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**Beyond the Rate – Chapter 2**

Is anyone telling the TRUTH in the mortgage business??

Hello and welcome to Beyond the Rate, a series of podcasts that are designed to educate the listener on the world of finance and in particular, the mortgage business. This is Chapter 2 and we'll be looking at the hierarchy of lenders in this industry and an overview of the underwriting guidelines within each category.

My name is Patrick and I'm a Mortgage Banker here in the San Francisco Bay Area. I'm your host and I really encourage you to subscribe to this series for an informative and detailed account of how the mortgage industry operates and how to navigate through all the confusing programs and deceptive marketing techniques being used by some of today's Mortgage Brokers.

I want you to think about the lending business like a ladder. On the top of the ladder, you get your A-paper loan products. We've all heard of A-paper loans. Credit is excellent. Income, assets; it's all there. So those programs are at the very top. In the middle of the ladder, you find what they call Alt-A loan programs or, effectively, the "alternative" to A-paper loan products. Think about it as A-minus paper. At the top, you've got A-paper with some programs for double A and even triple A. In the middle of the ladder, you've got the A-minus programs. They offer expanded guidelines for people who don't quite qualify for A-paper loans. On the bottom of the ladder, you get your Subprime loan products; programs designed for people with B or C credit. Down there, you can get almost anything approved. The guidelines are much more accommodating and the underwriting process is simpler.

These days, there's actually a fourth category below Subprime. It's called Hard Money and those programs don't even consider the credit of the borrower. Those guys are only concerned with the value of the property and how big the loan is, relative to that value. They look at a ratio called the Loan-to-Value ratio. The industry refers to this ratio as the LTV ratio. The Hard Money lenders know that a default is distinctly possible so they want to ensure there's enough equity in the property to fully pay off the loan (plus legal fees by the way) if the property goes into default and they have to foreclose. We won't spend much time on Hard Money lenders in this series because they're only used by a small number of homeowners.

Obviously, the higher up the ladder you get, the better the rates become. Likewise, the further down the ladder you go, the WORSE the rates become. Effectively, you PAY for the LUXURY of relaxed guidelines with a higher interest rate. On the top of the ladder, you get great rates but they'll ask you for everything. Income documentation. Bank statements. Good credit. They'll want an explanation of any large deposits in your bank account. They'll want a fully documented 2-year employment history. They'll want good cash reserves sitting in the bank after the deal is done, just in case. In other words, they'll give you the best rate, but they'll make darn sure you're well qualified to make the payments thereafter. Low risk, low rate. High risk, high rate.

The unfortunate reality today is that many Mortgage Brokers gently nudge their clients DOWN the ladder instead of UP. It makes their life easier. The guidelines are looser. Getting an approval is easier. They don't have to provide as much paperwork. Believe me. Getting an A-paper borrower approved in a Subprime loan program is EASY. There's nothing to it. So you get these situations where people are told, "don't worry about a thing; you've got great credit and we don't need anything else; the loan's already approved." Little do these people realize that they're paying for that luxury with a higher interest rate, and probably a prepayment penalty too. We'll talk more about that in Chapter 7.

The point is that you wanna work with someone who pushes you UP the ladder, not down. You want someone who will instinctively look for ways to squeeze you into the best possible program they can. You want someone who'll be a pain in the neck, asking for all kinds of documentation. That way, you know they're trying to get you into a strict program. Now, of course the better Mortgage Brokers will have a system in place where they can request and itemize everything they need right at the beginning, making the rest of the process simpler and smoother. But don't get too annoyed if your Mortgage Broker keeps asking for more. Generally speaking, it's a good sign.

Trust me. He doesn't WANT to ask for all that stuff. It's frustrating and it can be embarrassing you forgot to ask for something at the beginning. But he obviously submitted your application to a strict program and if he doesn't get that documentation, the underwriters will NOT approval that particular loan program. Plain and simple. So bite your tongue and get it done. When everything's signed, sealed and delivered, the only thing you'll remember is the rate. You won't remember the extra bank statement. You won't remember the explanation letter. You'll only remember the rate. And if your rate is lower than your friend's rate or your neighbor's rate, you'll feel good about the loan you got.

In Chapter 1, we talked about the source of mortgage money and the fact that a lot of money has been accumulating over the past 25 years or so. We'll talk more about that in Chapter 8 and 9. The result of all this cash accumulation has been two fold. First, we've seen interest rates drop pretty steadily ever since 1982. Second, we've seen a lot of new and innovative loan programs being offered. Both of these realities are fueled by the competitive process as lenders compete for a

limited number of borrowers. They're all trying to give you a reason to borrow the money from them, rather than their competition.

Well, twenty years ago, the only type of loan program out there was a traditional 30-year fixed A-paper loan. Period. That was it. AND, you had to have great credit, sufficient income and a 20% down payment to get it. So all the homeowners in the country fit right up at the top of the ladder. All homeowners were A-paper borrowers. There was no such thing as an Alt-A program; or a Subprime program. They didn't exist.

Over the years, as the amount of investment capital increased, the lending business got more competitive and some lenders started offering programs with looser guidelines. They started offering what are now known as Alt-A loan programs. This really started picking up speed about 15 years ago. More time passed and some lenders started relaxing the guidelines even further. They started offering what we call Subprime programs; programs that started gaining in popularity maybe 7 or 8 years ago. And now, in the past few years, we're seeing more and more people in the Hard Money area. The obvious trend is that the competitive pressures in the industry have resulted in a dramatic widening of programs available.

So, let's talk about the Subprime category for a minute. For our purposes here, that's the bottom of the ladder since Hard Money programs really only apply to refinance transactions with very low LTV ratios, and those situations aren't actually that common. Most of the loan programs in the Subprime category are fixed for only 2 years. We'll talk more about different loan programs in Chapter 4 but it's worth discussing the realities in the Subprime category for reasons you'll see in a minute.

Again, most of these programs are fixed for 2 years. Some for 3 but most for 2. After that, the rate is calculated as an index (like the LIBOR or the MTA, discussed in Chapter 1) plus some predetermined margin. In most cases, the addition of the index plus margin is 2 or even 3 percentage points higher than the starting rate. So if the starting rate is 6%, the index plus margin might be as high as 8 or 9%. And that's not all. Many of these loan programs have an Interest Only option to lower the payment but that option usually expires after two years as well. So when the fixed rate expires after the first 2 years, the rate jumps up 2 or 3 percentage points AND the Interest Only option disappears at the same time. That means the payment could easily DOUBLE at that point. DOUBLE.

It gets worse. Most of these programs come with a 2-year prepayment penalty to boot. So the borrower is completely stuck between a rock and a hard place. Their payment will likely double after 2 years but they can't really do anything until those 2 years pass, unless they want to pay some huge prepayment penalty. So the reality is that these people better start working on a refinance in the 23<sup>rd</sup> month, one month before their 2-year anniversary, so they can close on the new loan 1 or 2 days after the prepayment penalty expires. If they don't, they'll be stuck with a HUGE payment shock and may lose their house in the process.

It all sounds pretty bad, doesn't it? Sure it does. But not so fast. After telling you the obvious downsides of Subprime loans, we cannot villainize them entirely. What we're talking about here are loan programs that give people an opportunity to buy a home; people who NEVER could've qualified to buy a home just 10 years ago. No way. I recently did a purchase transaction here in the Bay Area for a woman who did 100% financing with a 577 credit score; a 577 credit score! -- That's awesome! That's incredible! There is NO WAY that woman could've bought a home with a 577 credit score back in 1995. No way. No possible way.

And it's programs like this that increase the demand for homes; demand that props up the values of your home too. The US Department of Housing and Urban Development estimated homeownership to be at 68.6% back in late 2003. The only reason homeownership is that high is because these new flexible loan programs give people an opportunity to buy a home; people who couldn't have done so otherwise. That increases demand and THAT props up the value of ALL houses, including yours and mine. These Subprime loan programs have a downside for sure. No doubt. You have to be careful. But they also provide real value. They serve a purpose.

Here's the deal. If you have to use one of these Subprime loan programs to get into a house or refinance your existing house, go ahead. No problem. But you've got TWO years; 2 years to clean up your situation, so you can start climbing that ladder when you're forced to refinance 2 years down the road. You've got 2 years to clean it up. And if you don't, you'll have to go through the cycle one more time. You get a 2-year window each time you go through the cycle. And every time you leave things the way they are, you'll be forced to go through it again. The only person who benefits from this cycle is your Mortgage Broker. They make money each time you refinance. You don't benefit. Believe me. It doesn't matter what anybody tells you, refinancing costs money. It's that simple. Refinancing costs money. And your Mortgage Broker will be thrilled that he can do another loan for you but it certainly won't leave you any better off, that's for sure.

Let me quickly distinguish between this example and the recent refinance boom. If rates are dropping and it's possible to refinance your mortgage at a lower rate, EVEN considering the fees involved, go crazy. Refinance all you like. Your Mortgage Broker will be making money but you'll be benefiting as well. But the refinance boom is over. It ended in 2004 and the opportunities to simply refinance into a lower rate are few and far between. What I was discussing here is a situation where the loan program forces you to refinance to avoid a huge payment shock. In that situation, you need to prepare yourself so you can get into a better program next time; a program that might be fixed for a longer period of time, or one that doesn't have a prepayment penalty, or one that provides a longer Interest Only option, or one with a lower margin. In order to do that, you have to climb that ladder and get above the Subprime category.

So, okay, how do you do that. Well, it starts with understanding how the underwriting process works. There are three primary pillars to underwriting; credit, income and assets. I had originally intended to cover this area right here in

Chapter 2 but this podcast is already approaching 15 minutes and I don't want to extend it any longer. I'm gonna readjust my Chapter plan and insert an extra Chapter exclusively devoted to the underwriting process, including the four different documentation options. It'll be Chapter 3 and I'll try to have it all recorded and posted early next week. That one's the real meat & potatoes. There's some great information there so keep an eye out for it. Before recording, I updated all the Chapter references in this podcast so they're all accurate but the ones in Chapter 1 are off. At some point, I'll update it but for now, please mentally add 1 for any Chapter references made in that podcast.

Okay, so if you like what you hear on this podcast, please tell a friend about it. My goal is to become a recognized authority in my field without having to sacrifice my freedom to tell the truth, even if it reflects poorly on my industry. Technology like podcasts can help elevate new and innovative thinkers but we all have to play our part to help spread the word for those who deserve our endorsements. If I am deserving of yours, please accept my thanks.

If you are considering a purchase or a refinance, please call me to discuss the options. I'm a Mortgage Banker. It's what I do for a living. Interest rates change everyday but I'll promise you two things; I'll tell you the truth and I'll do the best I can. My office phone number is 925-465-1223. Again, that's 925-465-1223. You can also reach me by email at [patrick@beyondtherate.com](mailto:patrick@beyondtherate.com).

See you next time for Chapter 3 where we'll explore the three pillars of underwriting and the documentation options within the A-paper, Alt-A and Subprime loan categories that we just finished defining. There's a bunch of detail in that Chapter so stayed tuned. It's fascinating stuff.

Bye for now.