are required to be recorded are stamped with a book and page number and returned from the recorder's office.

Liens

Liens are monetary claims that may provide the creditor with the right to foreclosure. Liens can come in the form of voluntary liens or involuntary liens. Voluntary liens are liens in which an owner has given consent to having the lien attached to their property. A mortgage is a perfect example of a voluntary lien. An owner consents to the terms of a mortgage and understands that there is a lien on the property until the mortgage is paid off. An involuntary lien is a lien that is imposed on the property for the owner's unpaid debt.

A good example of an involuntary lien is a tax lien. A tax lien is imposed by statutory right and is imposed on the property when the owner has not paid the real estate taxes on the property. Mechanic's liens are another form of involuntary lien. Mechanic's liens secure payment for a contractor's labor and materials for home improvements that have been completed but not paid for by the property owner. When there is a mechanic's lien placed on a property, the contractor must send the owner a notice of lien within the statutory time period of the completion of the improvements. Contractors are required to record the notice of their lien within a prescribed number of days of the completion of work.

A judgment, which is a decree issued by a court, is considered a lien. Judgments often have limited lives; generally 10 years, unless they are renewed (renewals usually may only occur once). In order to perfect the lien, the judgment must be recorded in the circuit court for the county where the property is located. A judgment lien is typically enforceable for many years from the date of filing.

An attachment is defined as a "seizing of a person's property to secure a judgment or to be sold in satisfaction of a judgment." An attachment is also considered a lien.

Lien priority is the chronological order in which liens are filed against a property. When a property is foreclosed to satisfy a lien, lien priority becomes an important issue for lenders and lien holders. Since there is only a limited amount of value in a property, a higher priority lien is more likely to be satisfied than a lower priority or later-filed lien. This is why lenders always require that prior liens be paid off as a condition of closing. In a purchase transaction, the primary lender always requires that its mortgage is in first lien position.

Priority of Liens:

- Generally, real estate taxes and special assessments take priority over all other liens
- Other liens follow in the order of recordation
- There are some exceptions, particularly for mechanic's liens which can rebate back on time even though filed or recorded later in time
- Subordination agreements between lien holders can change priority (for example, a first mortgage vs. second mortgage)

Title Theory States
In title theory states, mortgages are executed and the borrower gives legal title to the lender while retaining equitable title. Theoretically, the lender owns the property via a deed of trust until the debt is paid. Upon default, the lender has a right to possession. When the debt is paid and satisfied, legal title is returned to the borrower.

Lien Theory States
In lien theory states, the borrower retains both legal and equitable title. The mortgage serves as a lien against the property. In the case of default, the lender will be required to institute a foreclosure proceeding in order to obtain legal title to the property.

<u>Subordination Agreement</u>

If a customer has a second mortgage or a HELOC that is not being paid off in the case of a refinance, a subordination agreement may be needed to ensure the lender's priority of lien. A subordination agreement is a document that changes the order of priority. If a lender wishes to maintain a first lien position, they must receive permission from the second mortgage holder to do so by requesting a subordination agreement.

If a subordination agreement is needed, the originator or the title company should contact the subordinating lien holder to determine what is required to obtain a subordination agreement. In some instances, the subordinating lender may require a processing fee. The subordination agreement may be prepared by the title company or the subordinating lender. Ultimately, the agreement must be recorded with the new deed of trust to ensure priority.

Insurance: Hazard, Flood, Mortgage

There are a number of different types of insurance which are required in conjunction with origination of a mortgage loan. Hazard, flood, mortgage and title insurance are four common types. The beneficiary of the insurance depends on the purpose of the insurance.

Mortgage Insurance
There are two types of mortgage insurance: private mortgage insurance and FHA's mortgage insurance premium policy.

Private Mortgage Insurance (PMI): Generally required by lenders on conventional loans when the loan-to-value (LTV) is at 80% or higher. The intention of PMI is to provide some security to the lender in the event of default. The theory being that higher LTV poses a greater risk of default. Borrowers also qualify for a loan with a lower down payment when they are willing to pay PMI. Per federal legislation known as the Home Owner's Protection Act (HPA), borrowers may request discontinuation of PMI when they reach 20% equity position. HPA requires automatic discontinuation once the loan has reached 78% LTV.

When the borrower requests discontinuation at 80% LTV, it is at the lender's discretion to grant the request. The law allows lenders to consider the payment history of the borrower in determining whether to discontinue PMI at the higher LTV. A good payment history includes no payments more than 60 days late in the 12-month period beginning 24 months prior to the request. A good payment history also includes no payments more than 30 days late in the 12-month period immediately preceding the request.

Mortgage Insurance Premium (MIP): MIP is required on all FHA loans and is intended in a similar way as PMI. Unlike PMI, MIP is required on all loans for five years, regardless of the LTV. Upfront MIP is collected on all FHA loans as well as annual MIP, which is collected on a monthly basis.

Hazard Insurance
Hazard insurance is required to protect the security of the collateral property from damage caused by fire and other risks. It is also commonly known as homeowner's insurance. A **loss payee clause**, or lien holder clause, is included in hazard insurance policies in order to protect the lender. The clause permits insurance payments to be made to a third party (the lender) versus the beneficiary of the policy (the homeowner) to ensure the lender recoups its investment in the event of catastrophic damage to the property.

Flood Insurance
Flood insurance is also used to protect the security of the collateral property, although its use is determined by the geographic location of the real estate. Flood insurance was first made available by the National Flood Insurance Act of 1968. Homeowners who are required to carry

homeowner's insurance can obtain it through the Federal Emergency Management Agency's National Flood Insurance Program.

As part of the process of determining whether or not a property is suitable as collateral for the specified loan, the appraiser has a responsibility to determine the flood zone designation for the property's location. The originator, processor, and underwriter must ensure that if the property is located in a zone designated with an "A" or "V" prefix, proper flood insurance is in place.

The Federal Emergency Management Agency (FEMA) has undertaken a massive effort of flood hazard identification and mapping to produce Flood Hazard Boundary and Floodway Maps (FBFMs). One of these areas is a Special Flood Hazard Area (SFHA), which is defined as an area of land that would be inundated by a flood having a 1% chance of occurring in any given year. This is also referred to as the base or 100-year flood. All flood zones with an "A" or "V" prefix fall into this area.

Development may take place within an SFHA if the development complies with local floodplain management ordinances that meet minimum federal requirements. Flood insurance is required for insurable structures within an SFHA to protect federal financial investments and assistance used for acquisition and/or construction purposes within communities participating in FEMA's National Flood Insurance Program (NFIP).

Mandatory Flood Insurance

Flood zones with an "A" or "V" prefix fall under SFHA and require mandatory flood insurance under federally regulated loan programs. Other flood zones may or may not require insurance due to special circumstances.

Zone V and Zone VE are the zones that correspond to areas within the 1% annual chance coastal floodplains that have additional hazards associated with storm waves. Mandatory flood insurance purchase requirements apply.

Zone D designation is used for areas where there are possible but undetermined flood hazards. In these areas, no analysis of flood hazards has been conducted, but while mandatory flood insurance requirements do not apply, coverage is available.

Zones B, C, and X are the zones that correspond to areas outside the 1% annual chance floodplain; areas of 1% annual chance sheet flow flooding where average depths are less than one foot; areas of 1% annual chance stream flooding where the contributing drainage area is less than one square mile; or areas protected from the 1% annual chance flood by levees. Insurance purchase is not required in these zones.

Specific Program Guidelines

FHA, VA, USDA

FHA Guidelines

The purpose of the Federal Housing Administration (FHA) has always been to assist lower-income borrowers and first time home buyers in obtaining affordable loans. While the economic landscape has evolved drastically over the years since FHA was created, the agency's mission has remained largely unchanged. It is important to note that FHA doesn't make loans; rather, the agency insures loans made by approved lenders against default by borrowers.

FHA supports a number of different loan programs, and recent federal legislation has expanded the agency's offerings in an attempt to assist more borrowers. FHA's two primary programs are 203B – the fixed-rate program – and 251 – the adjustable-rate program.

The following is a broad overview of some of the FHA program guidelines:

- **Debt Ratios:** FHA utilizes debt-to-income ratios of 31% for housing and 43% for total debt
- **Down payment:** FHA requires the borrower to invest in the loan transaction by making a 3.5% down payment based on sales price or appraisal (whichever is less) – it can be from borrower's own funds, gift funds or housing authority grants

  In its January 20, 2010 announcement, "FHA Announces Policy Changes to Address Risk and Strengthen Finances," HUD explains that this guideline will change in the early summer of 2010. The new guideline states that new borrowers will be required to have a minimum FICO score of 580 to qualify for the FHA's 3.5% down payment program. New borrowers with less than a 580 FICO score will be required to put down at least 10%.
- **Seller Concessions:** Loans are permitted to contain up to 6% seller concessions. Also in the early summer of 2010, HUD expects to reduce allowable seller concessions from 6% to 3%. According to HUD's announcement, "The current level exposes the FHA to excess risk by creating incentives to inflate to inflate appraised value. This change will bring FHA into conformity with industry standards on seller concessions."
- **Mortgage Insurance Premiums (MIP):** All FHA loans require MIP for the first five years of the loan. MIP is collected as an upfront mortgage insurance premium (UFMIP) at closing as well as on a monthly basis (annual MIP). Both are expressed in basis points and calculated based on loan term and loan-to-value. HUD is authorized to make adjustments to MIP requirements as needed to maintain the security of the FHA Mutual Mortgage Insurance Fund. Updated MIP requirements may be found on the HUD website via Mortgagee Letter.

VA Guidelines

The Department of Veterans Affairs (VA) supports affordable loan programs for our nation's active veterans, honorably discharged/disabled veterans, and spouses of deceased veterans. It is important to note that the VA doesn't make loans, rather it provides a guaranty for a specific portion of the loan amount made by approved lenders.

The following is a broad overview of some of the VA program guidelines:

- **Certificate of Eligibility (COE):** In order to originate a VA loan, the veteran must obtain a COE which establishes the qualification to participate and lists the veteran's entitlement
- **Entitlement and Guaranty:** VA guarantees up to four times the amount of the veterans entitlement. The basic entitlement is $36,000.
- **Debt Ratios:** For VA loans, lenders are only required to consider the total debt-to-income ratio. The agency uses a total debt ratio of 41%.
- **Seller Concessions:** Loans are permitted to contain up to 4% seller concessions
- **Loan Limit:** The VA doesn't publish a maximum loan limit for loans it guarantees, however there are limits for certain types of loan transactions. The agency uses the loan limits established by Fannie Mae and Freddie Mac.
- **Funding Fee:** Instead of mortgage insurance, every VA loan includes a non-refundable funding fee. The fee depends on the type of loan transaction and whether the veteran has previously used his/her eligibility for a loan. The fee is not charged to disabled veterans and can be financed into the loan. Please note that the fees are also non-refundable.

USDA Guidelines

The United States Department of Agriculture (USDA) makes and guarantees loans for lower-income borrowers in rural areas. The program requires that loan applicants are without adequate down payment resources to secure a conventional loan.

The following is a broad overview of some of the USDA program guidelines:

- **Debt Ratios:** USDA utilizes debt-to-income ratios of 29% for housing and 41% for total debt
- **Funding Fee:** All USDA loans include a non-refundable 2% funding fee, also known as a guaranty (or guarantee) fee
- **100% Financing:** USDA loans do not require a down payment. Borrowers are also permitted to finance the required funding fee, allowing financing up to 102%.
- **30-Year Fixed:** The USDA loan program offers 30-year fixed-rate loans only

Additional underwriting requirements for USDA loans are available on the USDA website. [2]

[2] http://www.rurdev.usda.gov/CA/pdf%20files%20and%20documents/GRH%20UNDERWRITING%20GUIDEL.pdf

Fannie Mae, Freddie Mac

Conforming Loan Guidelines

Fannie Mae and Freddie Mac, also known as Government Sponsored Entities (GSEs) are in the business of securitizing loans. This means they purchase individual pools of loans that conform to their guidelines which, in turn, provide a new source of funding for lenders. The pools of loans are used to create investment vehicles such as bonds which are traded in financial markets.

Due to the risk of defaulting borrowers, the GSEs establish their guidelines to minimize potential losses to investors. Loan programs supported by Fannie Mae and Freddie Mac are extensive and include many different variations on fixed and adjustable rates.

The following is a broad overview of some of the GSE program guidelines:

- **Debt Ratios:** The GSEs utilize debt-to-income ratios of 28% for housing and 36% for total debt, although there is some flexibility for higher ratios depending on additional factors
- **Mortgage Insurance:** Conforming loans require private mortgage insurance when the borrower makes a down payment of less than 20%
- **Loan Limits:** Regulatory guidelines for the GSEs establish maximum loan limits annually. For 2010, conforming loan limits are $417,000 for a single-family residence and $729,750 for a single-family residence in a high-cost area

Closing

Title and Title Insurance

The title to a property is a document that provides evidence of an individual's ownership of the property. Information affecting property title must be recorded in public records in order to provide a clear lineage of the ownership and transfer of a property. A deed – a written agreement transferring property from one person to another – is an example of information that affects title and must be properly recorded. The title company is a key player in the loan origination and settlement process which provides information and services relevant to a property's title.

The title company's responsibilities begin with a title search performed by an attorney or abstractor. The title search is an examination of county or municipal records to determine the legal status of the property. The title search results in a title abstract which is a report containing the history (or chain) of title associated with the property. The title company will issue a title binder which acts as temporary title insurance until an actual title insurance policy is issued.

Title Insurance

The purpose of title insurance is to provide coverage for undisclosed liens or other title defects that did not turn up in the title search. Title insurance is available in two forms: lender's insurance and owner’s insurance. Lender’s insurance protects the lender and is generally mandatory for loan approval.

Owner’s insurance is voluntary on the part of the borrower. It protects the borrower from lawsuits and other harmful scenarios resulting from title defects. The borrower bears the cost of both lender’s and owner’s title insurance.

Closing Agent

The closing agent is often employed by the title company, although, in some cases, he or she may be an employee of the lender. The responsibilities of the closing agent include:

- Coordinate the closing process
- Verify transaction amounts
- Ensure all parties to the transaction (borrower/buyer, seller, etc.) have copies of forms and disclosures required for settlement
- Verify identity and notarize documents
- Discuss closing requirements with parties to the transaction including fees, dates, funding, rescission, etc.

Explanation of Fees and Documents

While the closing agent’s responsibilities include the duty to provide a comprehensive explanation of closing documents and related fees, the borrower should not be hearing these explanations for the first time at settlement. The services of a mortgage broker or loan originator should include full disclosure and discussion of all fees and obligations with the borrower.

While only a few states set up fiduciary obligation or agency relationship between mortgage professionals and borrowers, failing to provide open and honest communication about fees and other obligations constitutes predatory and unethical mortgage origination. Providing a comprehensive and accurate explanation of all fees ensures that a mortgage professional is meeting obligations under RESPA, TILA and other consumer protection laws. Neglecting to explain any of these items to a borrower can place a mortgage professional at risk for violating disclosure requirements of these federal laws as well as state and federal laws pertaining to deceptive trade practices.

Notice of Right to Cancel (Right to Rescind)

Rescission is a legal remedy that voids a contract between two parties, restoring each to the position held prior to the transaction. TILA gives borrowers the right to rescind some types of lending agreements.

The right to rescind does not apply to all types of lending transactions. *No right to rescind exists for:*

- Residential mortgages to purchase or construct a home
- Refinancing of credit already secured by the borrower's principal dwelling with the same creditor that made the first loan.

HELOCs and home improvement loans are the types of loans that are the most likely to be subject to a right of rescission. Notice to the borrower of the right to rescind is due at the time of closing. The notice must be given in a document that is separate from other TILA disclosures, and two copies must be given to each party who has a right to rescind.

Parties With Rights of Rescission

In order to exercise a right to rescind, the consumer is not required to be a signatory to the loan, but he/she must have an ownership interest in the dwelling subject to the lien.

Expiration of Right to Rescind in Closed-End Transactions

If the loan is for closed-end credit, the consumer can exercise his/her right to rescind the transaction **until midnight on the third business day** after the signing of the lending agreement.

Expiration of Right to Rescind in Open-End Transactions

In open-end transactions, such as home equity credit lines, when the lender has a security interest in the borrower's principal dwelling, a consumer can exercise his/her right to rescind the transaction **until midnight on the third business day** after the following events occur:

- The credit plan is open
- Credit extensions are made above previously established limits
- A security interest is added or increased to secure an existing plan
- Increasing the dollar amount of the security interest taken in the residence used to secure the plan
- The credit limit is increased

In calculating the time limitations for the right to rescind, note that **"business days" include Saturdays.** Only Sundays and federal public holidays are excluded from the definition of "business days."

Extended Right to Rescind

For both closed-end and open-end credit, a **three-year right to rescind** exists for the following violations by the creditor:

- Failure to provide a rescission notice that meets the TILA requirements for notification
- Failure to disclose all the terms of the lending transaction as required by TILA

Funding

The first step in the post closing process is funding. Generally, funding occurs the day of closing with purchase transactions and refinances involving investment properties. Funding practices vary from state to state. If a refinance transaction involves a principal residence, the loan will fund after the three-business-day rescission period provided the borrower did not decide to rescind the loan.

When funding occurs, the lender usually wires funds to the closing agent. The closing agent is responsible for disbursing funds to the appropriate parties according to the HUD-1 Settlement Statement. Payoffs statements related to mortgages and to judgments and liens are generally provided to the title company by the lien holder or judgment creditor. The borrower generally verifies credit card bills by providing the title company with a copy of the most recent bill statement. If the borrower needs to pay off any debt, the closing agent must make the check payable to the party to ensure that the lender's interest is protected.

Disbursements and payoffs may include payments to the following:

- First Mortgage payoffs
- Second Mortgage payoffs
- HELOC payoffs
- Tax payments
- Municipal charges
- Creditors
- Lender Fees
- Broker Fees
- Judgments and liens

Wet Settlement
A wet settlement is when the parties to a loan transaction meet to execute document and afterwards funds are disbursed. In wet settlement states, lenders involved in purchase transactions are required to provide loan funding prior to or the day of closing. Regarding refinance transactions, loans are to be funded the day after the rescission period expires.

Dry Settlement
A dry settlement is the opposite of a wet settlement. A dry settlement occurs when the parties meet to execute documents but funds are not disbursed. With dry settlements, the parties are made aware that the funds are not disbursing and the property will not be conveyed until certain conditions are satisfied. Some state recordation statutes even require that the mortgage or deed of trust is recorded prior to disbursing funds.

Table Funding
Table funding is a process that allows a broker to originate and process a loan under his/her name. However, at the time of closing, the loan is transferred to a lender who provides the funds for disbursement. This scenario and similar situations occur when a broker has correspondent lender status or is accessing a line of credit for the purposes of closing the loan.

Servicing

Once the file is returned to the lender by the closing agent, loan servicing begins. A loan servicer is the company who will be responsible for accepting loan payments. In addition to accepting loan payments, the servicer is responsible for:

- Disbursing funds out of the escrow account to pay taxes and insurance
- Maintaining records related to payments and balances
- Managing delinquent accounts

If the original lender on a loan will not be servicing the loan, the borrower must be informed. RESPA requires lenders to provide borrowers with a Mortgage Servicing Disclosure Statement. The statement discloses to the borrower whether the lender intends to sell or transfer the loan to another servicer. The statement must to be provided to the borrower within three business days of receiving the loan application.

If a loan servicer transfers, sells or assigns the loan, the servicer must notify the borrower at least 15 days before the effective date of the loan transfer. If the borrower makes a timely payment to the old servicer within 60 days of the loan transfer, the borrower cannot be penalized by the new servicer.[3]

Financial Calculations Used in Mortgage Lending

Interest Per Diem

Per diem, or daily interest, is calculated by dividing the annual interest rate by the number of days in a year, then multiplying the result by the outstanding balance of the loan. In most states originators will use 360 days, but some states require the use of 365 days. The lender will provide information on which calculation is correct. Others allow the use of either number. Originators must be sure to know what his/her state requires before making the calculation.

The formula is as follows:

$$\{\text{Interest Rate}\} \div 365 = \mathbf{\{Daily\ Interest\ Rate\}}$$

$$\{\text{Daily Interest Rate}\} \times \{\text{Loan Balance}\} = \mathbf{\{Per\ Diem\ Interest\}}$$

If the loan is amortized, the per-diem interest will change every month as the loan balance declines. For the figures included on a Good Faith Estimate, the calculation is made on the anticipated loan amount.

[3] http://www.hud.gov/offices/hsg/sfh/res/respa_hm.cfm, March 2008

Per-diem interest is collected at closing to put the loan on schedule. For example, if a loan is closing on the 20th day of a month, the closing agent will collect 11 days of per-diem interest to pay the interest cost until the end of the month.

Payments (PITI, Mortgage Insurance)

Amortized mortgage payments can only be calculated using a financial calculator designed to handle loan amortization. However, it is generally a very simple process when the originator has the total loan amount, interest rate and loan term. Based on the functions of the calculator, the originator will enter these three factors and ask the calculator to solve for a P&I (principal and interest) payment.

Many financial calculators allow a person to enter any three of the variables to return the fourth. For example a person may enter a loan amount, desired payment, loan term and ask the calculator to solve for the required interest rate. Likewise, entering the desired payment, loan term and interest rate will allow a person to solve for the corresponding loan amount.

A more important calculation to borrowers is the PITI (principal, interest, taxes and insurance) payment. It is based on the same principles as the P&I payment but more accurately portrays a borrower's potential monthly payment because it includes the required escrow amounts for taxes and insurance.

Financial calculator models differ in their functions but many models include a taxes/insurance function for adding these variables into the payment calculation. Regardless of calculator functions, taxes and mortgage insurance are simple calculations that can be added to a P&I payment to advise a borrower of his/her monthly PITI payment.

Calculating Taxes

Taxes are fairly simple to calculate. They are typically obtained as an annual, semi-annual or monthly amount from the locality where a property is located. They are based on the locality's assessed value of the property and the sales price of the property.

The annual tax amount is divided by 12 to arrive at a monthly tax payment (semi-annual is divided by 6), which can be added to a P&I payment or entered along with the other variables into a financial calculator.

{Annual Property Taxes} ÷ {12} = **{Monthly Property Taxes}**

Calculating Mortgage Insurance

Mortgage insurance varies based on the borrower's loan-to-value and the type of loan being originated. Fixed-rate loans will have a different mortgage insurance rate than adjustable-rate loans. This is true for both private mortgage insurance and FHA mortgage insurance premiums. However, it is important to note that some FHA loan transactions many require annual, upfront and/or monthly insurance. The calculations are generally handled the same as private mortgage insurance.

The monthly PMI is calculated by finding the rate for the specific loan product and multiplying it by the loan amount to find the annual PMI. The annual premium is divided by 12 to arrive at the monthly PMI.

The formula is as follows:

$$\{\text{Loan Amount}\} \times \{\text{Mortgage Insurance Rate}\} = \mathbf{\{Annual\ PMI\}}$$

$$\{\text{Annual PMI}\} \div \{12\} = \mathbf{\{Monthly\ PMI\}}$$

Monthly PMI can be added, along with monthly taxes, to a P&I payment to arrive at a PITI payment.

<u>Example</u>

Assume a borrower is purchasing a home for $200,000 and putting $15,000 down on a 30-year fixed loan at 6% interest. The PMI requirement for 93% LTV on a 30-year fixed is 0.78%. Property taxes are $1,500 annually. What would this borrower's PITI payment be?

The loan amount {185000}, term {30} and interest rate {0.6} are plugged into the financial calculator to solve for a P&I payment of **{$1,109.17}**.

Monthly property taxes are calculated as follows:

$$\{1500\} \div \{12\} = \mathbf{\{\$125\}}$$

Monthly PMI is calculated as follows:

$$\{185000\} \times \{.0078\} = \mathbf{\{\$1{,}443\}}$$

$$\{\$1{,}443\} \div \{12\} = \mathbf{\{\$120.25\}}$$

The PITI payment is calculated as follows:

$$\{\text{Monthly P\&I}\} + \{\text{Monthly Taxes}\} + \{\text{Monthly PMI}\} = \mathbf{\{PITI\ Payment\}}$$

$$\{1109.17\} + \{125\} + \{120.25\} = \mathbf{\{\$1{,}354.42\}}$$

Down Payment

Down payment is often a component of determining loan-to-value for the purposes of various loan programs or for figuring a maximum loan amount. For instance FHA borrowers are required to have a 3.5% investment/down payment in their loan transaction. Conventional lenders usually require borrowers to pay PMI if they make a down payment of less than 20%, or otherwise have less than 20% equity in their property.

Example

Assume a borrower is purchasing a property for $237,000 and the lender will require PMI unless the LTV is 80% or less. What is the minimum down payment for this property so that the borrower can avoid PMI? The calculation is as follows:

{Purchase Price} × {Maximum LTV} = **{Loan Amount}**

{237000} × {.80} = **{$189,600}**

{237000} - {189,600} = **{$47,400}**

Or, more simply:

{Purchase Price} × {Down Payment %} = **{Minimum Down Payment}**

{237000} × {.20} = **{$47,400}**

Loan-to-Value (LTV, CLTV/Total LTV)

There are two loan-to-value (LTV) calculations. The first describes the relationship between the first, or primary, mortgage and the property's value. This is the LTV. The second describes the relationship between all liens and encumbrances and the property value. This is called the combined loan-to-value, or CLTV.

The LTV formula is as follows:

{Loan Amount} ÷ {Lesser of the Property Value or Purchase Price} = **{LTV}**

The CLTV formula is as follows:

{1st Loan Balance} + {2nd Loan Balance} + {All Other Lien Balances} = **{Total Encumbrance}**

{Total Encumbrance} ÷ { Lesser of the Property Value or Purchase Price } = **{CLTV}**

A property with only one mortgage or lien will only have an LTV. The CLTV applies only when subordinate financing is, or will be, in place.

Examples

Loan-to-Value
Assume a borrower is purchasing a home appraised at $280,000. The purchase price is $278,000 and the borrower is going to make a 25% down payment. What is the LTV for this transaction? The calculation is as follows:

Determine the loan amount based on the purchase price and down payment:

{Purchase Price} × {Down Payment %} = **{Down Payment}**

{278000} × {.25} = **{$69,500}**

{Purchase Price} – {Down Payment} = **{Loan Amount}**

{278000} – {69500} = **{$208,500}**

Determine the LTV (note that the purchase price is used in this particular example since it is lower than the property value):

{Loan Amount} ÷ {Purchase Price} = **{LTV}**

{208500} ÷ {278000} = **{75%}**

Combined Loan-to-Value
Assume a borrower is looking to refinance and consolidate some of his debts. He has a first mortgage balance of $115,000 and a home equity loan with a balance of $21,000. He also has a tax lien of $4,000 against his property. His property has appraised at $192,000. What is his CLTV? The calculation is as follows:

{1st Loan Balance} + {2nd Loan Balance} + {All Other Lien Balances} = **{Total Encumbrance}**

{115000} + {21000} + {4000} = **{$140,000}**

{Total Encumbrance} ÷ {Property Value} = **{CLTV}**

{140000} ÷ {192000} = **{73%}**

Debt-to-Income (DTI) Ratios

The front ratio is calculated by adding all housing related monthly expenses and dividing them by the gross monthly income. Expenses that are added include the proposed PITI payment, subordinate financing, housing association dues, and any other fixed housing expense. Utilities and maintenance costs are not included. This basic calculation is:

{Housing Expense} ÷ {Income} = **{Front Ratio}**

For example, if a family earning $6,780 per month was seeking a new mortgage with a PITI payment of $1,756 and there were no association dues or subordinate financing, the ratio would be calculated by dividing $1,756 by $6,870, as shown below:

Housing Expense:	$1,756
Income:	÷ $6,780
Ratio:	0.26

This would be expressed as a 26% housing or front ratio. This ratio would be acceptable to most lenders. However, experience has shown that the front ratio is not the most important ratio. The back ratio, or total debt ratio, is far more predictive of future default. It is calculated by adding the payments for all long-term debts. A long-term debt is generally defined as one that will take more than 10 months to repay using the standard or minimum payment. That calculation is:

{Total Monthly Debts} ÷ {Income} = **{Back Ratio}**

To continue our example, we could assume that this family has a $358 monthly car payment with 22 months remaining and $3,500 in credit card debt. Unless there is evidence of a higher minimum payment, Freddie Mac and many other investors require the use of a 5% minimum payment on revolving debt. To calculate the total debt ratio, begin by calculating the total monthly payments:

Credit Cards:	$3,500
Minimum:	× .05
Payment:	$ 175

Next, add the three payments:

Credit Cards:	$ 175
Car loan:	+ $ 358
PITI:	+ $1,756
Total:	$2,289

Finally, divide the result by the income:

Total monthly:	$2,289
Income:	÷ $6,780
Total Debt Ratio:	0.34

Temporary and Fixed Interest Rate Buy-Down (Discount Points)

Temporary and fixed interest rate buy-downs are handled differently. In a fixed interest rate buy-down, the borrower pays fees to permanently reduce the note rate of a loan. For instance, the lender may offer an interest rate of 7.75% with no discount points or a rate of 7% with three points. The "three points" are equal to 3% of the loan amount and are paid as closing costs, which affect the APR of the loan. The calculation for points is as follows:

{Loan Amount} × {0.01} = **"1 point"**

A temporary buy-down is created when funds are placed in escrow to offset the monthly payment required by the terms of the loan. The escrow funds reduce the payment rate for a period of time but not the note rate.

Examples

Discount Points
Assume a borrower qualifies for a $175,000 loan at 6.50%. The lender offers a discount rate of 6% for two points. How much will the borrower pay at closing to obtain a 6% note rate? The calculation is as follows:

{Loan Amount} × {Points} = **{Cost of Discount}**

{175000} × {.02} = **{$3,500}**

Temporary Buy-Down
Assume a borrower has qualified for a $125,000 loan, 30-year fixed at 8.25% interest. She is expecting an increase in her salary over the next three years and would like to save money on her monthly mortgage payment for that period of time by using a 2-1 Buy-Down. The payment

analysis and total cost for her transaction is as follows. The total cost would be the escrow amount required to maintain the temporary buy-down:

	Payment Rate	**Borrower's Payment**	**Note Rate Payment**	**Difference**	**Difference × 12 = Cost Per Year**
Year 1	6.25%	$769.65	$939.08	$169.43	$2,033.16
Year 2	7.25%	$852.72	$939.08	$86.36	$1,036.32
Year 3	8.25%	$939.08	$939.08	$0.00	$0.00
				Total Cost	$3,069.48

Closing Costs and Prepaid Items

Fees associated with loan closing, fees owed to state and local government for real estate related transactions and pre-paid items such as per diem interest are funds that a borrower often needs to have available at settlement.

Determining the amount of money that needs to be brought to closing by the buyer in a purchase transaction or owner in a refinance transaction is calculated as follows:

{Loan Amount} – {Payoff} – {Financing Costs} – {Government Charges} – {Pre-paid Costs} =
{Cash Needed, or Overage Available as Cash, to Borrower}

ARMs (e.g. Fully Indexed Rate)

Worst-case Scenario

Prospective borrowers will frequently ask you to calculate the maximum amount that an interest rate on an ARM could rise in a given time period. This is often referred to as a "worst-case scenario." To perform the calculation, the following must be evident:

- The starting interest rate
- The first adjustment date
- The frequency of adjustments thereafter
- The periodic rate cap
- The lifetime rate cap
- The time frame of interest

Licensing exam questions will often provide the index and margin, but they are not needed for a worst-case calculation. It may be assumed that the rate will rise the most it can for each adjustment period. The start rate and caps, not the index and margin, control this.

To begin the calculation, determine the maximum interest rate by adding the lifetime rate cap to the start rate. This is the most the interest rate could ever be:

{Start Rate} + {Lifetime Cap} = **{Maximum Rate}**

The next step is to determine how many adjustments could occur in the given time frame. For example, a 3-1 ARM stays stable for three years, then adjusts every year thereafter. The amount of each adjustment is limited by the periodic rate cap and the lifetime rate cap.

Therefore, if the question pertained to the interest rate in the fifth year, it would be apparent that the rate would have already adjusted twice. The rate would have adjusted once at the end of the third year, which would have been applied to the fourth-year payments, and once at the end of the fourth year, which would have been applied to the fifth-year payments.

To calculate the rate in the fifth year, follow these steps:

{Number of Adjustments} × {Periodic Cap} = **{Periodic Adjustment}**

{Start Rate} + {Periodic Adjustment} = **{New Rate}**

The last step is to compare the new rate with the maximum rate. If the new rate is lower than the maximum rate, then the new rate is the correct answer. If it exceeds the maximum rate, then the maximum rate is the correct answer. Read these test questions very carefully before attempting to answer them. They can be tricky.

Sample Rate Calculations

John and Mary Smith are borrowing $280,000 toward the purchase of a home. The loan is a 3-1 ARM with a start rate of 5.625%, a periodic rate cap of 2% thereafter, and a lifetime rate cap of 6%. What is the highest interest rate that could be charged in the fifth year of the mortgage?

Step 1: Maximum Rate

(Start Rate) 5.625% + (Lifetime Rate Cap) 6% = (Maximum Rate) **11.625%**

Step 2: Adjustment Periods

In a 3-1 ARM, the first adjustment occurs at the end of the third year and applies to the fourth year. The rate adjusts each year thereafter. In this example, the rate would have adjusted twice, once after the third year and once after the fourth year.

The calculation is as follows:

Step 3: Maximum Rate for Adjustment Period

2 × 2% = **4%** (Maximum Periodic Adjustment)

5.625% + 4% = **9.625%** (New Rate for 5th Year)

Step 4: Comparison with Maximum Rate

9.625% < 11.625%

Using the Margin and Index

You might be asked a question in which the margin and index are given, as well as a hypothetical change in the index. In our previous example, the margin on the loan might be 2.75% and the index might have risen to 5.50% at the time the second adjustment occurred. In this case, the actual new rate would have been computed by adding the margin and index, then comparing the result to the maximum rate.

The calculations are as follows:

2.75% + 5.50% = **8.25%**

8.25% < 9.625%

Because 8.25% is less than or equal to 9.625%, the new rate for year five would be 8.25%.

A Word of Caution!

Borrowers often feel very anxious about how much their rate might rise. The worst-case scenario can be used to provide substantial comfort for the prospective borrower, but it must be used very carefully. Remind borrowers that the maximum allowable rate is not the rate they are likely to receive. However, if they cannot see a way to handle the maximum allowable rate, they may want to reconsider their choice of an ARM loan.

Discussion Scenario: General Mortgage Calculations

The following scenarios require you to apply several mathematical concepts to solve real world questions.

Scenario 1: A property is valued at $342,000. There is a first and second mortgage with a CLTV of 85%. The second mortgage has an 8% LTV. What is the approximate amount of the first mortgage?

Scenario 2: The Gonzales family is closing on a 30-year 1/1 ARM of $295,000 with rate caps of 1 and 6. The start rate is 6.125%. What is the most the interest rate could be following the third adjustment? What is the most the interest rate could be in the second year of the loan?

Scenario 3: The Jackson family is closing on a conventional mortgage for a property valued at $272,225 with an LTV of 90%. They will pay a private mortgage insurance premium of 1.35% at closing and an origination fee of 1.5 points. What is the dollar amount of the PMI premium? What is the dollar value of the origination fee?

Discussion Feedback

Scenario 1: The calculation is fairly straightforward – the second mortgage LTV can be subtracted from the combined loan-to-value and the resulting % can be used to determine the amount of the first mortgage.

The calculation is as follows:
85% [CLTV] – 8% [2^{nd} mortgage LTV] = 77% [1^{st} mortgage LTV]
$342,000 [property value] × .77 [1^{st} mortgage LTV] = $263,340

The approximate value of the first mortgage is: **$263,340**

Scenario 2: The calculations for the Gonzales' scenario are very simple – you just need to be clear on what is being asked. Since the ARM has a cap of 1% on the annual adjustment (referenced by "1" in "rate caps of 1 and 6" – "6" refers to the lifetime cap), each annual adjustment cannot exceed 1%. So, beginning with a start rate of 6.125%, the highest that the third adjustment could be is **9.125%.**

For the second question in the scenario, you need to reference the fact that it's a 1/1 ARM – the interest rate is 6.125% for the first year of the loan. In the second year, it will begin adjusting. Again, referring to the annual rate cap, the most the interest rate can be in the second year of the loan is **7.125%.**

Scenario 3: Points and premiums calculations are generally just a matter of multiplying the loan amount by the % specified. With points, you need to remember that 1 point = 1% of the loan amount. Also, take into consideration the LTV – the borrowers are putting down 10% so, while the property value is $272,225, the loan amount is approximately $245,000. In this scenario, a PMI premium of 1.35% would equal **$3,307.50** ($245,000 × .0135). The origination fee is **$3,675** ($245,000 × .0150).