

# C & G Financial Services



*Presents*

# Underwriting & Documentation II

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# *Underwriting the Conventional Loan*

Buying a home is inherently stressful for most people. It is made more so by the home buyer's fear that he or she does not understand what is going on, and has relinquished control over the process. If your borrower has not succumbed to confusion by the time the loan application is completed and submitted, then the days and weeks that follow - characterized by anxious waiting and limited communication from the lender - will undoubtedly find him or her resigned to powerlessness.

When your borrower turns to you for assistance, you will find that the most important tools available to you are *knowledge* and *communication*. In this course, we are going to arm you with the knowledge that you will need to make the loan process clear, and the ability to communicate that knowledge to your borrowers.

## *The Application*

The loan application is the foundation upon which the loan is built. It is also the basis upon which the ongoing relationship with the customer begins. The more complete the application, the less need there is to return to the customer for more information. With this the borrower's satisfaction with you is high, and consequently, so is the agent's. Remember that the borrower will report your strengths and weaknesses to the agent.

***You only get one chance to do it right the first time.***

Organization and clear communication will get the loan application process off to a good start. Let the borrowers know ahead of time what they will be expected to furnish (you may want to use the checklist included in this manual). There are two major functions:

### **1. Gathering information and documentation**

Getting enough information and documentation to speed the application to funding: the more information you have to go back for, the more doubt there will be from the borrower, and the longer the process. You want the first status letter to tell about all that is *in*, not just *ordered*.

### **2. Qualifying the borrowers**

If the borrowers do not qualify, now is the time to recognize the problems. Customers respond better to problem-solving at the beginning of a process than at the end. No one expects



a lender to do every loan, but when it takes 60 days to get a decline and the borrower's situation has not changed from the start, your customers are bound to get angry.

If it looks as though your borrowers do not qualify, try to determine if there is anything that can be done to help them get a loan. Look at different types of loans, the paying off of debts, and strong compensating factors that can build an approvable loan. There are many options available today that may help put your borrowers in a home.

With a complete package, the loan will move quickly. When there is sufficient information up front, it is possible to have a credit report and appraisal the only remaining documents necessary to approve the loan.

## *Underwriting & Documentation*

### *The Key is Consistency .....*

When underwriting a residential real estate loan, the underwriter will focus on two major areas; the Borrower and Property. The underwriter will want to see that the borrower is able and likely to pay, and that the value of the property supports the obligation.

The two integral parts of underwriting a borrower are the borrower's willingness and ability to repay the loan.

### *Willingness.....*

Has the borrower shown a willingness to repay debts?

### *Ability.....*

Does the information supplied verify a stable income such that we can reasonably expect the borrower to meet the proposed loan payment?

Does the borrower have sufficient funds to close and have adequate reserves to meet additional unexpected expenses?

## *Create a Picture*



After you have the pre-qualification information, ask yourself a few questions to determine if you are creating a picture, or in fact, you are still working on a puzzle.

1. Does the information supplied show a stable income so that the borrower can be expected to meet the proposed mortgage debt and other obligations?
2. Has the borrower shown a willingness to meet obligations in a timely manner?
3. Does the borrower have adequate funds to close and have a reasonable reserve to meet additional expenses that arise unexpectedly?
4. Does the property appear to be adequate collateral, both in value and salability? We must not only be able to sell the real estate, we must be able to recover any loss. We must be able to sell the property to a typical, reasonable buyer in a reasonable time.

## *Income Qualification and Documentation*

In this section, we will look at the income used to qualify the borrower for the loan and the questions the underwriter will ask. Does the borrower have the **ability**, now and in the future, to meet the proposed debt obligation and any other debts they may have? What types of income can be used to qualify, and what documentation will be necessary to substantiate that income?

### *Salaried Employee*

A salaried employee is typically one who works a standard 40 hour week, 52 weeks per year. If the person works less than 40 hours or 52 weeks - such as a teacher - the annual salary is divided by 12, even if the individual only works 10 months per year.

### *Auto Allowance*

Auto allowance is only acceptable as income if included as taxable income.

### *Hourly Paid Employees*

When an hourly wage is paid, simply multiply the hourly wage by the number of hours worked. When overtime is used, average the last two years, plus year-to-date income to calculate income. Overtime income must be verified with two years' W-2's and a current pay stub.



**IMPORTANT:** When looking at income over a period of time, remember this simple rule: if the income is increasing - average. If the income is decreasing - use the last available period and explain why the borrower's income will not continue to decrease. **Do not average decreasing income!!!!**

### *Social Security, Retirement Annuities, and Welfare Benefits*

All of these forms of income are considered stable income. Written documentation must be provided stating the amount of the award, the period over which it will be received, and, when available, evidence of receiving this type of income.

In the case where no defined expiration date is stated, evidence of receiving the benefit in the past is more critical. In these cases, it is important for the underwriter to adhere to underwriting guidelines, especially with regard to income ratios, as increases are not expected and if they are received, they do not equal the increased cost of living. This is even more important with adjustable rate mortgages.

Special consideration can be given to non-taxable income as it allows a greater percentage of spendable income.

### *Commissioned Employees*

This includes borrowers whose sole income is commissions as well as those who receive a salary plus a monthly commission. When commission earnings equal 25% or more of the borrower's income, the last two years' 1040's are required. Remember the rule for averaging.

When evaluating the 1040's we look for non-reimbursed business expenses. Any non-reimbursed business expense must be deducted from the gross to determine the net income.

### *Second / Part Time Job Income*

This type of income is considered if a two year history can be documented and there is a strong probability of continued employment. This income must be verified with a VOE or two years W-2's and a current pay stub. The probability of continued income should be considered in light of the number of hours worked and the reasonableness of continued employment given the relocation of housing.

### *Child Support and/or Alimony*

This income can be considered stable if there is documentation that it has been received on a regular basis and will continue for a minimum of three years. A divorce decree or separation agreement is required. This document must include the amount and indicate a minimum of three years to continue.



### ***Interest and Dividend Income***

This income can be used provided there is a two year history of receiving this income, as evidenced by 1040's. Additionally, the amount of cash or stocks must be recalculated after the funds to close have been subtracted. If the amount has been reduced and income must be recalculated, you should use a conservative current interest rate. This rate should not exceed 8% for this calculation.

In the case where there is no history pattern of cash reserves, interest income should not be used as qualifying income. It is, however, a strong compensating factor.

If the interest income is from a note held by the borrower, a copy of the note and trust deed are required. The interest from the note must continue for the next three years as evidenced by maturity date on the note.

### ***Rental Income***

Positive rental income can be considered stable income. There are two ways of calculating rental income. The first method is to take 75% of the monthly rental income as verified by a signed rental agreement and then subtract the monthly payment including PITI. The second method is calculated using the tax returns including adding back the depreciation. When using the tax returns, it is important to account for all current rentals.

Both methods are acceptable. If the rental income seems out of line, the underwriter can always request the 1040's to substantiate the income. If the borrower has three or more properties, two years' 1040's are required.

### ***Seasonal / Trade Income***

Some borrowers experience periods of unemployment due to the seasonal nature of their work, such as construction workers or farm workers. Their income can be considered stable provided that they demonstrate a history of regular seasonal employment. Two years' tax returns must be used to determine the income. Special attention needs to be paid to the cash reserves, as these borrowers often experience short periods of unemployment.

### ***Trust Income***

Trust income is also considered stable as long as it can be documented. Documentation includes two years' tax returns and a copy of the trust agreement. The trust agreement must include a disclosure of the principal assets of the trust and a statement from the trustee confirming the amount, frequency, and duration of the trust income.

### ***Income from Self-Employed Borrowers***



Any individual who has a 25% or greater ownership in a business is self-employed. Self-employed income can be considered stable if the borrower has been self employed for more than two years.

The following documentation is required on all self-employed borrowers:

- \* Year-to-date Profit & Loss
- \* Current balance sheet
- \* Two years' personal tax returns (1040's)
- \* Unless the company is a sole proprietorship filing Schedule C, we need two years' company tax returns:
  - ⇒ Corporation returns (1120's)
  - ⇒ Partnership returns (K-1's/ 1065)

When reviewing the self-employed borrower, it is important to understand the operation of the business and the structure under which it operates. For example, if the business is a sole proprietorship, the net income for the business on Schedule C is the borrower's income. If the business is a corporation, the usable income is usually made up of W-2 and net business income.

### ***Profit & Loss***

The bottom line income or net income is the number primarily used to determine the income of the company. Some items on the Profit & Loss statement can be adjusted:

**Depreciation** - Can be added back into the income.

**Pension and Profit Sharing** - If the company is a sole proprietorship and this expense is optional, as it is only for the sole owner, it can be added back. If it is a contractual agreement between employees and the company, it is an expense.

**Any One-Time Expense** - If an expense has occurred that will only happen once, such as a casualty loss, that expense can be added back in to the income.

In most cases, the bottom line net income will stand on its own.

### ***Self-Employed Borrowers Who Receive a Salary***

In the case where the self-employed borrower is paid a salary, such as in a corporation, we can qualify the borrower on that salary. However, the net income for the company must be positive and stable. Just because the borrower receives a \$100,000 salary does not mean we can ignore the fact that the company lost \$400,000 for the year. If the borrower is a 100% owner, then he or she actually made \$95,000 minus \$400,000 - or in fact lost \$300,000 for the year.

Corporate tax returns state the officers' compensation and the percentage ownership. It is a relatively simple matter to determine the borrower's income from these numbers. If the VOE



says the borrower gets \$10,000 per month, but the corporate tax returns show no compensation to the officers, we will use the tax returns.

## *Liabilities*

On all cases, be accurate and get detailed information.

**Credit Cards** - We will need the company or bank, type of card, account number and balance. Remember to ask for any bills being paid off during the transaction. You can include accounts with zero balances for additional credit.

**Real Estate** - Indicate the exact and complete address, the name and complete address of the lender, and the accurate account number. This is one of the harder accounts to get a payment history on and complete information helps.

## *Ratios: Does the borrower qualify?*

It is important to remember that ratios are guidelines; however, they do represent the industry's ongoing experience with borrowers. Also, remember that gross ratios of 28%/36% after tax are approximately 37%/48%.

### *Payment to Income (Top Ratio)*

The payment includes principal, interest, taxes, insurance, and any home owner's association fees.

The top ratio should not exceed 28%.

### *Total Obligation to Income (Bottom Ratio)*

The total obligation-to-income ratio includes the sum of the monthly housing payment and payments on liabilities. The guidelines for liabilities in this context are those that have a payment extending beyond 10 months. However, if an obligation has a payment that creates a major impact on the borrower's finances, such as a car payment of \$250, the debt will be considered even if it will not extend beyond 10 months.

The bottom ration should not exceed 36%.



Both ratios assume:

- \* The property is readily marketable.
- \* The borrower has good job tenure, two years or more.
- \* The borrower has cash assets, after closing of three to four months' PITI.
- \* The borrower's credit is good with no recent derogatory items.

### ***Compensating Factors***

Strong compensating factors *may* justify loans with higher ratios. The following items are not all-inclusive, but are generally recognized. Any verifiable characteristics that further demonstrate the borrower's ability to repay the debt are worth consideration.

#### **A Large Down Payment**

A large down payment, or excellent equity position in the case of a refinance, is considered a strong compensating factor for three reasons:

- \* The equity position is a strong indication of the borrower's motivation to repay the debt.
- \* The lower payment will enhance the borrower's ability to repay the debt.
- \* In determining sufficient security, our risk is reduced in case of default.

#### **Good Money Management**

The borrower's ability to repay a debt with higher ratios can be evidenced by three verifiable characteristics:

- \* A demonstrated ability to accumulate savings on a regular basis.
- \* A demonstrated ability to maintain a conservative credit position. Excessive use of credit may indicate a need to use credit to maintain a lifestyle beyond the borrower's income.
- \* A demonstrated ability to maintain a good credit history.

If the borrower has shown these qualities and the payment is similar to their current payment, this is a very strong compensating factor. If the payment is increasing, the borrower should have available cash each month to handle the increased payment, as evidence by a pattern of regular savings. If the borrower has a similar debt, it is important to verify that the debt has not recently increased.

#### **Net Worth**

When the borrower's net worth is substantiated enough to evidence the ability to repay - regardless of income - this can offset higher ratios. Assets in the form of cash that can readily be



used to make the payment are preferred. It is also important to verify that large cash reserves are not from a sale, but of a historical pattern.

### ***Reducing Debt to Reduce the Bottom Ratio***

There are a few methods of reducing the bottom ratio that are considered acceptable.

#### **Payoff of Installment Debt**

The payoff of installment debt is considered an acceptable method of reducing a high bottom ratio.

#### **Payoff of Revolving Accounts (Conforming Loans)**

The payoff of revolving debt is considered a marginally acceptable method of reducing a high bottom ratio. To pay off revolving debt only means that the card can be charged back up as soon as the loan funds. Currently the PMI companies are not allowing the payoff of revolving debt to qualify borrowers. Historically it has been acceptable to count \$10 for each paid off account in the ration calculation.

#### **Payoff of Revolving Accounts (Non-Conforming Loans)**

The payoff of revolving accounts to help qualify is **not** an acceptable practice for non-conforming loans. The borrowers are to qualify on current spending/credit patterns.

## ***Co-Borrowers***

Co-borrowers fall into two categories; those who occupy the subject and those who do not.

When borrower and co-borrower occupy the subject property there are no special considerations, restrictions, or requirements. It is important to show either a history of living together or a strong motivation to live together, such as that of close relatives.

The second category of co-borrower is generally used to strengthen the position of the occupant borrower. There are specific non-occupant co-borrower requirements:

#### **Occupant Ratios**



Occupant ratios should normally not exceed 35%/43% (or 40%/40%). For most non-conforming programs, the occupant borrower must fully qualify on their own.

### **Relationship**

A relationship between the occupant and non-occupant borrowers must be established. The co-borrower must be a family member or demonstrate a strong personal relationship.

### **Loan-to-Value Ratio**

LTV cannot exceed 90%

## ***Cash: Can the borrowers close the transaction with reserves?***

*W*e require funds to close plus a minimum of two months' reserves on most programs. This requirement is high on 95% LTV and higher and some Jumbo products.

This part of the application is not complete until we have accounted for all the money necessary to close with the appropriate reserves.

Always question large reserves in deposits as they may indicate new debt. Large increases must always be explained.

### ***Required Documentation***

Verification of Deposit including previous average two months' balance. If average balance is not indicated, we need two months' bank statements.

### ***Gift Funds***

If the loan is greater than an 80% LTV, 5% of the borrower's down payment must be from their own funds. If the loan is under 80% LTV, the entire down payment may be from gift funds.

### **Gift Fund Documentation**

Gift funds are acceptable when the borrower is able to document the source of the funds and verify that the funds are available for the borrower's use. The underwriter will require the following:



- \* Gift letter from the donor including specific amount, donor's name, and address, and a statement that the funds are not to be repaid.
- \* Verification that the donor has the funds available.
- \* Proof of transfer of funds, such as a copy of a canceled check or a copy of the donor's withdrawal slip and the borrower's deposit slip, etc.
- \* Verification of funds with borrower.

Usually the escrow can verify that the borrowers have the funds to close and their source. A copy of the check and verification of the deposit can also be used.

### ***Other Sources of Down Payment***

#### **Equity From Real Estate Sales**

We require a HUD-1 showing the net proceeds.

#### **Lease with Option to Buy**

Funds from the option may be used only if the "option to buy" is in the original lease along with the amount to be credited for the option. Additionally, the borrower's present rent must exceed the market rent as determined by a rental survey from the appraiser.

#### **Trade Equity**

The property seller may take the borrower's existing property in trade as all or part of the down payment, as long as the borrower's equity contribution is a true value consideration. This is determined by subtracting the outstanding loan balances, plus the costs, from the appraised value or trade-in value, whichever is less. An appraisal on the property being traded is required. For non-conforming loans a minimum 5% cash investment is also required.

#### **Borrowed Funds**

Generally, the funds for the down payment cannot be borrowed, with one exception. The money may come from a secured loan on another property that the borrowers own. (Pay special attention to cash out rules and occupancy problems when this is the case.)

## ***Alternative Documents***

Alternative documentation can speed the loan application process. It is completely acceptable to use alternative documentation for part of the file and regular documentation for the rest or alternative documentation for the entire file.



**Verification of Employment (VOE)**

Pay stubs for the most recent full month plus two years' W-2's. Pay stubs must show income, period covered, and year to date income.

If commissions are more than 25% of the income or the borrower is self employed, full documentation is required.

**Verification of Deposit (VOD)**

Most recent three months bank statements.

**Verification of Mortgage (VOM)**

Twelve months' canceled checks, or credit report rating for a minimum of 12 most recent months, or payment receipt from the lender showing the borrower's history for a minimum of 12 months.

## *Now The Credit Report Is In*

The credit report is an excellent indicator of a borrower's attitude toward paying his or her debts. Indicating whether or no the borrower has a willingness to repay their debts. An underwriter can form an idea of the borrower's character from the information on the credit report, for instance, whether the individual incurs debt responsibly and whether obligations are met in a timely manner.

***Problems***

The most serious problems are those that are current or indicate an ongoing problem.

**Current Problems Include Current Past-Due Debts or Over-Indebtedness**

Current past due debts must be brought current (ideally, before submission of the loan application). The borrower must also be prepared with a reasonable explanation of why the debt lapsed and what steps will be taken to avoid a re-occurrence of the problem in the future. Any explanation for late credit that is still in existence is necessarily a poor explanation, in that the problem still exists. Additionally, all derogatory credit in the past must be explained. Over-indebtedness is a signal that, even though the credit has been kept current, it is likely to drive the borrower under at some point. Over-indebtedness stems from a large number of debts combined with the revolving debts consistently run up to their maximum. This, coupled with high ratios, is cause for rejection.



Delinquent taxes are considered the same as a delinquent real estate loan. The borrower cannot pay off delinquent taxes with loan proceeds.

All credit inquiries must be explained as they may indicate that the borrower is applying for additional credit. Debts incurred by additional credit can affect the borrower's qualifying ratios and must be taken into account.

### **Judgments / Collections / Liens**

All judgments, collection actions and liens must be paid in full and the borrower must have a strong explanation of why the problem occurred.

### **Bankruptcy**

Two years must have passed since the discharge and the borrower must demonstrate re-established *good* credit. Documentation must include the Petition & Discharge and must be consistent with explanation.

## *Summary*

When it comes time to submit the loan application, we now have the information we need to show the underwriter why your borrower is a good candidate for a loan. Knowing up front what the underwriter will look for will remove much of the guessing on your end and help us speed the loan process. Knowledge of the process, combined with clear communication between you and the borrower, will boost the borrower's confidence in you and raise his overall satisfaction with the transaction. You will profit from your efforts to keep the loan process flowing, because a happy customer is a valuable asset in any business.

