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Beyond the Rate – Chapter 3

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 3 and we'll be breaking down the standard underwriting guidelines within the A-paper, Alt-A and Subprime loan categories defined and discussed in Chapter 2.

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.

There are 3 pillars to the underwriting process; credit, income and assets. That's what they look for to determine if you qualify for the program being offered. Remember that there are also 3 main categories of loan programs; there's A-paper programs at the top of the ladder, Alt-A programs in the middle of the ladder and Subprime programs at the bottom of the ladder. As you climb the ladder, the guidelines become increasingly strict but the rates are also increasingly competitive. On the other hand, the lower down the ladder you go, the looser the guidelines become but you pay for that luxury with a higher interest rate. In this Chapter, we'll see how the 3 pillars of underwriting each demonstrate this same progression within themselves.

Before we begin, it's important to discuss exactly where we get all of your information regarding your credit, your income and your assets. Your credit is given to us through your credit report. We will discuss credit in more detail in Chapter 6 but the bottom line is that your credit report GIVES us your credit score and there's no way for us to change it on that particular day. Of course, you can change your credit score by doing certain things over a period of time. There's even such a thing as a "rapid rescore" which can update your score with new information within a 72-hour period but your score on the day we run your report is a finite number.

The credit report also gives us all the other credit liabilities that have been reported in your name, including those that have long since been paid off or closed. It's all there. Every credit account you've ever had and it tells us your payment history on all those accounts, even the ones you closed or stopped using long ago. The liabilities that still have open balances list the minimum payments required to keep those accounts in good standing. Those minimum payments contribute to your debt ratios, calculated in the income section of the application. We'll get to that in a moment.

Your income information and your asset information are given to us directly by you. You provide your pay stubs or your W-2s or your tax returns. You also provide your bank statements verifying your liquid assets like bank deposits, investments or certain retirement funds. Well, as the lending industry has become more competitive and guidelines have been widened, many programs no longer require verification of your income or your assets. As discussed in Chapter 2, there are pricing implications to these relaxed documentation requirements so we need to discuss the various options before we talk about underwriting.

There are four major levels of documentation. Again, you can think about this as a ladder. In fact, you can consider the documentation options as a mini ladder within each of the three major loan categories; A-paper, Alt-A and Subprime. Most of these documentation options exist within each of the three loan categories so they essentially break each loan category down with four subcategories.

At the top of the ladder is Full Doc. That refers to a loan where both income and assets are "Fully Documented". In those situations, the lender knows exactly how much you make and how much you've got in the bank. The next level down is called SIVA, or S I V A. It stands for Stated Income Verified Assets. That means the borrower simply STATES their income but the actual number is not verified by the lender. Meanwhile, their assets ARE verified with bank statements. Below that is what's called SISA, or S I S A. That stands for Stated Income Stated Assets. Here, the borrower STATES both their income AND their assets, and the lender verifies neither. The bottom level is No Doc, in which case nothing is even stated. No income, no assets. That means no debt ratios; no reserves; nothing. The entire loan is done based on the credit score and the Loan-to-Value ratio.

The original idea behind Stated Income loan programs was that certain people are self employed or in some sales capacities that pay them mostly commission. With those occupations, the IRS allows tax payers to deduct a variety expenses before calculating their taxable income. In many cases, these deductions distort the true income these people earn. People have a legal right to minimize their tax liabilities so long as they don't break the law and many people in these occupations declare income far below what should reasonably be considered income from an underwriting point of view.

Anyway, the original idea behind these reduced documentation programs has all but faded away because Stated Income programs are available from almost all lenders and in all three loan categories, although they are scrutinized much more

closely in the A-paper programs. The reality today is that many Stated Income borrowers overstate their income in order to squeeze into the debt ratio limitations of various loan programs.

Because house values have gone up so far, the average person is really squeezing these days to make the mortgage payment, along with all the other expenses of everyday life. Car payments are the norm and credit card balances are at record highs (not to mention the new federal guidelines that have resulted in higher minimum payments on credit cards issued through national banks) so the debt ratios of the average person today are higher than they were in years past. Although they weren't originally designed to do so, Stated Income programs have accommodated these new realities by providing a mechanism for borrowers to qualify for loans they probably wouldn't qualify for otherwise.

Today, the reduced documentation options have become so widespread; the new motivations for using them have been all but accepted by the lending community. In essence, the borrower is asking the lender to trust that he or she can make the payments. And since they are NOT documenting their income (or perhaps even their assets) and in exchange for that trust, these borrowers will pay a slightly higher interest rate on the loan. It's important to mention, however, that a 2-year history of employment is still verified even though the actual income is not. The lender WILL verify that the borrowers are gainfully employed and have been in a similar field of work for at least 2 years. This represents a problem for those people who have recently changed careers or become self-employed, or are not employed at all.

The only documentation level that does NOT verify employment is the No Doc option. Here, nothing is verified. In fact, nothing is even stated. The only thing the lender makes their decision on is the credit score and the LTV ratio. For obvious reasons, interest rates are significantly higher for this documentation level but it does provide an option for those who do NOT have a verifiable employment history.

Okay, so back to the 3 pillars of underwriting; credit, income and assets. Let's look at each one individually. Please keep in mind that this discussion requires that we generalize underwriting guidelines across multiple lenders and programs; a dangerous activity to say the least. There are huge variations between different lenders and loan programs. There is significant overlap of the distinctions we'll be setting in the next few minutes. So please do NOT assume that all programs follow the guidelines we'll identify here. The purpose of this discussion is to give you an idea where the various programs are targeted. Who is the ideal borrower for an A-paper program? Who is the ideal borrower for a Subprime loan? And so on. Believe me. Most of these programs are designed to accommodate people far outside their target audience and this "Beyond the Rate" podcast series is very respectful of that reality.

For obvious reasons, the industry tries to flatter its clientele so an A-paper borrower is commonly said to have a credit score of 680 or higher. Fact is, a credit score of

680 is already in the bottom half of the population. More than half of the credit scores in the nation are above 700 and underwriting generally classifies A-paper at 720 or higher. Some A-paper programs offer price betterments at 750 or even 780 but a score of 720 or higher is a pretty good start when you're looking for a mortgage loan.

The Alt-A category specializes in credit scores between 620 and 720. Again, they offer alternatives outside those boundaries but their ideal borrower falls within them. The Subprime category specializes in the 500 to 680 range but also offers solutions beyond those limits. It's worthwhile noting that the lowest credit score you can have to do 100% financing is generally 575 or 580 for a Full Doc program and 620 for a Stated Income program. So if you're considering 100% financing, make sure your credit score is at least that high before you start looking.

Income is the second pillar of underwriting and it contributes to the underwriting process in the form of your debt ratios. One of the most common ratios in underwriting is a borrower's DTI ratio. DTI stands for Debt-to-Income and it measures the percentage of a person's GROSS income that goes towards all credit liabilities, including the proposed housing payment, any car payments, student loan payments and all credit card minimum payments. Where applicable, it would also include things like child support payments, alimony, judgments and liens. So if the program allowed a DTI ratio of 50% or less, that means exactly half the GROSS income (that's BEFORE tax income) will cover all those debts each month.

You can work this out with your own numbers. You know what you make each month. You know what your credit card payments are and you know if you have a car payment or student loans or whatever. And you also know your current housing payment (either your mortgage or your rent). So add up all those expenses and divide by your gross income. Generally speaking, the A-paper programs will want to see a DTI of 38% to 42%. Some will go as high as 45% under certain conditions. The Alt-A programs will allow DTI ratios between 40% and 45%, and Subprime programs will commonly allow DTI ratios as high as 50% or even 55%.

That's incredibly high if you think about it. Given federal and state taxes, not to mention healthcare costs, most people only take home about 65% of their GROSS earnings. That means the Subprime programs will allow almost ALL of that money to go straight to debt payments, leaving the borrower with only 10% of their gross earnings to pay for things like food, gas and utilities. So you can see how the Subprime programs are much more lenient than A-paper. Their guidelines are more accommodating and allow things the A-paper programs wouldn't touch.

Assets are the third pillar of underwriting and are considered in one of two ways. First, assets present themselves in the form of a down payment, so a 20% down payment shows significant assets while 100% financing shows absolutely no assets. The second consideration involves the cash reserves, so underwriters will look at how much money you'll have left over after the transaction closes, either in the form of bank deposits, investment accounts or retirement funds. Almost without

exception, they will look for these funds to be sitting in your accounts for at least 60 days to qualify. The reason for this is that they want to ensure the borrower didn't just borrow a bunch of money from his or her parents or a friend or relative. If such a loan existed, they would want to include an additional payment in the debt ratios so it's critical that you keep your assets nice and stable, sitting there quietly for at least 60 days before you apply for the loan.

For A-paper programs, underwriters will usually look for 2 to 6 months worth of the total housing payment in reserves after the deal has closed. If the borrower is using a Stated Income documentation level, they will often look for 4 months of the income stated. So if the borrower states they make \$10K per month, the underwriters will want to see at least \$40K in reserves somewhere. They refer to this as "assets commensurate of the income stated" and it's usually only a requirement in the A-paper category. In the Alt-A programs, they usually look for 2 months of the housing payment and the Subprime programs sometimes require even less.

Again, you can see the progression from A-paper to Subprime. The guidelines are looser with Subprime programs but the rates are higher as well. As we discussed in Chapter 2, you wanna work with someone who will push you UP the ladder of loan programs, not down. It may be more tedious during the process but it's well worth it if you can qualify. And keep in mind that you'll need all 3 components; credit, income and assets; to qualify for whatever program you're applying for.

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.

See you next time for Chapter 4. We'll be discussing all the various programs that are out there, including fixed rate products, the various ARM loans and the new Option ARMs that are heavily marketed these days with their aggressive 1% start rates. It's fascinating stuff. Stay tuned.

Bye for now.