# Fin 5413: Chapter 8 Mortgage 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:
- MIN(Sales Price, Appraised Value)
- The down payment depends on the property value

## Example

- You have signed a purchase agreement for $125000 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*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)

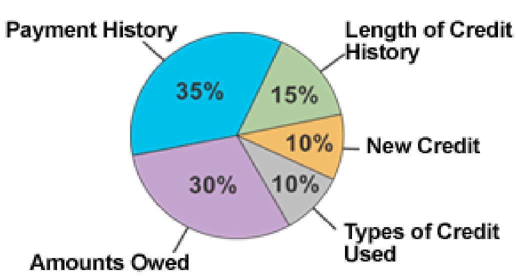
- If the house had appraised for $125,000 or more, you could have borrowed 0.9*125,000 and would need a down payment of $12,500.
- Conclusion:
  - If the house does not appraise at or above the sales price, you will need additional funds for the down payment
  - A low appraisal can be said to be a “deal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




## FICO Score Affects Loan Rates

**Fair Isaac: "The Median FICO Score in the U.S. is 723."**
(2010: 723 statistic no longer exists on myFICO.com)

**Charles A. Capone, Jr., Ph.D**, Senior Analyst, Microeconomic and Financial Studies Division U.S. Congressional Budget Office Washington, DC, writing in "Research Into Mortgage Default and Affordable Housing: A Primer": "For most of the 1990s, the mortgage market viewed a FICO score of 620 as the bottom cut off for prime loans, meaning loans that could be sold to Fannie Mae or Freddie Mac. Scores in the 580-620 range were considered 'near' prime, with labels such as A-minus, and those above 720 were considered low risk borrowers." (2001)(alt)

| Fico Score | Mortgage APR |
|---|---|
| 720-850 | 6.23% |
| 700-719 | 6.36% |
| 675-699 | 6.90% |
| 620-674 | 8.05% |
| 560-619 | 8.53% |
| 500-559 | 9.29% |

## 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

http://www.fha.com/fha_requirements_debt.cfm

**Front End Ratio (Traditional)**

$$\frac{\text{Housing Expense}}{\text{Income}} \leq 28\%$$

**Back End Ratio (41% current FHA)**

$$\frac{\text{Housing Expense + Other Debt Pmts}}{\text{Income}} \leq 36\%$$

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

## Compensating Factors

- Higher ratios may be allowed for compensating factors
  - Example:  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 loans size is $417,000)
- Non conforming conventional
  - Either Jumbo loans, or 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)

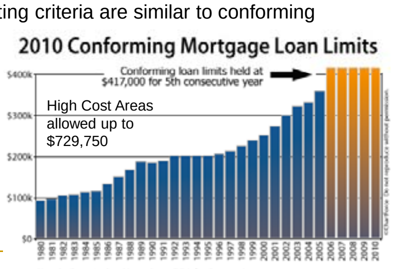
- There are two GSE's
- Federal National Mortgage Association
  - Also called Fannie Mae, from FNMA
- Federal Home Mortgage Loan Corporation
  - Also called Freddie Mac, FHMLC

## 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)
- 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 ARM's not teased 5% ceilings, 1% change per year, based on T-Bill

## 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 is 322,500 (in Bexar County), but is up to 729,750 in high cost areas (Los Angeles area limit) [2010 figures]

## Why Should I Consider an FHA Home Purchase Loan?

- There are many reasons for homebuyers to investigate an FHA home purchase. First time homebuyers should explore FHA loan options because **it's easier to qualify for an FHA home mortgage**. Your loan is guaranteed by the government, making your application more attractive to lenders. Since the typical first-time FHA home loan applicant is young and in the early phases of their careers, chances are they still have student loans and other debt to content with; an FHA home mortgage often costs less and is **more forgiving of youthful indiscretions with credit and payments.**

## Why FHA?

- FHA home loans don't require a big down payment at closing time. For first-time homebuyers this can be a real plus; that typical borrower in the early stages of a new career often doesn't have a lot of money set aside specifically for purchasing a home. The FHA mortgage requires a low 3.5% down payment, and that money can come from a variety of sources including HUD down payment assistance grants.

  For first time buyers, closing costs are another issue that can be a financial drain; typical closing costs for FHA home loans are around 2% or 3% of the total mortgage. One advantage when taking out an FHA loan? FHA mortgage terms may allow you to build in closing costs into your mortgage.

## 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

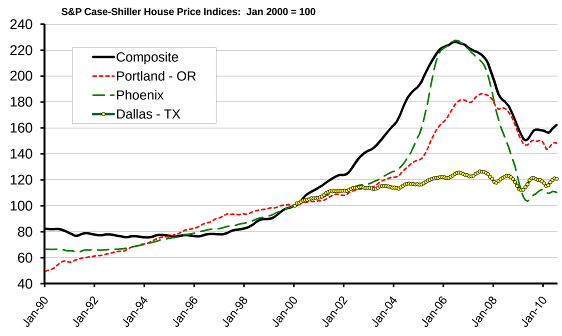
## VA Guarantee

- Somewhat like the 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)
- Subprime loans often have higher fees, points and interest rates
- Subprime loans may have very low down payments

## House Price Indices (Case-Shiller)




## Federal Truth in Lending for ARMS

- The FTLAPR is calculated assuming the Index does not change from its present value, over the life of the loan
- If your initial interest rate equals the index + margin, then the APR calculation will exactly the same as for a FRM.
- If your loan is "teased" I.e. the initial interest rate is lower than the index plus margin, the interest rate used to compute APR will increase, subject to any caps.

## FLTAPR for ARMs Example

- Margin = 2.5%, Index = 7.00%
- 10 year loan with 2 points ($100,000 note)
- 2 % maximum increase each year
- Initial Interest rate = 6.5%
- If the index remains the same, the second year interest rate will be 8.5%, and the third and following years will be 9.5%

## FLTAPR for ARMs Example

- First year Payment
  - PMT(PV=100,000, N=120, I/YR= 6.5) = 1135.48
  - Bal 12 = -92,658.07
- Second year Payment
  - PMT(PV = 92658.07, N=108, I/YR = 8.5) = 1230.44
  - Bal 12 = -85,493.89
- Third year and future year Payment
  - PMT(PV= -85,493.07, N= 96, I/YR = 9.5) = 1274.79

## FLTAPR for ARMs Example

- Table of Cash Flows

| t | CF | Nj |
|---|---|---|
| 0 | -98000 | --- |
| 1-12 | 1135.48 | 12 |
| 13-24 | 1230.44 | 12 |
| 25-120 | 1274.79 | 96 |

Shift IRR/YR = 9.14%, which can be rounded to the nearest ¼% so can round to 9.25%

## FLTAPR for ARMs

- The lender must also show the borrower an example of a worst case scenario (I.e. how payments will change if interest rates rapidly adjust upwards)
- The lender must clearly state the index that will be used and the margin that will be added to the index.

## 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