



# Residential Real Estate Lending

## Product Development

### **205 Underwriting Standards**

#### **205.01 General Statements**

This section describes the Bank's mortgage underwriting guidelines for residential loans. These guidelines are designed to assist Underwriters in making sound underwriting decisions in granting credit for mortgages. Mortgages that the Bank originates are to be repaid through regular monthly payments. Therefore, mortgages are to be secured by properties that are owned by borrowers who can be expected to repay the debt in a timely manner.

Underwriters are to provide sound rationalization for both approving and declining a loan application. For every loan decision, the Underwriter in his or her comments must address the following loan characteristics:

- borrower's ability to repay the debt
- borrower's willingness to repay the debt
- whether the borrower has sufficient assets for reserves and closing
- whether the property affords adequate security

The items that are used to analyze a borrower's credit worthiness include the DU Findings Report, a three-in-file merged credit report and the Fannie Mae Form 1003 ("loan application"). The initial loan package should include the following documentation:

- Completed Loan Application
- Completed Appraisal Report
- One current pay stub per salaried applicant and W-2(s) for one (1) year
- Signed copies of the most recent federal income tax returns with all schedules and W-2 forms for each applicant that is self-employed or commissioned
- Copy of monthly checks, award letter and 1099 forms for each applicant that receives retirement, disability and/or other applicable income
- A copy of the contract of sale for purchase transactions
- IRS Form 4506T
- Most recent bank statement and /or broker/investment statements
- Deed (refinances)
- Survey

From these and other documents including income and asset documentation, information can be gathered to establish the three main credit factors in determining loan eligibility: (1) income stability (2) assets and (3) credit reputation.



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### **205.02 Stable Income**

An applicant must have a history of receiving stable income from employment or other sources and there must be a reasonable expectation that the income will continue to be received in the foreseeable future (usually for three years). The Borrower's income from all sources should be analyzed and may include the following:

- income from employment
- income from self-employment
- secondary income
- real estate income
- alimony, child support or maintenance payments
- any other income.

#### ***Income from Employment***

A borrower who has demonstrated income stability or is in a line of work in continuing demand where advancement is possible, may be viewed favorably, provided an ability to manage financial affairs has been demonstrated. Education or training may be used as a compensating factor for a shorter length of employment and/or gaps in employment history. A borrower who has changed jobs in the same line of work as a result of new and better opportunities may be viewed favorably. Job changes are recognized as normal in some lines of work, although frequent job changes without advancement or from one line of work to another lead to unstable income; however, if stable income has been maintained by the borrower over the recent past, job changing may not normally lead to unfavorable consideration. Each situation should be reviewed on a case-by-case basis.

#### ***Secondary Income***

Secondary income, such as bonuses, commissions, overtime or part-time employment, is recognized if such items are typical of the occupation. Such income must be substantiated by the borrower's previous two-years' earnings and tax returns or the income documentation noted on the DU Findings Report. A determination should also be made whether continuation of the income is probable based on foreseeable circumstances. Many families rely heavily on secondary income, and care should be taken that evaluation of such income does not artificially restrict opportunities for home financing. In most cases, verification of all income for the previous two years is required.

If employment is seasonal (e.g., construction), at least two years' tax returns and/or W2 Forms will be required to evaluate income.



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### ***Income from Self-Employment***

In cases where a borrower is self-employed, the minimum documentation required for verification of income is two years' signed, completed Federal income tax returns, or the income documentation required by the DU Findings Report. These documents should evidence that the net income of the borrower is consistent with that stated in the application, and that the business can reasonably be expected to continue to support this net income.

### ***Real Estate Income***

Income and debt on improved real estate needs special consideration. The loan application contains a section in which income and expenses are itemized. The net rental income from such real estate is entered in the "Gross Monthly Income" section of the application and must be substantiated by signed leases or tax returns. The Underwriter must relate the type of property to the net income. Generally, a single-family house will generate income, which essentially offsets the mortgage and operating expenses, unlike multi-family units, which generally provide greater net cash income. The Underwriter should be familiar with vacancy rates and expenses, which can materially offset net income and affect the marketability of the property. Analysis of a borrower with significant real estate holdings may require consideration of net cash flows rather than gross income and expenses. If the borrower has substantial equity in properties, which are not producing net income, then the monthly obligations are not to be considered as stringently as consumer or other unsecured debt. The real estate could conceivably be liquidated and the borrower relieved of the installment obligation without the credit position being jeopardized.

### ***Alimony, Child Support or Maintenance Payments***

This income will be considered if the borrower consents to having such income used for qualification under the Bank's credit standards, and if it is likely to continue. If included, it must be verified by written court decree or agreement plus confirmation that payments are being made on a continuing basis. Factors used to determine the likelihood of continued payments include the length of time payments have been received, and the ages of the children.

### ***Other Income***

Except where there is a doubt that the borrower has reached the legal age to enter into a contract, age is not a criterion for rejection of a loan. If the borrower is about to retire, or is retired, the underwriting should be based upon retirement income.

Investment income may be considered, provided confirmation is made by the broker holding the securities or by tax returns or as required by the DU Findings Report. Care should be taken not to include income that would cease if investments were liquidated in order to provide the down payment and/or settlement costs.



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Pension and disability income can be verified by a copy of the pension or disability award that the recipient has received. Increases, such as COLAS, can be verified by a copy of a recent check. It is necessary to demonstrate that the pension is to continue into the future.

Verification of income information is required in all cases. In the analysis of the borrower's income, the Underwriter may recognize all, none or a portion of the income, depending on the documentation provided. If the presentation is inadequate, the Underwriter cannot make an intelligent analysis, and such inadequacy could be a basis for rejection of the loan.

Nontaxable income, such as child support, social security benefits, disability retirement payments, workers' compensation benefits, certain types of public assistance payments, food stamps, etc., and any other income permissible by secondary marketing guidelines will be grossed-up by a factor of 25% once it is determined that the particular source of income is nontaxable. A borrower's tax returns must be obtained for verification of nontaxable income.

### **205.03 Assets and Funds for Closing**

Accumulation of financial assets is a strong indication of creditworthiness. A borrower who has accumulated substantial financial assets from earnings and savings has demonstrated an ability to manage financial affairs. If the assets are liquid, they can be used to service the debt, pay unusual obligations or protect against short-term income interruptions.

#### ***Funds to Close***

It is essential that the availability and sources of all assets required for down payment and closing costs be verified. These written verifications should evidence sufficient liquid assets to consummate the transaction. The Underwriter should require these verifications for all loans before arriving at a final decision. It is considered good lending practice to investigate further if the verification indicates that the account was recently opened, a large deposit was recently received or the account balance has averaged considerably less during the previous few months. Any of these could be indications of borrowed funds. If the borrower is selling a property (which must be indicated under "Schedule of Real Estate Owned"), the difference between "Present Market Value" of the property and the "Amount of Mortgages and Liens" plus the selling expense of the property may be considered an asset to apply to the cash payment and other costs.



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### *Gifts*

The availability of funds from a gift must be verified. A gift for any portion of the cash required of the borrower in the transaction must be confirmed in writing by the donor. In addition to the amount of the gift, the donor's letter must include name and address of the donor, the relationship to the applicant, address of the property being purchased and the statement that no repayment is required or the documentation required by the DU Findings Report. Receipt of the gift must be verified by the applicant prior to closing. Underwriters must remember that some investors require a 5% minimum cash down payment by the borrower.

### *Liabilities and Pledged Assets*

The liabilities of the borrower should be considered in relation to the assets and credit history of the borrower. A borrower who has demonstrated the ability to manage financial affairs may be given favorable consideration. The relationship between assets and liabilities can give the underwriter insight into whether or not a borrower has been or will be overextended.

If there is an increase in a borrower's "Monthly Housing Expense" over previous housing expenses and there are constant or increasing liabilities, the borrower may be operating at a break-even point or less, and a potential credit problem may exist. Additionally, a borrower who continually increases liabilities through refinancing and debt consolidation may be a credit risk. Evidence of increasing debt over an extended period without a compensating increase in income is generally a sign of credit weakness.

The Underwriter should pay close attention to the purpose of any recent debts as the indebtedness could have been incurred to obtain a portion or all of the required down payment. Borrowing on the security of other assets may be acceptable when the terms are disclosed and considered in the underwriting process.

### **205.04 Credit History**

The Bank requires a three-in-file merged credit report and must maintain a printed copy of the credit report used by DU in the permanent loan file. The Bank must request credit scores for each borrower when ordering a credit report. The Credit Scores are produced from software developed by Fair Isaac Corporation (FICO). In addition, the Bank is required to provide each borrower with a credit score as soon as is reasonably possible. (*See EXHIBIT III – Credit Score Information Disclosure*)

A copy of the borrower's credit report is attached to the Credit Score Information Disclosure.



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Each loan applicant must have at least one credit score in order to generate a recommendation thru DU. If the loan applicant does not have a credit score, the DU Findings will indicate an Out of Scope recommendation, which means that the loan must be manually underwritten outside of DU.

A weak credit reputation may be offset by other factors in the application such as the nature and/or tenure of employment, education, down-payment amount, or reserves.

In all instances where derogatory credit information is received, a satisfactory written explanation must be obtained from the applicant unless it is not required on the DU Findings Report. In general, if there was a bankruptcy, the applicant's explanation must be supplemented with a copy of the petition, schedule of debts and a copy of the discharge in bankruptcy with schedule of debts discharged, or whatever the DU findings may require. In all cases, the Underwriter must confirm that the bankruptcy was discharged at the time of the loan application.

### **205.05 Ratio Analysis**

Although the following ratios are used as a basis for underwriting mortgage loans, Desktop Underwriter (DU) does not use these in determining the underwriting findings.

The Bank uses two standard ratios as an analysis tool in underwriting:

- monthly housing expense/stable monthly income and total monthly debt payments/stable monthly income.
- the standard ratios of 41/43 are used when qualifying a borrower. . No exceptions to the debt ratios will be permissible.

### ***Monthly Housing Expense***

Monthly housing expense is the sum of the principal and interest payments on the mortgage, hazard insurance premium, real estate taxes and, if applicable, private mortgage insurance, homeowners' association dues (excluding unit utility charges), ground rents (leasehold payments), flood insurance and public water and sewer charges. Utility charges are not included in the housing expense since such charges vary because of differences in utility rates, family size and living style. Consideration must be given to the energy efficiency of the property, especially those items which will reduce energy related costs on the property, thus permitting a greater portion of the borrower's income to be applied to housing expenses. The monthly housing expense should not exceed 41 percent of the stable, verified monthly income of the qualified borrowers.



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Higher ratios may be justified by other compensating factors, such as:

- demonstrated ability of the borrower(s) to devote a greater portion of income to basic needs, such as housing expense;
- demonstrated ability of the borrower(s) to maintain a good credit history, accumulate savings and maintain a debt-free position;
- a large down-payment on the purchase of the property;
- and the potential for increased earnings of the borrower(s) indicated by education or job training relative to the time employed or practiced in the profession.

### *Monthly Debt Payments*

Total monthly debt payments are the sum of the monthly housing expense, payment of installment and revolving debt regardless of the number of remaining payments and alimony, child support or maintenance payments. The total monthly debt payments should not exceed 43 percent of the stable monthly income of the borrower. No exceptions will be considered.

### *Underwriting with Desktop Underwriter*

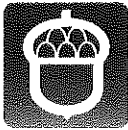
Desktop Underwriter (DU) is an automated underwriting system that uses the Fannie Mae "Selling Guide" rules and streamlined processing requirements to produce fast, objective recommendations and reduce underwriting time. This automated system is used for the majority of the Bank's residential products as a guideline to underwriting. There is an embedded interface between the Bank's origination system and Fannie Mae's system.

Desktop Underwriter provides a recommendation to "approve" the loan or "refer" it to a Bank Underwriter. The recommendations are delivered on the "Underwriting Findings Report." This report includes detailed back-up information with reference to the relevant sections of the Fannie Mae "Selling Guide."

The files are documented based upon the conditions as stated in the Underwriting Findings Report.

There are six recommendations which may be given by DU on the "Findings Report":

1. Approve/Eligible - the loan meets Fannie Mae's credit risk and eligibility requirements.
2. Approve/Ineligible - the loan meets the credit risk requirements, but is not eligible for sale.
3. Refer/Eligible - the loan does not meet the credit risk as defined by DU, but should be reviewed by a Bank underwriter to determine if the loan meets the requirements as described in the "Selling Guide". The loan is eligible for sale to Fannie Mae.



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4. Refer / Ineligible - the loan should be reviewed by a Bank underwriter and is not eligible for sale to Fannie Mae.
5. Refer with Caution - DU has evaluated a combination of risk factors based on the data submitted and does not appear to meet the credit risk requirements of DU.
6. Out of Scope - DU does not contain the rules or models necessary to underwrite the products, borrower or type of loan submitted.

#### ***Underwriting Criteria for Short-Term ARMs***

In compliance with FNMA requirements, ARMs (Adjustable Rate Mortgages) are now to be approved based on the following criteria:

<u>Product</u>	<u>Qualifying Rate</u>
1/1, 3/1, 3/3, and 5/1 ARMs	Greater of Note Rate plus 2 Points, or the Fully Indexed Rate
Example: 4.05 Index + 2.75 Margin = 6.80 Fully Indexed Rate vs. 6.125% Note Rate plus 2% = 8.125%. In this case the borrower is to be qualified at 8.125%.	
7/1, 10/1 and 15/1 ARMs	Greater of Note Rate, or the Fully Indexed Rate

Example: 4.05 Index + 2.75 Margin = 6.80 Fully Indexed Rate vs. 6.125% Note Rate. In this case the borrower is to be qualified at 6.80%.

**For additional information on underwriting - please see FNMA's Guide for Underwriting with Desktop Underwriter.**