

Loan Underwriting Best Practices

Industry Standards and Guidelines - 2024

Introduction

This document outlines industry best practices for loan underwriting, based on guidelines from federal agencies, industry associations, and market standards. These practices should be followed to ensure prudent lending decisions while maintaining compliance with regulatory requirements.

1. Ability to Repay

The fundamental principle of responsible lending is ensuring the borrower's ability to repay:

- Verify stable income from reliable sources
- Calculate accurate debt-to-income ratios including all obligations
- Consider residual income after debt payments
- Assess employment stability and industry outlook
- Review asset reserves for cushion against unexpected events

Key Metrics:

- Front-end DTI (housing expense ratio): Maximum 28%
- Back-end DTI (total debt ratio): Maximum 36-43%
- Residual income: Minimum varies by family size and location

2. Credit History Evaluation

Comprehensive credit review beyond the credit score:

- Payment history patterns across all credit types
- Length of credit history (older is better)
- Credit mix (variety indicates experience)
- Recent inquiries (multiple may indicate financial stress)
- Credit utilization ratio (under 30% is optimal)
- Public records (judgments, liens, bankruptcies)

Red Flags:

- Recent late payments without explanation
- High credit utilization (over 80%)
- Multiple recent inquiries
- Collections or charge-offs
- Inconsistent payment patterns

3. Property Valuation Standards

For secured loans, proper collateral valuation is essential:

- Use licensed, independent appraisers
- Require recent comparable sales (last 6 months)
- Consider market conditions and trends
- Verify property condition through inspection
- Review title for liens or encumbrances

Conservative Valuation

Approach: • Use lower of purchase price or appraised value • Apply market condition adjustments • Consider property type and marketability • Factor in necessary repairs or defects

4. Risk Mitigation Strategies

Implement appropriate risk mitigation measures: • Require private mortgage insurance for high LTV loans • Establish escrow accounts for taxes and insurance • Obtain appropriate property and liability insurance • Set aside reserves for anticipated expenses • Consider loan terms appropriate to borrower situation
Compensating Factors: • Excellent credit history can offset higher DTI • Substantial reserves mitigate income concerns • Low LTV reduces default risk • Stable long-term employment • Significant equity in other properties

5. Documentation Requirements

Maintain complete documentation for each loan: • Completed loan application with signatures • Credit reports from all three bureaus • Income verification (pay stubs, tax returns, W-2s) • Asset verification (bank statements, investment accounts) • Employment verification (VOE or verbal verification) • Property appraisal and title report • All disclosures and borrower acknowledgments
Documentation must be: • Current (typically within 90 days) • Complete and legible • From reliable third-party sources • Verified for accuracy and authenticity

6. Fair Lending Compliance

Ensure compliance with fair lending regulations: • Apply consistent underwriting standards to all applicants • Base decisions on objective, credit-related factors • Avoid discrimination based on protected classes • Provide adverse action notices when required • Maintain detailed records of decision rationale
Protected Classes: • Race, color, national origin • Religion • Sex (including gender identity and sexual orientation) • Familial status • Disability • Age (for certain loan types)