

BORROWER QUALIFICATION

KEY TERMS AND PHRASES

Affordable housing loans	FTC Privacy Rule
Assets	Housing expense
Assured income	Income ratio method (VA)
Conforming loan	Liabilities
Cost of living expense (VA)	Loan application
Credit report	Percentage guideline method
Credit scoring	Principal Interest Taxes & Insurance (PITI)
Effective income	Private mortgage insurance (PMI)
Equal Credit Opportunity Act (ECOA)	Production-related income
Fair and Accurate Credit Transactions Act	Residential loan
Fair Credit Reporting Act	Residual method (VA)
FHA new minimum credit scores	Willingness to pay

LEARNING OBJECTIVES

At the conclusion of this chapter, students will be able to:

- Understand similarities and differences in borrower qualification between Veterans Administration, primary FHA, and conventional mortgage loan programs
- Describe how the application process differs between conventional, Veterans Administration and FHA residential mortgage loans, and commercial mortgage loans
- Identify just how mortgage insurance has extended the residential mortgage market to a broader base with the introduction of FHA's Mutual Mortgage Insurance Fund and later private mortgage insurance and their effects on closing costs and continuing mortgagor obligations
- Understand the development of private mortgage insurance products and their current features
- Describe how a home equity revolving line of credit mortgage works
- Explain the function and costs of a reverse annuity mortgage



INTRODUCTION

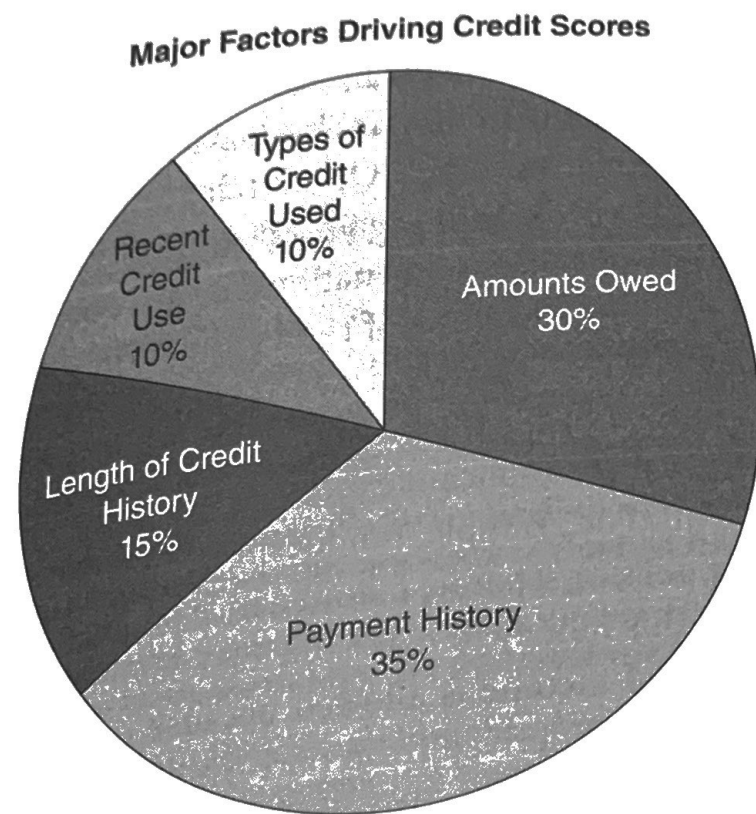
For the purpose of analysis, mortgage loans may be divided into two categories: those made to individuals and families to buy homes, and those made to individuals and companies to acquire commercial properties. Because the basic source of loan repayment is not the same, the analysis differs in emphasis. For a home loan, the analysis focuses first on the applicant's income. It is the buyer's personal income—essentially, income unrelated to the property itself—that will be used to repay the loan. For a commercial property loan, the lender normally expects repayment from income produced by the property, and that source takes priority in the analysis.

This chapter examines, first, the individual as borrower for the purpose of buying a home. **Residential loans** comprise over two-thirds of the mortgage loan market and may be classed in four major categories: (1) insured by a government agency such as HUD/FHA, (2) having some complete or limited government-agency guaranty from an entity such as VA or RHS, (3) conventional/conforming, and (4) other conventional. (A conventional loan is one without government underwriting.) Of the four, both HUD/FHA and VA or RHS offer fairly clear standards and guidelines for the industry and the consumer.

The third category, conventional/conforming, covers loans made with the expectation of selling them to either Fannie Mae or Freddie Mac. Both of these secondary-market purchasers have developed uniform documents and some common limitations (but not always the same standards) on the loans they can accept.

The fourth category, other conventional, offers few uniform procedures with many minor variations, and includes those residential loans characterized as Alternate A and subprime. The latter classifications of subprime and Alternate A are a recent variation of a conventional loan originally designed to better fit the needs of lower-income families and will be explained later under the umbrella term of *affordable housing loan*. In sum, the field of loan qualification does not offer standards used by everyone. (Some of the variations appear in Table 9-1 later in this chapter.)

We will examine the similarities and the differences between the four major categories of borrower qualification in this chapter. Examples are given for each using the same basic applicant's income and loan amount. Generally, the analyses arrive at similar conclusions but use slightly different methods to reach that point.



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A requirement for all borrowers is to furnish a credit report, and we will examine the information found in these reports in this chapter. Also, we will discuss the qualification of corporate borrowers. Finally, because private mortgage insurance has become an essential part of mortgage lending practices, we will review this kind of underwriting.

Loan analysis begins with the loan application. Lenders no longer have the freedom to ask whatever questions they may wish of an applicant, for in the past this practice has led to some discriminatory lending practices. As a step toward reducing discrimination in all kinds of credit transactions, Congress passed the Equal Credit Opportunity Act, which had an important effect on mortgage lending procedures, as we will discuss next.

EQUAL CREDIT OPPORTUNITY ACT

The basis for analysis of a borrower is the loan application. As a step toward equalizing the availability of credit, the **Equal Credit Opportunity Act (ECOA)**, passed in 1974, limits information that may be required in an application. Questions that could lead to discriminatory lending practices have been eliminated and new questions have been added that need only be answered on a voluntary basis. The act was implemented under

the direction of the Federal Reserve Board and is administered by the Consumer Affairs Office of the Federal Reserve.

Initially, the act prohibited discrimination in the granting of credit on the basis of sex or marital status. On March 23, 1976, the ECOA was amended to expand the prohibition against discrimination in credit transactions by adding race, color, religion, national origin, age, receipt of public assistance income, and the exercise of rights under the Consumer Credit Protection Act, of which the ECOA is a part, as protected categories.

The restrictions covering information on sources of an applicant's income do not apply if the applicant expects to use that income as a means of repaying the loan. For example, no questions may be asked regarding alimony, child support, or separate maintenance payments *unless* the borrower plans to use this money to make the loan payments.

No discounting of income is allowed because of sex or marital status or because income is derived from part-time employment. In earlier years, it was not uncommon to discount the income of a wife of child-bearing age by as much as 50%. In regard to a credit history, an applicant must be permitted to show evidence that facts in a joint report do not accurately reflect his or her individual ability or inclination to repay the loan. If credit is denied, the lender must provide the reasons for denial upon request of applicant.

ECOA preempts only those applicable state laws that are inconsistent with the federal requirements. Lenders in states that may impose additional requirements, such as additional prohibitions on what may be in a loan application, must also comply with state laws. It should be noted that the requirement for separate liability for separate accounts (i.e., married persons can demand that separate credit records be maintained in either a married name or a maiden name) cannot be changed by state laws. However, any action taken by a creditor in accordance with state property laws directly or indirectly affecting creditworthiness will not constitute discrimination.

In general, the law does not specify how or to whom loans should be made, but does call for lenders to be much more specific with reasons for rejection of a loan applicant. Generalizations and categories of persons not eligible for credit are no longer permissible. For example, at one time a married person who was separated could be denied credit by lenders as a customary policy. Or a single person might not be accepted as a loan applicant. This kind of blanket denial is no longer permitted because each person must be considered as an individual and judged by the same standards.

There can be a difference in the standards that a lender may use for long-term mortgage credit as opposed to a short-term installment-type of credit, but the standards must be applied uniformly to all applicants.

THE LOAN APPLICATION

A mortgage loan application offers information for qualification of both the borrower and the property. If the loan is residential, as explained earlier, the information requested on an application must conform to the requirements of ECOA. For this purpose, the Federal Reserve has prepared model application forms for five different types of credit, one of which is residential real estate. On the basis of the Federal Reserve model, Fannie Mae and Freddie Mac designed their own standard form (FNMA 1003 and FHLMC 65, respectively). As the need for greater standardization developed, this form became mandatory for use after November 15, 1986, by all lenders with all residential loans. The latest revision, dated June 2009, appears in the Appendix.

The information required in a residential loan application may be summarized as follows:

1. Identification of borrower (and co-borrower)
2. Cost of house, down payment, financing requested
3. Employment and income data
4. Anticipated monthly housing expenses
5. List of assets and liabilities
6. Permission to obtain a credit report
7. Details of the transaction, including an estimate of cash needed to close the loan
8. Applicant's certification as to accuracy of information

Commercial Loan

If a loan is for commercial property, the lender is more likely to use its own application form because considerably more information is needed. Further, federal laws regarding application information designed to better protect an individual generally do not apply to commercial loans.

Since most commercial loans are expected to be repaid from the property income, rather than from the borrower's personal income, specific information is needed on that property. An appraisal, market information

with a review of competition, and substantial financial data on anticipated operations would be required. More detailed information on commercial loans will be considered in this chapter after the examination of residential loan qualification.

FINANCIAL EVALUATION OF THE BORROWER

The high loan-to-value ratios (LTVRs) often found in residential loans place a premium on an accurate examination of the borrower's repayment ability. In the event of default, the conventional lender, or the private mortgage insurance company covering only a portion of the loan, would be hard pressed to make full recovery from disposition of the collateral in case of an early foreclosure. Proper analysis of the borrower to determine total available income, any claim against that income, and the borrower's credit record are important for a home loan.

A borrower's other assets are helpful as additional security for a loan and can result in a lower rate of interest, but other assets cannot always be counted on for use in repayment. The lender knows that in many cases of actual default in payments, the borrower has met with financial problems that were beyond his or her control. Accidents, job layoffs, or serious illness in the family can deplete most of a family's financial assets, leaving the lender with few means of recourse beyond the house that has been pledged as loan collateral.

No two borrowers ever present the same credit picture. Even so, analysis of a borrower can be handled two different ways: (1) by a human underwriter, called *manual underwriting*, or (2) by a computer, called *automatic underwriting*. Software programs have been developed for computers that can reference a variety of information and give loan approval when it is justified. However, the machine does not provide a rejection of the applicant. Any questions that should be answered are referred back to the lender's underwriter for further work.

Because a computer is more number-oriented, it also uses **credit scoring**, which is a method of giving a default probability number based on an individual's credit record. The method has been available for nearly 50 years but has received publicity recently because of its wider use. A more detailed explanation of the procedure appears in Chapter 14 as a part of the discussion on automated underwriting.

There are some guidelines and general rules, mainly based on common sense, that are helpful in determining whether or not a borrower

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should be able to make a loan repayment. One popular rule is to always follow the "Three Cs" of good underwriting.

1. **Capability**—evaluating a borrower's capacity to make the required payments
2. **Credit**—assessing the borrower's credit reputation (willingness to pay)
3. **Collateral**—determining that the property is adequate collateral for the mortgage loan

Thus, to make a sound prediction, the underwriter must consider the three basic questions: (1) What is the applicant's ability to pay? (2) What is the applicant's willingness to pay? (3) Does the property provide enough collateral?

We will examine the issue of collateral in the next chapter.

Ability to Pay

More than for any other type of loan, the residential lender looks to a family's income as the basic resource for repayment. Assets are important, but are used in part to determine the spending or saving patterns practiced in the use of that income. Therefore, a careful review of the employment record, present income, and future potential is important. The following are some of the income elements considered by a lender, with commentary on each.

Types of Income

Lenders make a broad distinction between **production-related income** and **assured income**. Production-related income means commissions, bonuses, and in some cases, piecework pay. It does not have the certainty of assured income such as wages or a salary and normally requires a longer record of earnings to qualify. Following are major types of income and comments on their acceptability:

1. **Salary.** A salary, particularly from a major company or institution, is highly acceptable for loan qualification. It can be easily verified from IRS W-2 reports.
2. **Bonus.** A bonus should not be counted on unless a regular pattern can be established for several successive years.

3. **Commission.** A straight commission job can be very lucrative, or it can be a complete bust. Only a past record of income culled from several years of tax returns can be accepted as factual.
4. **Hourly wages.** An hourly wage is a solid basis for continuing income and one that can usually be confirmed by an employer.
5. **Overtime wages.** This is an uncertain basis for making a long-term loan, as most employers try to avoid overtime, using it only for an emergency situation or as a temporary practice. Again, a consistent pattern of overtime payments for several years would make this an acceptable addition to an applicant's gross income.
6. **Second job.** Many people today hold more than one job on a full- or part-time basis. Teachers, police officers, and skilled hourly workers all can have other capabilities and may spend extra hours augmenting their income. If the second job has been held over a period of several years on a regular basis, it provides a substantial lift to the regular income.
7. **Unreported income.** A few people accept extra work, or even become involved full-time, in jobs that pay in cash and on which income is not reported for tax purposes. Such income, if not reported, is illegal and cannot be used under any condition to justify a loan. This "borrower" could lose this income abruptly and spend some time in prison.
8. **Co-borrower's income.** Prior to enactment of the Federal Equal Credit Opportunity Act, it was a fairly common practice to reduce the effective income that could be accepted from a working wife. The reasoning then was that young married couples were also interested in raising families, and earlier customs generally assigned more of the problems concerned with family emergencies, sickness, and childcare to the wife. The new laws recognize changing customs, and a lender is now required to apply the same qualification standards to each borrower without questioning marital status or gender.
9. **Income from children.** While many young men and women living with their parents earn substantial money at full- or part-time jobs, these earnings are not generally a recognized addition to the family income for loan purposes. The obligation on the part of children to contribute to family finances for support of the home is not a continuing one. Normally, children will leave home to set up their own households within a few years. Therefore, temporary income supplied by grown children lends no real weight to most loan

requests. There is another qualification pattern that considers children's income differently. Many state and local housing authorities offer loan assistance programs using lower cost "bond money" that limit eligible income. Generally, for qualification, eligible "family income" is the combined income of all persons who will live in the house to be financed. Similar provisions apply to the more recently designated category of affordable housing loans.

10. **Pension and trust income.** In years past, not many have enjoyed pensions, retirement funds, or other work benefits at a sufficiently early age to apply them toward a home purchase. However, this pattern is changing. For instance, many veterans of military, government, and corporate services have completed 20 or 30 years of employment before the age of 50 and are eligible for further lifetime benefits. These benefits are one of the most reliable forms of income.
11. **Child support and alimony.** Some states do not permit alimony in divorce actions but provide child support as a matter of court decree. Other states permit both alimony and child support. Such payments can be considered as regular income for a divorced spouse or remarried person, depending on the court ruling. However, the record of payment must show dependability over a period of time before it would constitute an acceptable addition to total income. ECOA restricts information that must be provided on this source of income if it is not to be counted as income for repayment of the loan.
12. **Self-employed persons.** Many people operate their own businesses or work as self-employed individuals in professional capacities. This type of income is one of the more difficult to evaluate because of the flexibility in accounting procedures that define such income. Some small business owners are able to pay certain living expenses from their business (car expenses, entertainment, travel, etc.), but weight can only be given to the individual's income that is reported as taxable. Without an employer to verify income, lenders must rely on several years of federal income tax returns. Certified copies of these returns can be obtained from the Internal Revenue Service for a small fee upon application by the taxpayer only.
13. **Interest and dividends.** This type of income derives from investments that may or may not provide an ongoing source of funds. If the assets can be held as an investment, they represent stable income. However, losses can occur and the assets might be sold, which would

eliminate that particular source of income. Again, the past record would give some indication of how investment assets have been managed.

14. **Part-time employment.** In the past, income derived from part-time work was not accepted at full value toward a person's income applicable to repayment of a mortgage loan. The concern was about the future stability of this source of income. ECOA requirements now permit no discounting of income from part-time employment. However, the lender may still require that an applicant show evidence of stability and reasonable assurance that part-time work will continue.

Stability of Income

Along with the size of an applicant's income, the assurance that it will be continued must be investigated. Two measures are most commonly used: (1) time on the job and (2) type of work performed.

Length of Time on Job

While standards vary, some length of time on the same job is a measure of stability. The changing nature of job tenure has brought a reduction in the former three-year standard to a more common one-year requirement. There is a basis for this restriction in that any new job may or may not work out due to personality factors, lack of accomplishment, or dissatisfaction with the work.

With the more rapid changes in jobs today, tenure may be more fairly judged from the individual's job history. Has the applicant made a record of "job-hopping" without noticeable improvement in income? Is the present job one of greater responsibility and growth potential than the previous job? Has the applicant maintained a record of employment in a chosen field of work, or is the present job an entirely new type of work? The lack of standards makes this question a judgment call for an underwriter.

Type of Work

While a person with a long record of steady employment provides a very good answer to the question of income stability, many seeking loans cannot provide such a record. Thus an additional standard is helpful in analysis of an applicant: the type of work.

Persons with salaried jobs employed by major companies or institutions rate very well. So do professional people with job tenure of various kinds. Hourly workers, some with the protection of union contracts, can be more stable (and often more highly paid) than lower level management and clerical staff workers. Government employees carry good security, as do teachers, police officers, and other service workers.

On the lower side of the scale, new sales representatives enticed by stories of high commissions, entertainers, and seasonal workers give poor evidence of continued stable income. To some lenders, socially unacceptable types of work carry unduly low ratings. It might be noted that laws do not protect persons against credit discrimination due to type of work.

Liabilities

For residential loan qualification, fixed liabilities must be reported on the application. If **liabilities** are excessive, an applicant can be rejected (a judgment call). The standard measure applied is a conversion of liabilities to a per-month basis. Not all liabilities are included or measured in this manner—only those that are required by the lender to be listed. The key determinant is whether or not the required monthly payments could prevent making a mortgage payment. However, that determinant is limited. For instance, cost of food, clothing, transportation, and income taxes need not be listed even though they are all essential.

To qualify an applicant's income, certain monthly obligations should not exceed guideline percentages of the applicant's income. The obligations that fall under this criterion are housing costs, as reflected in the monthly mortgage payment, plus other fixed obligations such as installment payments and revolving account payments. In general, more than half of an applicant's income is open to use for unlisted obligations. Each of the major categories of loans (FHA, VA and RHS, conforming/conventional, and other conventional) apply slightly different guideline standards for listing liabilities. These will be more fully explained later in this chapter.

While there are some differences between lenders and types of loans as to which monthly obligations must be listed, caution should be taken before incurring additional debt prior to qualifying for a mortgage loan. A recent study indicates that a major cause of loan rejection is not the housing payment itself; rather, it is heavy monthly installment obligations for other items such as cars, computers, video equipment, and similar purchases that might well be postponed.

Assets

Unlike applicants for commercial loans, residential applicants need not show substantial **assets** to qualify. Many home buyers are younger people who have had little time to accumulate much in other assets yet still qualify for suitable home loans. However, there is an advantage if assets other than a home are held by an applicant. Ownership of stocks, bonds, real estate, savings funds, and other such assets does indicate an ability to live prudently and conserve a portion of one's income. If this is the case, the applicant should find qualification of income much easier, as the percentage guidelines that limit the amount of obligations will most likely be relaxed a bit.

As a commentary on how lenders might look at other assets, life insurance is viewed as both an asset (due to its cash value and protection features) and a liability (due to its cost). Cars and boats represent some trade-in value, but are usually discounted. Furniture and personal property are often overvalued in an applicant's statement of assets because of the owner's personal attachment to these items, and these values are not given much weight by lenders. Employee trust and pension funds can represent value if the interest is a vested one—that is, if employees can take the funds with them should they leave the job. An interest in one's own business is best determined by an audited financial statement of that business. Accounts and notes receivable should be detailed for proper valuation.

Willingness to Pay

The element of **willingness to pay**, sometimes called *credit character*, is the most difficult to analyze and judge. Yet this factor alone can be the cause of loan rejection. An underwriter's judgment is crucial in making this decision because it can involve questions of credit discrimination.

Creditworthiness is judged from an applicant's previous record of meeting obligations. The most common source of information to make this determination comes from credit reports as issued by credit bureaus. Information for mortgage loans is also obtained from public records covering litigation, judgments, or criminal actions. Conversations with persons involved in the house sale transaction can sometimes bring to light information on the applicant's manner of living, personal attitudes, and activities that might give cause for a more detailed investigation.

Some lenders prefer to take loan applications at the borrower's place of residence because a person's manner of living can be helpful in judging credit character. There is a question as to when personal inquiry becomes an invasion of one's privacy. But lenders are obligated to exercise prudent judgment, and need information to make sound decisions. The true picture can be just as advantageous for the borrower as for the lender and is mandatory in making proper judgment on any loan. Individuals asking to borrow someone else's money should be willing to provide complete and accurate information about themselves within the requirements of the Equal Credit Opportunity Act.

Under the category of willingness to pay, lenders have always tried to assess an applicant's motivation for owning a home. Lenders in the past have felt that the strongest incentive for owning a home came from a family unit committed to the rearing of children. But lifestyles have changed, and many persons today are not interested in having a family, but do want houses. Even prior to the enactment of the Equal Credit Opportunity Act, lenders were enlarging qualification standards and making loans to single persons, both men and women, and nonfamily units where there was reasonable assurance of continuity of interest in owning a house. ECOA has eliminated gender and marital status as a basis for loan rejection, but it has not foreclosed the lender's right to exercise judgment as to the continuing need to repay a mortgage loan. This is an area that does not lend itself to clear-cut definitions and thus can present problems for a responsible loan officer.

Credit Reports

Most adults in this country have **credit reports** compiled by the more than 1,100 credit bureaus, whether or not they are aware of it. Information is routinely submitted to local credit bureaus by their members, who normally are those extending credit within the community. Credit bureau members consist of local merchants, financial institutions, gasoline retailers, providers of medical services, taxing authorities, and possibly utility companies. (Many utility companies do not submit credit information because they have very effective constraints if payment becomes delinquent.)

Records of credit card accounts are generally kept separately in huge computer data banks, not in local credit bureaus. Information in credit files is classed as proprietary, available only to approved credit bureau

members and to individuals seeking information on their own records. Those who pay bills only in cash are not likely to have credit records anywhere, which can create some problems when seeking a mortgage loan. However, to properly handle such persons wanting to obtain credit, the fairly new credit criteria allowed under “affordable housing loans” recognizes insufficient credit records and accepts timely cash payments as proof of sound payment practices.

Keepers of Credit Records

Before applying for any loan, it is wise for an individual to review any credit information that he or she may have on file. The Fair Credit Reporting Act grants individuals the right to do this. Errors can be corrected, and this is best handled before a loan officer examines the record. The place to begin is with the local credit bureau, which is listed under “Credit Reporting Agencies” in the Yellow Pages. Large cities have multiple bureaus and usually one will dominate mortgage loan information—the one commonly used by FHA, VA, and mortgage companies. Individual credit reports generally cost about \$15 and may take several weeks for delivery; they are free if a bad report is the reason for denial of credit.

Three major national credit data companies (also called national repositories) hold credit information on individuals and may be contacted directly. Most mortgage lenders now require reports from at least two of the three, in addition to the local credit bureau report, as part of the loan documentation. The three do not share credit information, and their reports can differ. Contacts are as follows:

EQUIFAX

Box 740241

Atlanta, GA 30374-0241

Phone: 1-888-202-4025 Business Service for Lenders; 1-800-685-1111 for Consumers

EXPERIAN

475 Anton Blvd.

Costa Mesa, CA 92626

Phone: 1-888-243-6951

TRANSUNION

2 Baldwin Place

P.O. Box 1000

Chester, PA 19022

Phone: 866-922-2100 Business Service for Lenders; 800-916-8800 for Consumers

Credit Information

Credit bureaus provide records of credit accounts and payment histories of those accounts. Each creditor makes the decision as to whether or not to grant credit. The information contained in a report covers the past seven years (ten years for bankruptcy filings). If an individual files a complaint against a credit reporting company, the law requires that an answer be provided within 30 days. Disputed information may be removed from the credit record while an investigation is made into the original creditor. If the information is accurate, it is returned to the record. If it is inaccurate, the information must be deleted and the individual can instruct the credit bureau to send a correction to all creditors who reviewed the file in the previous six months. If unfavorable credit information is on the record and there are mitigating circumstances (such as a serious injury causing delay in making payments), an individual can file a statement with the credit bureau of up to 100 words in explanation.

Responsible Federal Agency

The basis for the preceding information on consumers' rights stems from the **Fair Credit Reporting Act (FCRA)**, passed in 1970. The FCRA is administered by the Federal Trade Commission, which is headquartered in Washington, D.C., with regional offices in major cities. In 2003, the **Fair and Accurate Credit Transactions Act (FACT)** was passed, which significantly amended the Fair Credit Reporting Act. The FACT sought to protect consumers from inaccurate credit information that might be reported by credit reporting agencies. In addition to protecting consumers' privacy rights when reporting their credit, the FCRA included consumers' right to inspect their credit reports for accuracy. Consumers can also contest possible errors and attach explanations regarding derogatory listings.

When notifying prospective borrowers that their mortgage loan application was denied based on information in their credit report, lenders must also meet the requirement of the Equal Credit Opportunity Act for disclosure of detailed reasons for the loan denial. To comply with both FACT and ECOA requirements, these notifications must include statements of the reasons for the denial and/or a counteroffer notice. For approvals, notifications must include consent for credit disclosure along with disclosure of any lock agreements. Approvals, denials, and counteroffers all must come with privacy policy disclosures to consumers stating

how they meet the requirements of FCRA and FACT. The necessity for compliance with these privacy policy rules (which we will cover more fully below) stems from the new Red Flag Rules issued by the Federal Trade Commission (the primary regulatory oversight and enforcement agency for FACT) that became effective on November 1, 2008. These Red Flag Rules, also adopted by the banking and credit union regulators, require financial institutions and creditors to have developed and implemented written identity theft prevention programs as part of their compliance with FACT. The Red Flag Rules cast a wide net, covering almost all credit extension that falls under the two broad categories below:

1. *Creditors*—a category that includes mortgage companies, mortgage brokers, banks, credit unions, and any other entity that regularly grants credit
2. *Covered accounts*—in which credit is extended with multiple payments; these include mortgages, credit cards, checking or savings accounts, and public utilities

Almost everyone taking a mortgage loan application is covered by these Red Flag Rules, and compliance officers must have in place staff training programs that explain the role of each person involved in the mortgage loan origination process. Each employee must be alert to the following requirements:

- *Identify*: Each covered entity must identify and incorporate relevant patterns, practices, and specific forms of activity that constitute “red flags” signaling possible identity theft.
- *Detect*: Once a covered entity identifies its red flags, it must then develop policies and procedures to detect these red flags when they occur.
- *Respond*: Each covered entity must develop appropriate policies and procedures to respond to any detected red flags in order to prevent and mitigate identity theft.
- *Update*: Each covered entity must update its program periodically to identify new red flags or adjust to changes in risks of identity theft.

FTC Privacy Rule

All the information collected from borrowers to be able to qualify them for the various loan programs comes under the **Federal Trade**

Commission's Privacy Rule, issued in 2003. This ruling established that mortgage brokers are financial institutions because brokering loans is a financial activity, as referenced in section 4(k)(4)(F) of the Bank Holding Company Act and listed in 12 C.F.R. § 225.28(b)(1) (see 15 U.S.C. § 6809[3]; 16 C.F.R. § 313.3[k][2][xi]). Mortgage brokers are subject to the FTC's enforcement authority, its Privacy Rule, and its Safeguards Rule. The Privacy Rule requires that mortgage brokers as well as depository institutions provide an initial privacy notice as soon as the customer relationship is established. Under 16 C.F.R. § 313.4(a), as the customer relationship is considered to be established as soon as an individual provides personally identifiable financial information to a lender in an effort to obtain a mortgage loan. Depository institutions or mortgage brokers involved in taking mortgage loan applications must deliver a privacy notice before or at the same time as any individual borrower provides this information in person. In 2003, the federal government passed the Identity Theft Deterrence Act (ITDA) and worked closely with the Federal Trade Commission to find ways to protect consumers from lenders who might make use of consumer credit to commit loan fraud, mortgage fraud, credit fraud, credit card fraud, and commodities and services frauds. The IDTA made the possession of any means of identification for the purpose of knowingly transferring or using it without lawful authority a federal crime. This applies to any persons or institutions collecting information required under the Patriot Act as well.

Credit Reporting Problems

Almost all credit information is now maintained in computerized systems. Large creditors send data to their own bureau on computer tapes, minimizing the possibility of errors. Nevertheless, problems remain in the confusion of persons with similar names and changes of married names, and just plain errors in the recording of data. Confusion over names is not always simplified by the use of Social Security numbers because creditors are prohibited from demanding a Social Security number when considering granting credit. The Social Security Act itself classifies an individual's number as private. However, depository institutions must record a depositor's number in order to report any payment of interest to the IRS. But the refusal to disclose a Social Security number to a creditor cannot be used as a basis for denial of credit.

Credit Scoring

The increased use of computer analysis has brought greater use of credit scoring to mortgage lending. Credit scoring is the assignment of a numerical rating to consumers based on their credit history. Credit scores continue to have a rising influence by residential mortgage lenders, auto lenders, credit card issuers, and other extenders of credit. Credit scoring is calculated by credit bureaus using information from one or more of the three major credit repositories: Equifax, Experian, and TransUnion. Therefore, they can report different ratings.

A number of other factors enter into judging a person's creditworthiness; scoring is just one. Further information on this subject may be found in Chapter 14, "Technology Advances in Mortgage Lending." For a detailed walk-through of a typical credit report, with explanations from the issuer, browse to http://www.experian.com/credit_report_basics/pdf/samplecreditreport.pdf and go through the sample. Each page begins with a description of what you will see. There is also a sample three-party credit report included in the Appendices of this text.

QUALIFYING APPLICANTS

All lenders have the same underwriting goal: a borrower capable of repaying the loan plus a property providing adequate collateral. As examined earlier in this chapter, more than income is involved in borrower qualification for a residential loan. This is only one of the elements that falls under "ability to pay," albeit a crucial one. Greater emphasis is being given to income qualification today, as it involves numbers that provide easier comparisons between applicants. Comparison between applicants is one method of screening the mortgage market for discriminatory practices.

A residential loan applicant's personal income is examined carefully since that is where the money will come from to repay the loan. Other obligations against that income must be weighed to determine if an additional burden can be undertaken. It does neither party—the lender nor the borrower—any good to place an overload of debt on a home buyer. Several different paths are used to reach a judgment on qualification, but in the final analysis, the decision has to be a judgment call. The decision can be made by a human underwriter or by a computer with a software program that uses artificial intelligence to evaluate the information submitted.

Following are explanations of the qualification guidelines—income and other measures—as applied to each of the four principal kinds of home loans: (1) HUD/ FHA, (2) VA and RHS, (3) conventional/conforming, and (4) other conventional loans, with special attention given to affordable housing loans. While each procedure is slightly different, the thrust is the same: to set a measure that limits other obligations to a percentage of the applicant's effective income. An underlying problem is defining what should be included as "other obligations."

HUD/FHA Borrower Income Qualification

HUD/FHA uses a percentage guideline method to measure the adequacy of an applicant's income. As part of an ongoing effort within the industry to standardize residential loan procedures, the measures used to qualify FHA loan applicants have been simplified and are now similar to those used for conventional loans.

Taxes, maintenance, and utilities are now considered payable from "residual income"—that income remaining after the required mandatory expenses has been deducted.

Percentage Guideline Method

The **percentage guideline method** considers an applicant's monthly liabilities in two separate categories and measures each amount against the applicant's effective income. The two categories and limits applied are as follows:

1. Housing expense should not exceed 31% of the applicant's effective income.
2. Housing expense plus other recurring charges are identified and should not exceed 43% of effective income.

How HUD/FHA defines the measures that are used is important. Following is a brief explanation of the major items considered.

Effective Income

This includes gross income from all sources, including borrower and co-borrower, that can be expected to continue for the first three years of the mortgage. Even though an applicant's income has been properly verified,

HUD/FHA reserves the right to adjust, or disallow, unacceptable income. A bonus or unusually large commission should be supported by a record of equivalent previous earnings. The owner of a business is allowed the amount he or she withdraws as salary, provided this amount does not exceed actual earnings. Money reimbursed for travel expenses cannot be accepted, nor can any repayment of principal on a capital investment. The HUD Handbook Section 4155.1 4.D.1.a defines "**Effective Income**" in detail, assisting with the understanding of how to handle more unique income sources. Examples of acceptable income sources, if verified, are rental property income, royalty income, or annuity payments.

PITI or Housing Expense

These expenses include the mortgage payment of principal, interest, real estate taxes, and hazard insurance, plus flood insurance if applicable. (In conventional loans, this payment is often identified simply as **PITI**.) The **housing expense** also includes the FHA annual premium charge and homeowners' association or condo fees if applicable.

How might a real estate professional or loan officer easily explain the maximum PITI for which an applicant would qualify? She would multiply the applicant's effective or gross monthly income by the debt-to-income ratio described on the next few pages.

Example

Determine Maximum Debt Ratio

Borrower's Income	\$6,000.00 monthly
Multiply by Total Debt Ratio	$\times 36\%^*$ (or actual amount)
Maximum Monthly Payments	\$2,160.00**

* Maximum Debt Ratio for Conventional Residential Mortgages

** This is the maximum amount the borrower can afford for all monthly obligations.

A quick prequalification for a home buyer may be performed by learning the home buyer's non-housing monthly debt and subtracting it from the \$2,160 calculation to arrive at an amount that could approximate the PITI. This provides the amount of mortgage loan the borrower

could afford and, thus, the price range of home for which the home buyer should be shopping.

Recurring Obligations

In addition to the monthly housing expense, the lender must include the following when computing the debt-to-income ratios for recurring obligations:

- Additional recurring charges extending 10 months or more, such as:
 - a. Payments on installment accounts
 - b. Child support or separate maintenance payments
 - c. Revolving accounts
 - d. Alimony

Debts lasting less than 10 months must be included if the amount of the debt affects the borrower's ability to pay the mortgage during the months immediately after loan closing, especially if the borrower will have limited or no cash assets after loan closing.

Monthly payments on revolving or open-ended accounts, regardless of the balance, are counted as a liability for qualifying purposes even if the account appears likely to be paid off within 10 months or less.

Fixed Payment

A *fixed payment* is an FHA-defined term that equals the sum total of the housing expense and the recurring charges (such as car payments and student loan payments) and is used in the calculation of the "back-end" or "debt" ratio covered later.

Residual Income

This is effective income minus fixed payment. Because residual income is affected by tax liabilities, Social Security deductions, and utility and maintenance expenses, HUD/FHA does not establish a required residual income amount as is found in VA procedures.

Ratios

The measure of adequacy is determined by ratios. Dividing the housing expense by the applicant's effective income determines a ratio. Housing expense, as defined earlier, should not exceed 31% of income (take PITI and divide it by gross effective income). The second ratio is for the total fixed

payment. This ratio, obtained by dividing fixed payment by gross effective income, should not exceed 43% (also referred to as the back-end ratio or debt ratio).

These ratios are guidelines and subject to an underwriter's judgment. If compensating factors are present, the ratios may be exceeded. Table 9-1 describes the compensating factors that may be used to justify approval of mortgage loans with ratios that exceed FHA benchmark guidelines.

The underwriter must document the availability of potential employment.

The following simplified example serves to illustrate the key elements of an applicant's income qualification.

Example

Percentage Guideline--Monthly Basis

Gross effective income		\$3,500
Housing expense		
Mortgage principle and interest	\$695	
Taxes and insurance	<u>180</u>	
Total housing expense		\$875
Recurring charges		
Car payment	\$290	
Revolving account payments	<u>170</u>	
Total recurring charges		<u>\$460</u>
 Total fixed payment		 \$1,355
Ratios:		
Housing expense	$875/3,500$	$= 25.0\%$
Fixed payment	$1,355/3,500$	$= 38.7\%$

In this example, the housing expense or front-end ratio shows 25.0% of effective income, which falls within the HUD ceiling of 31%. The other measure—fixed payment or back-end ratio—shows a 38.7% ratio of effective income, which also falls within the HUD 43% guideline. If either exceeds the guidelines, the underwriter would look for other compensating factors that might justify the granting of an insurance commitment. For those borrowers who qualify under FHA's Energy Efficient Homes (EEH), the ratio is set at 33% for the front-end ratio and 45% for the back-end ratio (sometimes referred to as the debt-to-income ratio).

TABLE 9-1 The compensating factors that FHA underwriters may use to justify approval of mortgage loans with ratios that exceed FHA benchmark guidelines are as follows.

Compensating Factor	Guideline Description
Housing Expense Payments	The borrower has successfully demonstrated the ability to pay housing expenses greater than or equal to the proposed monthly housing expenses for the new mortgage over the past 12 to 24 months.
Down Payment	The borrower makes a large down payment of 10 percent or higher toward the purchase of the property.
Accumulated Savings	The borrower has demonstrated: • An ability to accumulate savings, and • A conservative attitude toward using credit.
Previous Credit History	A borrower's previous credit history shows that he/she has the ability to devote a greater portion of income to housing expenses.
Compensation or Income Not Reflected in Effective Income	The borrower receives documented compensation or income that is not reflected in effective income, but directly affects his/her ability to pay the mortgage. This type of income includes food stamps, and similar public benefits.
Minimal Housing Expense Increase	There is only a minimal increase in the borrower's housing expense.
Substantial Cash Reserves	The borrower has substantial documented cash reserves (at least three months' worth) after closing. The lender must judge if the substantial cash reserve asset is liquid or readily convertible to cash, and can be done so absent retirement or job termination, when determining if the asset can be included as cash reserves, or cash to close. Funds and/or "assets" that are not to be considered as cash reserves include • Equity in other properties, and • Proceeds from a cash-out refinance.
Substantial Nontaxable Income	Lenders may use a portion of a borrower's retirement account, subject to the conditions stated below. To account for withdrawal penalties and taxes, only 60 percent of the vested amount of the account may be used. The lender must document the existence of the account with the most recent depository or brokerage account statement. In addition, evidence must be provided that the retirement account allows for withdrawals for conditions other than in connection with the borrower's employment termination, retirement, or death. If withdrawals can only be made under these circumstances, the retirement account may not be included as cash reserves. If any of these funds are also to be used for loan settlement, that amount must be subtracted from the amount included as cash reserves. Similarly, any gift funds that remain in the borrower's account following loan closing, subject to proper documentation, may be considered as cash.
Potential for Increased Earnings	The borrower has substantial nontaxable income. This applies if no adjustment was previously made when computing ratios.
Primary Wage-Earner Relocation	The borrower has a potential for increased earnings, as indicated by job training or education in his/her profession.
	The home is being purchased because the primary wage-earner is relocating, and the secondary wage-earner • Has an established employment history • Is expected to return to work, and • Has reasonable prospects for securing employment in a similar occupation in the new area.

Borrower Rating

Income qualification alone is not the final determinant. One further judgment must be made by a HUD/FHA underwriter, and that is a *borrower rating*. An older method using a five-point gradient scale (from excellent to reject) has been replaced with only two grades: acceptable or rejection. A rejection on any one of the ratings is cause for denial of the loan commitment. The four elements that are rated are: (1) credit characteristics, (2) adequacy of effective income, (3) stability of effective income, and (4) adequacy of available assets.

RECENT ADDITIONAL CREDIT SCORE REQUIREMENTS FOR HUD/FHA

FHA Institutes Minimum Credit Scores and Loan-to-Value Ratios

- The older construct of borrower rating has been affected due to the **FHA new minimum credit scores** and loan-to-value (LTV) ratio requirements for FHA-insured loans, effective September 3, 2010. In accordance with the final Federal Register Notice (FR-5404-N-02) on minimum decision credit scores and LTV ratios for FHA-insured single-family mortgages, the new requirements are now as follows:
 - Borrowers with a minimum decision credit score at or above 580 are eligible for maximum financing.
 - Borrowers with a minimum decision credit score between 500 and 579 are limited to 90 percent LTV.
 - Borrowers with a minimum decision credit score of less than 500 are not eligible for FHA-insured mortgage financing.
 - Borrowers with a nontraditional credit history or insufficient credit are eligible for maximum financing but must meet the underwriting guidance in HUD 4155.14.C.3.
 - Borrowers using 203(h), Mortgage Insurance for Disaster Victims, are eligible for 100% financing and no down payment is required, provided that the borrowers have a minimum credit score of 500 (borrowers with decision credit scores below 500 are not eligible for FHA financing).

These new requirements are applicable to all single-family programs *except* Title I, Home Equity Conversion Mortgages; HOPE for Homeowners; Section 247; Section 248; Section 223(e); and Section 238.

It is important to note that for temporary *minimum credit scores* and LTV requirements for *refinancing* conventional mortgages, borrowers must meet all the requirements of that program and have a minimum credit score of 500.

By taking credit scores into consideration and using the four-element process in determining eligibility for FHA mortgages, underwriters no longer enjoy the same level of discretion in decision-making that they had in the past.

VA BORROWER QUALIFICATION

In Chapter 8, we discussed how the VA qualifies property offered as collateral, including the need to obtain a VA form 26-1843, Certificate of Reasonable Value, if the lender has not been approved by the VA for its Lender Appraisal Processing Program. This section examines the methods used by the VA to qualify an applicant who is a veteran. In addition to meeting the requirements for eligibility and entitlement stated in Chapter 8, the applicant must show an income adequate to repay the loan and have an acceptable credit record with other creditors. To qualify an applicant's income, the VA requires two separate sets of calculations. One, called the **residual method**, has been used for many years. The other, a procedure using income ratios, became effective October 1, 1986. Explanations, examples, and guidelines for each of the two methods follow.

Residual Method of Income Qualification

The VA's residual method of qualifying an applicant's income might be called a summation process. It starts with the applicant's *gross monthly income*, which means gross pay before any deductions are taken. Then, mandatory deductions start with the applicant's monthly tax liabilities, continue with shelter expenses and other fixed obligations, and result in what the applicant has left. What remains after the applicable mandatory obligations have been deducted is called *residual income*. How the VA underwriter defines the various items is discussed next.

Gross Income

The recognized income of both borrower and spouse are combined; that income should have a reasonable expectation of continuing.

Tax Liabilities

The applicant's tax liabilities include federal and state income taxes, Social Security tax, and any other tax liabilities that may be due. The amount of tax is based on that shown by tax tables applicable to an applicant's recognized income and may not be the same as what the taxpayer pays. Tax liabilities are deducted from the gross income, resulting in the applicant's net take-home pay. Take-home pay is not a critical number with the VA because it is not used as a basis for qualification.

Shelter Expenses

For the residual method only, the VA adds certain shelter expenses not found in either FHA or conforming loan qualification calculations. In addition to the standard mortgage payment (principal, interest, taxes, and insurance, or PITI) and any special assessments, the VA adds estimated costs of maintenance and utilities for the house to be acquired. (These two expenses are not included in the VA's income ratio method.) The costs of maintenance and utilities are developed by the VA Regional Office from experience with various neighborhoods.

Other Monthly Obligations

Under other monthly obligations, the VA lists installment obligations (such as a car payment) with six or more monthly payments still due, revolving account payments, alimony and/or child support, and job-related expenses (such as union dues). If the applicant is obligated for other state and local taxes or life insurance premiums, these should also be listed.

Residual Income

After deducting the taxes, shelter expenses, and other monthly obligations from the applicant's gross monthly income, what remains is called *residual income*. For qualification, the residual income must be sufficient to cover the applicant's required *minimum residual income*. The minimum residual income is a cost-of-living amount that varies by region, by family size, and loan amount. It is adjusted periodically by the VA to meet changing conditions.

Cost of Living Expense

Unlike any other underwriting procedure, the VA residual method uses a calculated figure for determining the **cost of living expense**. These costs

include food, clothing, transportation, personal and medical care, and other consumption items. Since 1986, these costs have been determined by the standards for the four Census Bureau regions: West, South, Midwest, and Northeast. The actual figures are developed by the VA from Department of Labor data on consumer expenditure surveys.

The applicant's residual income (what remains after total monthly obligations have been deducted) must be sufficient to cover the applicable cost of living amount. Whatever remains of the applicant's income after total obligations and cost of living expenses are deducted is called *excess residual income*. The "excess," if any, may be used to help qualify marginal applicants, as shown below.

Example

Residual Guideline Method: Monthly Basis

Gross salary or earnings		\$3,000
LESS:		
Federal income tax	330	
Social Security tax	205	
Total tax liabilities		535
Net take-home pay		2,465
LESS:		
Principal and interest	660	
Realty taxes	105	
Hazard insurance	60	
Maintenance	55	
Utilities	125	
Total monthly shelter expenses		1,005
LESS:		
Installment obligation	240	
State and local taxes	90	
Total other obligations		330
Applicant's residual income		\$1,130

If the applicant in the example is a family of two living in the South region and the loan amount is less than \$79,999, the minimum required

residual (see VA website for residual income limits by region at http://www.benefits.va.gov/warms/pam26_7.asp; click on Chapter 4 and look starting on page 4-56) amounts to \$738. The applicant's residual income of \$1,300 is adequate to meet the requirements. It may be worth noting that the VA process favors single people and small families. By applying the cost of living table as family size increases, an applicant is less likely to qualify.

Excess Residual Income

There is one more piece of information to be derived from this method of calculation, and that is how much the applicant's residual income exceeds the minimum required amount. To continue using the same example, the *required* residual amounted to \$738. Subtracting that amount from the applicant's residual income of \$1,300 leaves an "excess residual" of \$562 (\$1,300 minus \$738 equals \$562). It is not the amount, but the ratio, that is significant. To find this ratio, divide the applicant's excess residual by the minimum required residual. The result is the *excess residual ratio*. In the preceding example, dividing \$562 by \$738 gives a ratio of .76, or 76%. This ratio fits into the qualification measure if there is a problem with the income ratio qualification calculation. If the excess residual ratio is 20% or greater, the applicant may still qualify even though the income ratio guidelines are not met. The income ratio method of calculation is explained next.

VA Income Ratio Method of Qualification

As of October 1, 1986, the VA introduced the **income ratio method** of qualifying an applicant's income. It is used in conjunction with the residual method. If the income ratio is not met, an applicant may still be approved, providing the excess residual is at least 20% of minimum required residual. The income ratio method uses some different measures—one being that the applicant's income is gross income (i.e., income taxes and Social Security taxes are *not* a recognized deduction). Other differences in definitions for the income ratio method follow.

Shelter Expenses

The same expenses apply for the income ratio method as for the residual method, with the exception of utility and maintenance costs. These are

not included when calculating the income ratio method. Unlike FHA or conforming-loan guideline procedures, VA draws no line that requires any percentage limit on shelter expenses.

Other Monthly Payments

There is no difference in defining other monthly payments between the two methods. Recurring monthly obligations include other loan repayments, installment obligations, and other obligations such as child support. Federal tax obligations are not included in this method because they are expected to be paid from income that remains after all mandatory deductions are taken.

Income Ratio

The sum of housing expenses plus other monthly payments (as briefly defined above) is then compared with the applicant's gross income. The limitation is 41%—that is, the listed expenses should not exceed 41% of gross income. In this example, the total monthly obligations amount to 39% of the applicant's gross income. Since this number falls within the VA's 41% guideline, the applicant would meet the test for adequate income.

Comparison with Residual Guideline

As a final step in qualifying an applicant's income, the underwriter must review the results of the residual method qualification. This becomes most important if the income ratio method exceeds the 41% guideline limit. Should that occur, the underwriter then reviews the amount by which the applicant's residual exceeds the minimum residual, as required by the VA cost-of-living figures. As explained earlier, if the excess residual ratio is 20% or greater, the applicant may still qualify.

Other Qualification Considerations

While the VA considers the income available for family support a significant factor, it is not the sole criterion for approving or rejecting a loan. Other important considerations for qualification are as follows:

1. Applicant's demonstrated ability to accumulate liquid assets such as cash and securities
2. Applicant's ability to use credit wisely and refrain from incurring excessive debt

3. Relationship between proposed housing expenses and the amount applicant is accustomed to paying
4. The number and ages of applicant's dependents
5. The likelihood of increases or decreases in income
6. Applicant's work experience and history
7. Applicant's credit record with other obligations
8. The amount of any down payment made

Conventional/Conforming Loan Qualification

A **conforming loan** is a conventional loan that meets the requirements of either Fannie Mae or Freddie Mac. Both of these secondary-market agencies, while publicly owned, are subject to a HUD oversight committee and must have Congressional approval for any major change in their operating procedures. Congress has set the policy on the maximum loan amount that these agencies may purchase, which amounted to \$417,000, with a few exceptions for high-costs areas of the country in 2015 for a single dwelling unit. Because Fannie and Freddie are continuously in the market to purchase mortgage loans, this loan limit has set a benchmark for pricing loans. Loans that do not exceed the limit are more readily salable and can be delivered at lower cost than larger loans.

While Fannie Mae and Freddie Mac use the same basic documents (application, verification forms, mortgage, and note) in processing their loan applicants, there are some differences in the standards applied and the kinds of repayment plans that are acceptable. For instance, Fannie Mae will not accept either ARMs with negative amortization or GPMs if combined with ARMs, while Freddie Mac will accept both but requires at least a 10% down payment. There are no restrictions on who is eligible for a conforming loan other than meeting the minimum standards set by each agency. What makes the procedures a bit confusing is that loan originators may set requirements that are more stringent than those acceptable to the agencies, but they cannot exceed the limitations if the loan is to be sold through either agency.

Like both FHA and VA, a conforming loan must meet certain percentage guidelines covering an applicant's income. The mortgage payment cannot exceed 28% of an applicant's gross income, and other obligations when added to the mortgage payment cannot exceed 36%. Note that for conforming loans, the applicants' gross combined income is used to measure adequacy.

Mortgage Payment

For a conforming loan, the mortgage payment amount is defined as principal, interest, taxes, and insurance (PITI), plus any special assessments that may hold the power of a lien on the property.

Other Monthly Payments

Recognized obligations include installment debt that extends for six months or longer, revolving account payments, and other payments that represent a fixed claim on the applicant's income. Like both FHA and VA, the definition of what comprises a fixed claim on an applicant's income is subject to some interpretation. Many real demands on income, such as food, clothing and taxes, are not included. This does not mean that these costs are overlooked. It is simply that these costs represent considerable flexibility and are expected to be paid from the 64% of an applicant's income that is not designated for mandatory payments.

Example**Conforming Loan Qualification**

Applicant's total gross income		\$3,000
Mortgage payment (PITI)		
Mortgage principal and interest	\$660	
Taxes and insurance	<u>165</u>	
Total mortgage payment		825
Other monthly payments		
Car payment	240	
State and local taxes	<u>90</u>	
Total other payments		<u>330</u>
Total mortgage plus other payments		\$1,155
Ratios:		
Total mortgage payment	\$ 825/3,000 = 27.5%	
Total mortgage and other payments	\$1,155/3,000 = 38.5%	

The figures in this example would disqualify an applicant from a conforming loan. The total mortgage payment ratio of 27.5% falls within the 28% limit for a 90% loan. However, the total of the mortgage payment plus other monthly payments at a 38.5% ratio exceeds the 36% limit for total fixed payments. If either ratio exceeds the limit, the applicant's income does not qualify.

Where Are We Now?

Comparing HUD/FHA, VA, and Conventional Qualifying Housing Ratios

Sam and Sally Summers want to buy a house priced at \$200,000 and will make a 10% down payment. They have total monthly obligations in the amount of \$645. They are both veterans living in the South, so they will examine all available programs. The interest rate for all programs is 5%. The following table lists the minimum family income required to qualify for each program.

HUD/FHA	\$5,150	Ratios 31/43
VA Residual	\$5,275	
VA Income Ratio	\$5,634	Ratio 41
Conventional	\$6,418	Ratios 28/36

Other Conventional Loan Qualifications

With the exception of a fairly new set of standards for "affordable housing" loans, there are few fixed guidelines for conventional loan qualification. When a lender is offering its own deposit assets to fund a loan, it is free to set standards that meet its own requirements. There are some general limitations such as nondiscrimination laws and state usury laws, but perhaps the biggest constraint is the need to attract borrower/customers. Borrowers usually investigate more than one source for loans, and if the qualification standards are unreasonable, there are other sources available. Even when making conventional loans intended to be held in portfolio, many lenders prefer to follow the guidelines for conforming loans in case there is a need to sell the loans at a later date.

Affordable Housing Loans

The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) passed in 1989 expanded the 1977 Community Reinvestment Act to target both regulated and nonregulated lenders. FIRREA sharpened the performance ratings for regulated institutions and required disclosure of what each is doing to meet local credit needs.

Grades ranging from "outstanding" to "substandard compliance" are issued periodically by an institution's regulatory authority and publicized locally. Satisfactory ratings are a prerequisite for regulatory approval of activities including mergers, acquisitions, expansions, and the establishment of new branches.

While satisfactory compliance involves a number of activities, one is to offer a range of residential mortgage, housing rehabilitation, and small business loans. One result of the application of FIRREA is the creation of a new category of conventional loan that targets low- and moderate-income people. The generally accepted definition of *low income* is 80% of the local area's median income and 115% for *moderate income*. Loans are limited to low- and moderate-income families. Some programs limit the maximum purchase price of the house and all include an education course for home buyers. The education course is usually six hours of instruction covering the functions of brokers, appraisers, title companies, and mortgage lenders. The course also explains the responsibilities of owning a home.

Fannie Mae and Freddie Mac, as well as private mortgage insurers such as Radian Group, Inc. and Mortgage Guaranty Insurance Corporation, have shown strong support for **affordable housing loans**. All four of these organizations sell their services to regulated lenders and are interested in assisting them in this particular activity. All have developed special programs for this purpose. Fannie Mae, for example, has a variety of community-oriented programs, such as the following:

- My Community Mortgage®
- HomeStyle® Renovation Mortgage
- Making Home AffordableSM Program

Freddie Mac's affordable housing and mortgage relief programs go by the following names:

- Freddie Mac Relief Refinance MortgageSM
- Home Possible® 97

- Home Possible® AdvantageSM
- Neighborhood Solution® 97

The purpose is not to make risky loans to unworthy borrowers, but rather to recognize that many people simply follow different living practices. Studies have indicated that lower-income families normally pay a higher percentage of their income for housing than others do. Some but not all affordable housing programs will allow a higher ratio of income applied to housing, such as 33% of gross income instead of the 28% or 31% found with other kinds of loans. These families do not normally commit to an overload of other debt, so total fixed obligations are limited to 38% of income—somewhat less than the 43% and 41% found in FHA and VA qualification, respectively.

Many lower-income people prefer to pay bills with cash instead of using checking accounts. To accommodate this practice, these programs accept timely payment of rent and utility bills as evidence of creditworthiness. Cash requirements for closing, a special problem when income is low, can be reduced by allowing some borrowing or acceptance of grants from others. A number of housing agencies and local communities offer support programs that include cash grants.

What has become evident from this particular program in its few years of existence is that the credit experience has been excellent. Low income does not mean poor payment. The higher default rates seen in the recent financial crisis seem to stem from higher-income borrowers, those with poor credit scores, and those who were underwritten using nontraditional credit reviews that are no longer allowed under current affordable housing programs.

Temporary “Making Home Affordable” Programs

Starting in 2006, poor credit and underwriting practices combined with overly aggressive origination-to-distribute mortgage programs were just two of many factors that led to the recent financial crisis. After placing Fannie Mae and Freddie Mac into conservatorship, the federal government was suddenly faced with the need to work in concert with the Federal Reserve Bank and the commercial banking industry to come up with innovative programs not aimed at making new affordable mortgages, but rather, trying to keep existing homeowners in their homes during a prolonged slump in the economy and one of the most severe downturns in

residential real estate prices since the Great Depression. The programs listed below only apply to mortgages that are owned or guaranteed by Fannie Mae and Freddie Mac or serviced by over 100 servicers participating in HAMPSM. These programs have been developed over the period 2008–2014. While the life of these programs is coming to a close, they can be broken down into the following broad categories, followed by a few of the more common programs:

- Lowering borrower payments
 - Programs in effect as of January 2015 are:
 - Home Affordable Modification ProgramSM (HAMPSM)
 - Second Lien Modification Program (2MP)
 - FHA Home Affordable Modification Program (FHA-HAMP)
 - Veteran's Administration Home Affordable Modification (VA-HAMP)
- Lowering borrower mortgage interest rates
 - Programs in effect as of January 2015 are:
 - Home Affordable Refinance Program (HARP)
 - FHA Refinance for Borrowers with Negative Equity (FHA Short Refinance)
- Assistance for unemployed borrowers
 - Programs in effect as of January 2015 are:
 - Housing Finance Agency Innovation Fund for the Hardest-Hit Housing Markets (HHF)
- Assistance for borrowers with poorly constructed second mortgages
 - Programs in effect as of January 2015 are:
 - Second Lien Modification Program (only available to those borrowers with mortgages modified through the Homes Affordable Modification Program listed above)
- Assistance for borrowers with negative equity
 - Programs in effect as of January 2015 are:
 - Home Affordable Refinance Program (HARP)
 - FHA Refinance for Borrowers in Negative Equity (FHA Short Refinance)
 - Housing Finance Agency Innovation Fund for the Hardest-Hit Housing Markets (HHF)

- Foreclosure alternative programs for borrowers
 - Programs in effect as of January 2015 are:
 - Home Affordable Foreclosure Alternatives (HAFASM) Program

Each of the programs above has unique eligibility requirements and provisions, and many are under sunset provisions that are set to expire. Many of the programs below have a requirement that the mortgage be made prior to 2009. These programs will naturally wind down over time since the average mortgage pays off within 12 to 15 years. The success of many of these programs has been the subject of much criticism in the financial press and among industry professionals and investors. For aforementioned reasons, only the most widely used programs—HAMPSM, HARPSM, HHE, and HAFASM—will be discussed in detail below.

HAMPSM

The Home Affordable Modification Program is intended to help borrowers lower their monthly mortgage payment to 31% of their verified monthly gross (pretax) income to make their going-forward mortgage payments more affordable. The typical HAMPSM modification results in a 40% drop in a monthly mortgage payment. The Department of Housing and Urban Development reported in April of 2011 that 18% of HAMPSM homeowners had reduced their payments by \$1,000 or more. The eligibility requirements for a borrower are as follows:

- The mortgagor must occupy the house as their primary residence.
- The mortgage must have been obtained on or before January 1, 2009.
- The current mortgage payment must be more than 31% of the mortgagor's monthly gross (pretax) income.
- The mortgagor can owe up to \$729,750 on the home.
- The mortgagor must show that he or she has a financial hardship and is either delinquent or in danger of falling behind.
- The mortgagor must have sufficient, documented income to support the modified payment.
- The mortgagor must not have been convicted within the last 10 years of a felony, larceny, theft, fraud or forgery, or money laundering or tax evasion, in connection with a mortgage or real estate transaction.

HARPSM

The Home Affordable Refinance Program is intended to help borrowers who are current on their mortgages and have been unable to obtain a traditional refinance because the value of their homes has declined. HARPSM was designed to help mortgagors refinance into new, affordable, and more stable mortgages. The HARPSM mortgage is a new loan and will require mortgagors to make a loan application with normal loan refinancing fees. Applicants must meet all of the following criteria:

- Mortgagor must have a mortgage owned or guaranteed by Fannie Mae or Freddie Mac.
- Mortgage cannot be a FHA, VA, or USDA loan.
- Mortgagor must be current on his or her mortgage payments and have not been more than 30 days late in making a payment over the past year.
- Mortgagor can owe more than the home is worth, but the mortgage cannot exceed 125% of the current market value of the home.
- As refinanced, the mortgage must improve the long-term affordability or stability of the new mortgage (a fairly subjective process).
- Mortgagor must have the ability to make the new mortgage payments.

HHF

The Housing Finance Agency Innovation Fund for the Hardest-Hit Housing Markets was a new program established by the U.S. Treasury Department in early 2010 to provide at least \$7.6 billion in targeted aid to states hit hard by the economic crisis. This program continues to be coordinated with various state housing finance agencies to develop innovative programs to stabilize the local housing markets and help borrowers avoid foreclosure. The Hardest-Hit Fund programs complement the Making Home Affordable® Program, but are not limited to homeowners eligible for Making Home Affordable. The HHF program fund has been allocated to just 18 states plus the District of Columbia¹. The programs vary greatly by state but commonly include the following benefits:

¹Hardest Hit Fund (2015). Making Home Affordable Program. Retrieved on July 14, 2015 at <http://www.makinghomeaffordable.gov/programs/unemployed-help/Pages/hhf.aspx>

- Mortgage payment assistance for unemployed or underemployed homeowners
- Principal reduction to help homeowners get into more affordable mortgages
- Funding to eliminate homeowners' second lien loans
- Help for homeowners who are transitioning out of their homes and into more affordable places of residence

HAFASM

The Home Affordable Foreclosure Alternatives Program is targeting those borrowers who have a mortgage payment that is unaffordable and borrowers who are interested in transitioning to more affordable housing. The typical borrower is eligible for a short sale or deed in lieu of foreclosure through HAFASM. The benefit of a HAFASM short sale is that the mortgagor will no longer be responsible for the difference between what he or she owed on the mortgage and the amount for which his or home sells. The mortgagor will also receive \$3,000 in relocation assistance upon successful closing of any arranged and approved short sale or deed in lieu of foreclosure. For a mortgagor to be eligible for a HAFASM, he or she must meet all of the following criteria:

- Mortgagor must have lived in the home for the last 12 months
- Mortgagor must be able to document financial hardship
- Mortgagor must not have purchased a new house within the last 12 months
- The first mortgage must be less than \$729,750
- Mortgagor must have received the mortgage on or before January 1, 2009
- Mortgagor must not have been convicted within the last 10 years of a felony, larceny, theft, fraud or forgery, or money laundering or tax evasion, in connection with a mortgage or real estate transaction

The requirements and existence of the programs above are handled by the U.S. Treasury Department and the Department of Housing and Urban Development.

Comparison of Qualification Guidelines

Table 9-2 provides a summary of the percentage guidelines found in the four types of loans just discussed.

TABLE 9-2 Summary of percentage guidelines

	Housing Ratio	Fixed Payment Ratio
HUD/FHA	31%	43%
VA	(Not limited)	41
Conforming/conventional	28	36
Affordable housing	33	45

Source: © 2016 OnCourse Learning

COMMERCIAL LOANS

As explained earlier, commercial loans follow a different pattern than residential loans. In most instances, repayment of the loan is expected from the property's income rather than from the borrower's personal income. A creditworthy borrower is still important, but greater emphasis is placed on the property. Furthermore, commercial loans are made primarily to businesses rather than individuals, and detailed financial statements are normally required. These are scrutinized as to the company's profitability and the accumulation of assets over a period of time. Ownership of the company must be examined and information submitted on the principal owners and/or officers and directors. A loan agreement is usually required that spells out certain limitations on the company's operations during the term of the loan. Even though quite different, like all loans, the process for obtaining a commercial loan begins with a loan application.

Commercial Loan Application

No consumer-based protective restrictions on what questions may be asked apply to commercial loan applications. Lenders may develop their own forms to fulfill their need for information since there are no standards. This is one of the reasons why commercial lenders often specialize in the kind of loans they will undertake. Knowledge of a particular kind of property and the business operation involved is crucial to making sound commercial loans. So knowing what kind of information is necessary is reflected in the questions on the application.

The general areas of information covered in a commercial loan application may be listed as follows:

1. Company name, address, and business structure
2. Information on owners or corporate officers and directors

3. Name of contact person
4. Purpose of the loan requested
5. Financial statements for past three to five years, including a balance sheet, a profit and loss statement (P&L), and a pro forma statement showing the impact of the loan on profitability
6. Names of suppliers and banks for credit references
7. Appraisal of the property to be pledged as collateral
8. An environmental assessment of the property
9. Possibly a feasibility study if project is new construction

The listed information above would suffice for a preliminary review of the loan application, but more detail may be required later.

With commercial loans, it is normal for a lender to require an upfront charge to review the application. Some set a rather high fee for new applicants simply to discourage frivolous requests. All costs of information are paid by the borrower.

The review necessary for a commercial loan can be very broad, covering management, sales, production, purchasing, research and planning, and personnel policies, plus the physical plant and equipment. The loan underwriter expects to have current, preferably audited, financial statements presented with the loan application. An *audited statement* is one in which all pertinent data are verified by the certified public accountant preparing the report.

When examining a financial statement, the underwriter looks for a record of profitable use of existing assets; the accumulation of cash, property, and other assets versus outstanding obligations; and the very important working ratio of current assets to current liabilities. A favorable ratio would be at least \$2 of assets for every \$1 of liabilities. The ratio indicates both the manner of operation and the immediate cushion of assets available to protect the company against a temporary reversal.

Creditworthiness of a commercial loan applicant can be determined by contacting the firm's suppliers and bank references (an applicant's permission is required to do so). Also, various credit reporting agencies are sources of commercial credit information. One of the largest is Dun & Bradstreet, which can provide something of a history on some companies as well as a credit rating.

Where Are We Now?

Qualifying a Commercial Loan: The Wistful Vista Apartments

Pro Forma	
Gross scheduled	\$1,200,000
Vacancy and credit loss (5%)	<u>60,000</u>
Adjusted gross income	1,140,000
Operating expenses	<u>684,000</u>
Net operating income (NOI)	456,000
Debt coverage ratio (DCR) required by lender for apartments of this quality	1.20
Loan constant (K) for this type of loan	7.25%
Debt service (DS)	$= \text{NOI} / \text{DCR} = 456,000 / 1.2 = 380,000$
Maximum loan amount = DS / K	$= 380,000 / .0725 = 5,241,379$
	\$5,240,000 (rounded)

To evaluate the results of the loan on the company's finances, it is customary to prepare pro forma statements: both a balance sheet and a profit and loss statement. These statements are a projection of what the loan will do for the company—such as enable it to increase the investment in productivity, add a new product line, provide an additional service, or enter a new market—as well as an estimate of the expected effects on profitability. It is the long-range ability of a company to operate profitably that is the real key to the trouble-free recovery of a loan.

Loan Agreement

Since the ownership and/or management of a company may change during the term of a commercial loan, a separate agreement is usually a part of the loan commitment. The agreement may state how the proceeds of a loan are to be used and can provide penalties for noncompliance. In addition, certain restrictive covenants are often added that limit company policies during the term of the loan. These would include such actions as loans or advances to officers or employees, control over the amount of salary increases, restrictions on the payment of dividends, and limits on any other borrowing. Furthermore, the agreement might require lender

approval before any major assets, patents, or leasehold interests could be sold. All terms of a loan agreement are negotiable and are designed primarily to protect a lender's interest in the company until the loan is repaid in full.

PRIVATE MORTGAGE INSURANCE

Many, many years ago, in the jargon of the mortgage industry, an "insured loan" was simply another name for either an FHA or VA loan. These government-backed insurance programs created a standardization of loan practices and uniform documentation that produced loans readily salable to investors throughout the country. Investors knew in advance what they were buying. Conventional loans—those not covered by government insurance—were not standardized; they remained localized in their procedures and documentation for many years.

During that time period, the lack of standardization was no big handicap because prior to the 1980s, major funding for conventional loans was found in local savings associations and a few banks. As this source of funds declined in the early 1980s, the need for alternate sources to fund conventional loans helped fuel the growth in **private mortgage insurance**. As sources of funds became national, and thus further removed from the geographic location of a mortgage loan, the need for protection against loan defaults increased.

History of Private Mortgage Insurance

The idea of writing an insurance policy to protect a lender against loss in the event of loan default began with the creation of the Federal Housing Administration in 1934. It was not until the 1950s that several entrepreneurs began testing the market for private default insurance coverage for conventional loans. Progress was slow at first, as few lenders required the coverage; after all, if an insured loan was needed, one could simply contact the FHA or VA.

It was not until 1971 that private mortgage insurance became a requirement for higher-ratio conventional loans. In that year, regulatory authorities expanded lending limits for conventional residential loans and required the use of default insurance coverage. The new limits allowed federally chartered savings and loan associations to make loans up to 95% of the appraised value of a house, compared with 90% previously,

provided that loans over 90% were insured. The result was a tremendous growth in private mortgage insurance.

One major pioneering insurance company, Mortgage Guaranty Insurance Corporation (MGIC, called "Magic"), based in Milwaukee, increased its loan coverage volume from almost nothing in 1970 to \$7.5 billion in 1972, with about 40% in 95-percent loans. The private sector topped the FHA coverage in that year and retained its lead until the financial crisis beginning in 2008.

By the end of the 1970s, private mortgage insurance companies had become popular growth companies on the nation's stock markets. More growth meant higher stock values, and many companies overlooked loan quality in the competitive surge for more premium income. The fallout came in 1982 and 1983 when loss ratios increased dramatically due to more foreclosures. A few companies withdrew from the mortgage insurance market, but most tightened their loan qualification requirements and raised premium rates to rebuild their resources, a strategy that was effective until the industry's recent test, the most difficult since the Great Depression, when all private mortgage insurers failed as discussed in Chapter 5.

Private Mortgage Insurance Companies

The very specialized nature of default risk has limited the number of companies offering this kind of coverage. The insurance companies work through various loan originators to sell their coverage. The originator must meet company requirements to be designated as an agent. Agents obtain the necessary qualifying information from a loan applicant for submission to the insurance company underwriter.

Qualifying Information Required

Loan originator/agents use information taken from a borrower's application to prepare a request for coverage to the private mortgage insurance company. The decision to approve or disapprove is made by the insurance company's own underwriters. The insurance company relies on loan originators to submit complete and accurate information on an applicant because response time is fast—within 24 hours—allowing no time for verification. A request for coverage includes submitting: (1) a copy of the loan application, (2) a property appraisal made by an approved appraiser,

(3) a credit report on the borrower, (4) several verifications, and (5) any other data helpful in analyzing the loan.

Amount of Coverage Offered

While private mortgage insurers, FHA, and VA all offer protection against the same risk of default, the amount of coverage differs. HUD/FHA insures 100% of the loan amount, while the VA guarantees only a portion of the loan. Private mortgage insurance carriers issue a variety of policies for residential loans that range from a low of 12% of the loan amount insured to a high of 35%. For example, a 12% insurance commitment limits the insurer to paying only 12% of the original loan amount should default occur.

Term of PMI Insurance

Furthermore, there is a difference in the term of insurance coverage. HUD/FHA and VA offer their commitments for the life of a loan, while private mortgage insurers limit their coverage to a shorter term of years. The range varies from three to 15 years. This means that insurance coverage would terminate at the end of the term regardless of the balance due on the loan.

Types of Property that Can Be Covered

Private mortgage insurance is available for a greater variety of property than with government programs. Residential loans that can be insured include primary residences, second or leisure homes, multifamily properties, mobile homes (if permanently secured and classed as real estate by state law), and modular housing. Commercial loan coverage is available for hotels, motels, shopping centers, office buildings, warehouses, and others. The loans may be participation loans, loans secured by junior liens, and seller-financed mortgages. Each insurance company may set its own standards for the loans it will cover, as there are no national requirements.

Premiums Charged

Because private mortgage insurance usually covers less than the full amount of a loan for a shorter term, the premiums are less than those found with a HUD/FHA loan. As a type of insurance, PMI comes under

the regulation of state insurance commissions in those states with that kind of authority. These states determine insurance premiums, including PMI, as a protective measure for their citizens. The state in which the property is located controls.

Premiums on PMI may be paid as a single premium at time of closing or in installments as an annual premium plan. The premium amount is expressed as a percentage of the original loan amount, measured in "points." If the premium is paid in installments, the charge is simply added to the interest rate.

Because they are a type of insurance, it has been customary to treat PMI premiums the same as other insurance charges—that is, to require two months' worth of premiums to be paid at closing, plus the cost for one year placed in escrow. By 1993, competition had brought a change in this policy. In an effort to reduce the upfront cash requirement for some loans, several companies began offering to drop the one-year escrow requirement and make charges only on a monthly basis.

Up until 2007, the premiums charged for PMI insurance were not deductible from individuals' federal or state income tax returns if they had sufficient itemized deductions to include a Schedule A with their IRS Form 1040. For loans originated in 2006, the federal government, as a way to discourage piggyback mortgage exposure to the GSE, allowed premiums to be tax deductible for those mortgages made in 2007. This provision was set to expire after one year, but it has been extended to cover loans made in 2007 through 2014 as an allowed deduction through 2014, and seems to be renewed annually since it was to have expired in 2011. The homeowner will usually find the amount of private mortgage insurance premiums shown in Box 4 of Form 1098.

Cancellation of PMI Coverage

The normal PMI policy has allowed for payment of premiums for the life of the loan. This has been true even though the coverage may no longer be needed. Lenders have been able to legally collect premiums even though Fannie Mae, for one, has had a rule that allows dropping the insurance when a mortgage balance is paid down to 80% of the original value of the property. A U.S. District Court ruled in 1996 that the Fannie Mae rule is a set of instructions from a lender/principal to a servicer/agent, not a contract between borrower and lender.

Federal legislation passed in 1998, effective July 29, 1999, changed this policy. The law exempts FHA and VA loans and does not preempt any state statutes in effect before January 2, 1998. Lenders are required to notify consumers of their right to cancel PMI when the equity in their homes reaches 20%, if requested by the borrower. In addition, the law provides for automatic cancellation of PMI when the loan reaches 78% of the original LTVR for a conventional loan with private mortgage insurance. FHA has its own new statutes, as discussed in Chapter 8, when HUD Mortgagee Letter 13-4 was issued. To cancel the MIP for FHA mortgages, the following criteria must be met:

- Loans with terms less than or equal to 15 years and LTVs of less than or equal to 78% require MIP in place for 11 years.
- Loans with terms less than or equal to 15 years and LTVs of greater than 78% or less than 90% require MIP in place for 11 years.
- Loans with terms less than or equal to 15 years and LTVs of 90% or greater require MIP in place until to the end of the loan term, or when it is paid off.
- Loans with terms greater than 15 years and LTVs of less than or equal to 78% require MIP in place for 11 years.
- Loans with terms greater than 15 years and LTVs of greater than 78% or less than 90% require MIP in place for 11 years.
- Loans with terms greater than 15 years and LTVs of 90% or greater require MIP in place until the end of the loan term, or when it is paid off.

Who Determines the Need for PMI?

The answer is lenders, not borrowers. The need is based on risk: the larger the down payment, the lower the risk. A general rule of lenders is that loans with 20% or more down payment (80% loan-to-value) are not required to carry PMI. (The federal regulator limit is that loans over 90% loan-to-value must carry PMI.)

In practice, the borrower has little voice in the selection of coverage or the insurance carrier, as that decision is made by the loan originator. This is because it is the lender who is protected by the insurance, not the borrower. What the borrower gains is an easier qualification for perhaps a larger loan and a lower down payment than might otherwise be available.

PMI Obligations in the Event of Foreclosure

Even though PMI coverage is limited to a percentage of the loan amount, insurance companies have generally followed a practice of reimbursing the lender in full on a mortgage loan should foreclosure become necessary. By taking title to the foreclosed property, the insurance company relieves a lender of any further problems. This is one of the settlement options offered by PMI carriers. The purpose, of course, is to make the insurance coverage more competitive in a market that places a high value on service. As foreclosure problems escalated in some parts of the country, many insurers were forced to limit their exposure to the legal obligation contained in the insurance contract—that is, to reimburse the lender for the amount of the loan actually covered.

Lenders and borrowers should be assured that the mortgage insurance companies with which they do business are highly rated both from a financial standpoint and from a claims paying ability. The recent financial crisis has seen the demise of several large private mortgage insurance firms as a result of the large number of failed mortgages and lower market price of residential real estate during that time. Many of the companies taken over by their state insurance regulators have only paid a percentage of legitimate claims made. Investors that counted on the insurance to shield them from losses failed.

Indemnification Clause

Another obligation often overlooked, and not very well understood by borrowers, is the indemnification clause in many private mortgage insurance policies. What this clause means is that if the insurance company suffers a loss in the settlement of a claim with a lender (when the loan balance due exceeds the value of the property), the borrower is liable for reimbursement of the loss. Remember, the insurance protects the lender against loss. And unlike many other kinds of insurance, the insurance company holds the borrower responsible for repayment of any loss. While the indemnification clause is clearly stated in the body of policies, it is not usually carefully explained to a possibly unwary borrower. However, recovery of such a loss against a borrower/debtor who has just lost his or her home is not always feasible.