Chapter 12
Controlling Default Risk, Borrower Qualification, and Loan Underwriting

Some Basic Mortgage Underwriting Questions
- Who should you grant a loan to?
- How do we determine the appropriate interest rate for a loan?
- What is the maximum dollar amount we should lend on a given property?
- If someone walks in your mortgage office seeking a loan, what questions should you ask?

Classification of Mortgage Loans
- Conventional mortgages
  - A lender and borrower agree on a set of terms for a real estate loan
- Insured conventional mortgages
  - When the amount of the loan, relative to the value of the property exceeds a certain ratio (say 80%) then mortgage insurance may be required
- Conforming
  - Means the loans conform to the FNMA or FHLMC standards

Classification of Mortgage Loans (con’t)
- FHA insured mortgages
  - Privately originated mortgages written to guidelines promulgated by the FHA that are insured by the FHA
- VA guaranteed loans
  - Privately originated mortgages written to guidelines promulgated by the VA that are insured by the VA
  - VA loans are a benefit to vets

Two Sources to Evaluate
1. Evaluate the Property
2. Evaluate the borrower

Property Evaluation
- Appraisal
  - Sales comparable (common for residential)
  - Present Value of Income generation
  - Cost to replace, less depreciation
- Legal Description
- Survey (boundary lines)
- Inspections
  - Structural and needed repairs
  - Pests
- Preliminary Title Report
Value of Property

- The value of the property used in loan underwriting is:
  - \( \text{MIN}(\text{Sales Price}, \text{Appraised Value}) \)
- The down payment depends on the property value

Example

- You have signed a purchase agreement for $125,000 that you will fund with a 90% LTV mortgage. (LTV=Loan to Value)
- The house appraises for $122,500
- The maximum amount you can borrow is 90% of the value, i.e. \( 0.9 \times 122,500 = 110,250 \)
- Your down payment must be:
  \[ 125,000 - 110,250 = 14,750 \]
  - which is more than 10% of the purchase price.
- You also need funds for closing costs

Example (continued)

- If the house had appraised for $125,000 or more, you could have borrowed 0.9*125,000 and would need a down payment of $12,500.
- Conclusion:
  - If the house does not appraise at or above the sales price, you will need additional funds for the down payment
  - A low appraisal can be said to be a “deal killer”

Borrower Evaluation

Credit Bureaus collect data on your use of Credit

- Credit Worthiness is usually expressed with a credit score
  - (See www.myfico.com)
- A credit score is a statistically derived number that ranks you compared to others

From www.myfico.com

![Credit Score Chart]

Fico Score Affects Loan Rates

<table>
<thead>
<tr>
<th>Fico Score</th>
<th>Mortgage APR</th>
</tr>
</thead>
<tbody>
<tr>
<td>720-850</td>
<td>6.23%</td>
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<tr>
<td>700-719</td>
<td>6.36%</td>
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<td>675-699</td>
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<td>620-674</td>
<td>8.05%</td>
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<tr>
<td>560-619</td>
<td>8.53%</td>
</tr>
<tr>
<td>500-559</td>
<td>9.29%</td>
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</table>
What affects credit scores?
- Charge offs and Bankruptcies significantly reduce credit scores
- Severely delinquent accounts significantly reduce credit scores
- Many credit inquiries reduce credit scores
- High balances reduce credit scores
- Too many open accounts reduce credit scores
- A short credit history reduces credit score

Other Underwriting Factors
- Employment History
- Type of Employment (Self Employed versus salary)
- Education (more educated typically lower defaults)
- Residence history (Rent or Own, How often one moves)

Other Underwriting Factors
- Income
  - Size
  - Regularity
- Savings and Investments
  - Money available for down payment and closing costs
  - Ability to save and invest

Housing Expense - PITI
- Housing expense if often described as PITI
- Principal
- Interest
  - (Principal plus interest is the mortgage PMT we have been computing thus far in this course)
- Taxes – property taxes
- Insurance – “hazard” insurance, flood insurance, mortgage insurance, association fees
- Housing Expense does not typically include Maintenance Costs and Utilities

Uniform Residential Application

Qualifying Ratios
\[
\frac{\text{Housing Expense}}{\text{Income}} \leq 28\%
\]
\[
\frac{\text{Housing Expense} + \text{Other Debt Pmts}}{\text{Income}} \leq 36\%
\]

Plus, you must also have enough cash at hand to cover the down payment plus closing costs
Borrower Qualifying Ratios

- Loan-to-Value Ratio (LTV)
  - The Higher the LTV Ratio, the Higher the Default Risk
- Payment-to-Income Ratio
  - Conventional: 28% for Conventional, 29% for FHA/VA
  - PITI: 28%
  - PITI+other: 36%

Compensating Factors

- Higher ratios may be allowed for compensating factors
  - Examples:
    - You have never been late with a rent payment and you have been able to save money to for a down payment.
    - Your house payment would be lower than your rent payment.
    - You may be allowed a ratio that exceeds the standard ratio.

Common Loan Types

- Conforming Conventional
  - Conforms to the Fannie Mae and Freddie Mac underwriting guidelines (current maximum loan size is $417,000, temporarily increased to $729,750)
- Non conforming conventional
  - Either Jumbo loans, of subprime loans
- Privately Insured Mortgages
- Portfolio Loans
  - Loans that will be held in the asset portfolio of a financial institution such as Washington Mutual or World Savings
- FHA/VA Loans

GSE (Government-Sponsored Enterprise)

- There are two GSE’s
  - Federal National Mortgage Association
  - Also called Fannie Mae, from FNMA
  - Federal Home Mortgage Loan Corporation
  - Also called Freddie Mac, FHMLC

Congress Mandated Three Housing Goals for the GSEs

- Low- and Moderate-Income Housing Goal: Targets families with incomes at or below the area median income. ("Area median income" is defined as the median income of the metropolitan area, or for properties outside of metropolitan areas, the median income of the county or the statewide nonmetropolitan area, whichever is greater.);
- Special Affordable Housing Goal: Targets very low income families (at or below 60% of area median income), and low-income families in low-income areas (at or below 80% of area median income); and
- Underserved Areas Housing Goal: Targets families living in low-income census tracts or in low- or middle-income census tracts with high minority populations.

Jumbo Loans

- Are loans that exceed the Fannie Mae and Freddie Mac loan amount (currently $417,000, though temporarily increased to $729,750)
- There is no implicit government subsidy in such loans
- Other underwriting criteria are similar to conforming
FHA Loans
- Loan made by traditional underwriters that are approved to underwrite to the FHA standards or who get the loan package approved by the FHA.
- The FHA does not originate loans.
- The FHA insures loans written to its standards, which may be different than those for Fannie Mae and Freddie Mac.
- Typically used by lower income borrowers.

FHA Loans (continued)
- Can have a very small down payment (traditional reason for FHA loans).
- Must pay a mortgage insurance premium that is can be added to your initial loans balance (in addition to a monthly mortgage insurance premium).
- Maximum loan size varies by location. In early 2008 it was 200,160 for San Antonio, but in response to financial crisis has been increased to 332,500.
- In Los Angeles it was 362,790 (a high cost area) which has been increased to 729,750.

Mortgage Insurance
- If you have a down payment of less than 20% on a conforming loan, you must purchase PMI (private mortgage insurance).
- This consists of a pre-payment for the premium for your first year, and collecting monthly premiums to cover future years.
- When you can show you have 20% equity in your property you can apply to no longer pay a mortgage insurance premium.
- Unlike other insurance, if you default on your mortgage, and the issuer suffers a loss, it can come after you with a judgment.

VA Guarantee
- Somewhat like the FHA, the VA guarantees a portion of a mortgage for qualified Veterans as part of a military benefit.
- This allows Vets to obtain zero down financing.
- The borrower must pay the VA a funding fee that is conceptually similar to a mortgage insurance premium, though the VA guarantee is a benefit of military service.
- The loans are assumable to both Vets and others, and may not have a pre payment penalty.
- The loan is not made by the VA.

Subprime Loans
- Loans of low credit quality that do not meet conforming standards are called subprime loans.
- Subprime borrowers typically have low credit scores, and may have spotty employment history.
- Subprime borrowers may use “Low Doc” or “Stated Income” rather than submitting traditional documentation such as income tax returns.
- Loans are often classified as: Alt-A, B, C.
- Some lenders specialize in subprime lending – Many are now out of business (e.g. New Century or Option One Mortgage, Indy Mac).
- Subprime loans often have higher fees, points and interest rates.
- Subprime loans may have very low down payments.

Borrower Qualifications
- Mortgage Credit Analysis includes:
  - Determining Maximum Loan Amount
    - Historically Ratio of Payment to Income
  - Estimating Closing Costs
    - You typically need cash to close the loan
  - Analyzing Credit History
    - Credit Score a key variable now
    - Low credit score makes you subprime
  - Calculating Income and Housing Expense
  - Assessing Ability to Repay
House Price Indices (Case-Shiller)

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Default Risk
- Ability-to-pay Theory
  - For Whatever Reason, Borrower Cannot Make the Payments
- Equity Theory (Put Option)
  - The Lower the Equity, the Greater the Likelihood That the Borrower Will "Put" the Property in Place of the Debt, i.e., Default on the Mortgage
  - Research indicates this is the most important variable linked to default

Mortgage Contracts
- Mortgage - Defines the Debt and Creates the Lien Against the Property
- Promissory Note - Outlines the Provisions of the Loan
  - Recourse vs. Non-Recourse
  - Interest and Payment Structure
  - Pre-Payment
  - Default and Acceleration
  - Due-on-Sale Clause
  - Amount of Loan
  - Assignment of Rents and Income

Shopping for a House
- Step 1. Compute the approximate maximum house you can afford (Qualify yourself using the guidelines presented)
- Step 2. Decide whether you want to go for the max.
- Step 3. Find a Realtor for "Listed Properties" and do a search on your own for FSBO (For Sale by Owner)

Shopping for a House
- Buyer Broker – represents you
- Seller Broker – represents the seller (Used to be that all brokers represented the seller as the seller is typically paying the commission)
- Which should you choose?
- The offer and bargaining process