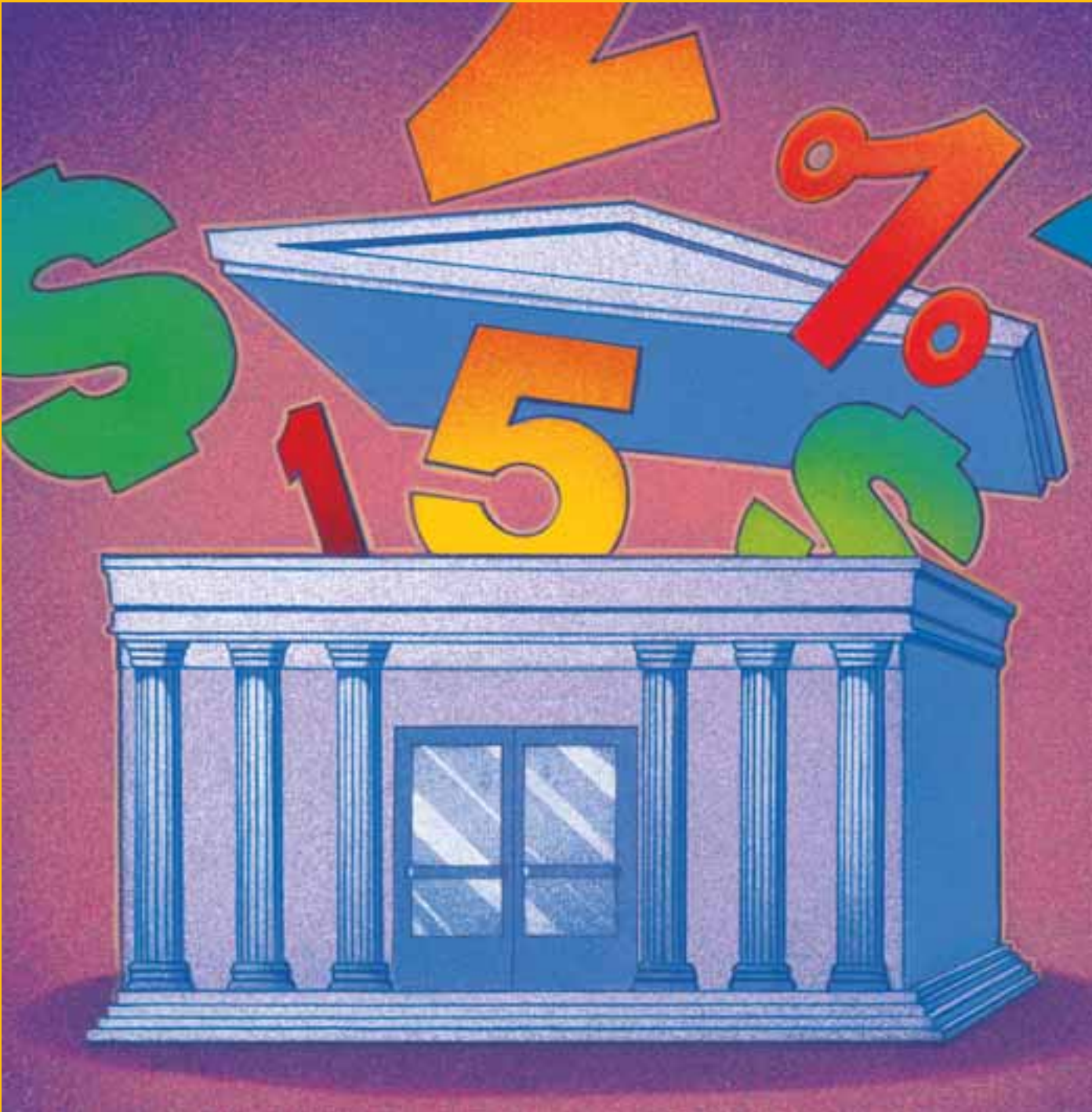


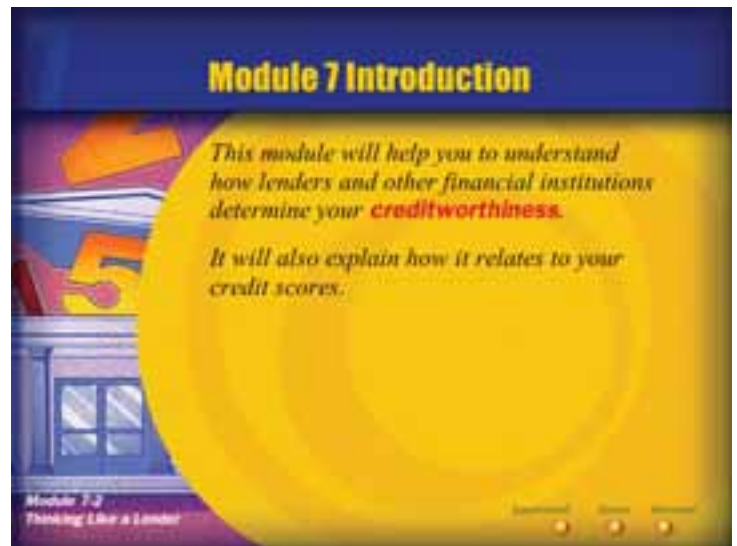
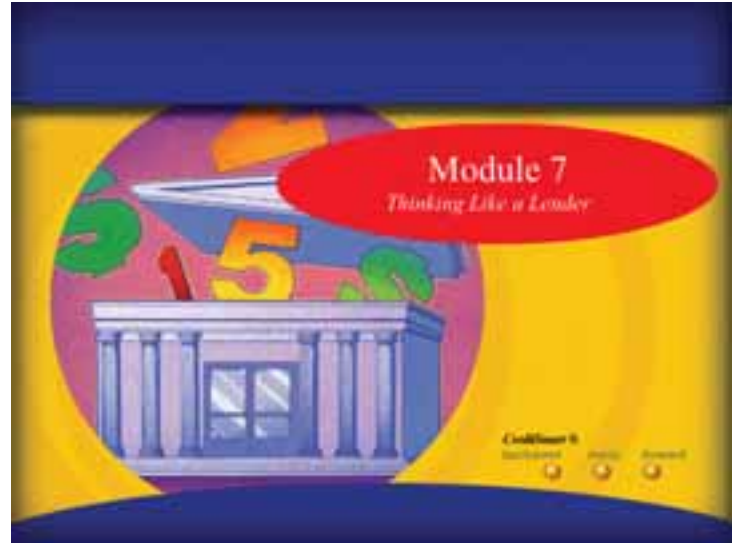
Module 7
Thinking Like a Lender

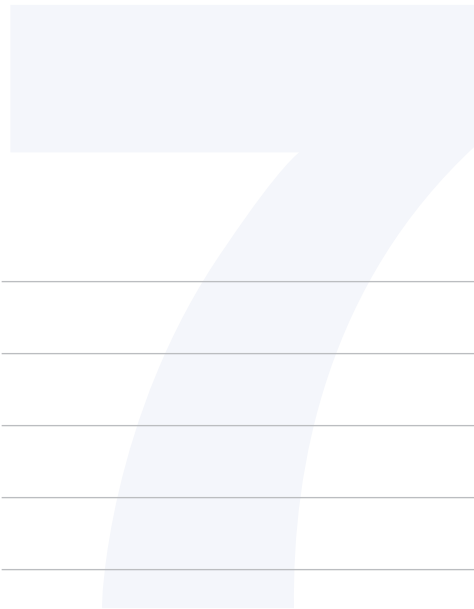


Module 7: Thinking Like a Lender

► Presentation Slides

Module 7





Capacity (Income)

Does the potential buyer have sufficient income to repay the loan?

Module 7.4
Thinking Like a Lender

Capital (Cash Reserves)

Capital refers to **cash reserves** (savings), investments, property or assets possessed by an individual that may be liquidated.

Module 7.4
Thinking Like a Lender

Credit (Credit Usage and Payment History)

Lenders will review an applicant's credit history to determine overall creditworthiness.

Module 7.4
Thinking Like a Lender

► **Verifying Income Through Tax Returns**

One of the ways that lenders verify your income is by reviewing your annual federal income tax returns. Administered by the Internal Revenue Service (IRS), income taxes are imposed on people living in the U.S. more than 180 days a year. As such, the IRS considers you a resident and the money you make in the U.S. is fully taxable. You can obtain a tax identification number even if you do not have a Social Security number from the IRS. A tax identification number will serve as a way to record your income and file a tax return.)

If you work for an employer, a certain portion of your pay will be subject to “withholding” and be remitted directly to the federal and state governments before you receive your paycheck. If you work for yourself, you are expected to make estimated tax payments in advance to the IRS and state tax department on a quarterly basis.

On April 15 each year, you are required to file a tax return with the IRS for the previous year. The return will list your income and any allowable deductions or credits against that income. Once calculated, you will either owe more money in taxes or you will get a refund made up of the surplus tax dollars that you paid.

Note: If you earn a low or moderate annual income, you may qualify for a special tax benefit administered by the IRS. Known as the Earned Income Tax Credit (EITC), it is the largest federal aid program targeted to people with low- and moderate-incomes. Millions of taxpayers currently benefit from the tax credit annually yet many people who are eligible don't know it exists, how to qualify, or how to claim it.



People who qualify for EITC and file a federal tax return can get back some or all of the federal income tax that was taken out of their pay during the year. They may also get cash back from the IRS. Even people whose earnings are too small to owe income tax can get the EITC. For more information, contact the IRS 24-hour information line at **800-TAX-1040** or visit **www.irs.gov**.

If you do not file income taxes in the U.S., begin doing so right away. It is an important way for lenders to document your income and income history so that you can obtain a loan or mortgage on a home. And, if you file your annual tax returns and end up qualifying for a refund, it will certainly brighten your day.

Lenders, especially in the case of mortgage lenders, will carefully consider “ratios.” Ratios are calculations or percentages of the amount of your gross monthly income which may be paid for monthly debts.

► **Calculating Your Debt-to-Income Ratio**

Within the credit industry, it is commonly stated that your expenses (excluding a home mortgage) should not exceed more than 20% of your take-home (net) income.

In other words, if your take home (net) income is \$2,000 per month, your total monthly debt payments, such as car loan payments, credit card payments, student loan payments, etc., should not exceed \$400 per month ($\$2,000 \times .20 = \400).

Debt-to-Income Calculation: Net Monthly Income times 0.20 = MAXIMUM monthly debt.

For Example: If a person’s net monthly income is \$2,500, then to determine the maximum monthly debt payments, take $\$2,500 \times .20$ which equals \$500. (In this example, no more than \$500 per month should be spent on monthly debts.)

Obviously, the less debt you have, the stronger your application, and the better your chances of securing credit at favorable terms.

Although it depends on the type of mortgage product, a typical home mortgage qualifying ratio is 28/36. This means that no more than 28% of your gross monthly income can be used to pay for your principal, interest, property taxes, and insurance (PITI). Furthermore, no more than 36% of your gross monthly income can be used to pay for your PITI **AND** your monthly debts combined.

It is also important to note that in addition to PITI, home buyers who pay less than 20% down may be required to purchase mortgage insurance. If using an FHA loan product, the cost of the insurance is called the Mortgage Insurance Premium (MIP). Conventional loans with less than a 20% down payment may require Private Mortgage Insurance (PMI). These added insurance costs will increase the amount of your monthly payment. The annual mortgage insurance premium may be canceled when the mortgage amount is reduced to 78% or less (for FHA) and 80% or less (for conventional) of the property value.

The *Mortgage Affordability Worksheet (Example #1)* below provides a simplified example of how the mortgage affordability requirement is calculated and used as part of the process to qualify for a mortgage. In this example, An Li earns \$36,000 per year (\$3,000 per month). An Li's long-term debt payments (payments which need to be made for more than six remaining months) include her car loan, a school loan, and monthly credit card minimum payments totaling \$600 per month.

► **Mortgage Affordability Worksheet**

Example #1

Step #1:

Gross Monthly Income		\$ 3,000
Times 28% (this percentage varies with the type of loan product)	x	0.28
Equals	=	\$ 840

Step #2:

Gross Monthly Income		\$ 3,000
Times 36% (this percentage varies with the type of loan product)	x	0.36
Equals	=	\$ 1,080
Minus monthly long-term debt*		- \$ 600
(* long-term debt = remaining payments exceeding six months)		
Equals	=	\$ 480

Step #3:

The lesser of the two results from Step #1 and Step #2 (\$840 and \$480 respectively) is the maximum amount that An Li would be able to qualify for as a mortgage payment (PITI: principal, interest, taxes, and insurance).

Note that despite An Li's level of income, her debt has greatly reduced her ability to qualify for her full potential mortgage payment of \$840.

In the next example, let's assume that An Li earns \$36,000 per year (\$3,000/month) and that her long-term debt payments total \$175 per month.

► **Mortgage Affordability Worksheet**

Example #2

Step #1:

Gross Monthly Income		\$ 3,000
Times 28% (this percentage varies with the type of loan product)	x	0.28
Equals	=	\$ 840

Step #2:

Gross Monthly Income		\$ 3,000
Times 36% (this percentage varies with the type of loan product)	x	0.36
Equals	=	\$ 1,080
Minus monthly long-term debt*		- \$ 175
(* long-term debt = remaining payments exceeding six months)		
Equals	=	\$ 905

Step #3:

The lesser of the two results from Step #1 and Step #2 (\$840 and \$905 respectively) is the maximum amount that An Li would be able to qualify for as a mortgage payment (PITI: principal, interest, taxes, and insurance).

Note that in this example, because of the reduction of An Li's debt, she would be able to qualify for her full potential mortgage payment of \$840.

The following *Mortgage Affordability Worksheet* has been left blank for you to use it and calculate your own mortgage borrowing potential.

► **Mortgage Affordability Worksheet**

Step #1:

Gross Monthly Income	\$
Times 28% (this percentage varies with the type of loan product)	x 0.28
Equals	= \$

Step #2:

Gross Monthly Income	\$
Times 36% (this percentage varies with the type of loan product)	x 0.36
Equals	= \$
Minus monthly long-term debt*	- \$
(* long-term debt = remaining payments exceeding six months)	
Equals	= \$

Step #3:

The lesser of the two results from Step #1 and Step #2 is the maximum amount that you would be able to qualify for as a mortgage payment, (including principal, interest, taxes, and insurance) using a qualifying ratio of 28/36.

Feel free to use this form to calculate various qualifying scenarios by increasing and decreasing your

▶ Sample Debt Worksheet

This worksheet provides a sample listing of an individual's debts (financial obligations) which are normally paid on a monthly basis, such as car loans, student loans, credit cards, or other loans. It also indicates the interest rate, the monthly payment amount, and the remaining balance owed.

Use this worksheet as a sample to help you complete the blank Debt Worksheet on the following page. Include only the debts that have more than six monthly payments remaining.

A. Name or Type of Account	B. Interest Rate	C. Monthly Payment Amount	D. Remaining Balance Owed
Auto Plus Car Loan	12.5%	\$265.80	\$9,376.53
Student Loan Services	6%	\$110.00	\$3,249.23
Furniture One	10%	\$60.00	\$1,171.19
The Audio Store	18%	\$35.00	\$367.98
Visa	22%	\$43.00	\$860.13
TOTAL MONTHLY DEBT PAYMENTS: (add the numbers in column C)		\$513.80	
TOTAL INDEBTEDNESS: (add the numbers in column D)			\$15,025.06

► **Sample Cash and Asset Worksheet**

This worksheet provides a sample listing of an individual's cash and assets. Use this worksheet as a sample to help you complete the blank Cash and Asset Worksheet on the following page.

Lenders who calculate your net worth, will generally average your checking and savings balances over the past three months.

Type of Account or Asset	Account Name and Account Number	Account Balance
Checking account(s)	Citiwide Credit Union 432110573	\$ 567.29
		\$
Savings account(s)	Citiwide Credit Union 799321449	\$ 2,763.22
		\$
		\$
Mutual funds, stocks, and bonds	Techworld International (stock) 8219-039	\$ 1,344.29
	Investment Inc. (mutual funds) 143922-4	\$ 3,847.87
	U.S. Savings Bonds (EE Series)	\$ 1,200.00
		\$
Cash value of life insurance policy(s)	Life Assured 2917742	\$ 3,241.33
		\$
Other liquid assets	Car	\$ 8,200.00
	Motorcycle	\$ 1,200.00
		\$
Total Net Worth:		\$ 22,364.00

► **Cash and Asset Worksheet**

This worksheet will help you to determine your net worth.

Lenders who calculate your net worth, will generally average your checking and savings balances over the past three months.

Type of Account or Asset	Account Name and Account Number	Account Balance
Checking Accounts		\$
		\$
Savings Accounts		\$
		\$
		\$
Mutual funds, stocks, and bonds		\$
		\$
		\$
		\$
Cash value of life insurance policy(s)		\$
		\$
Other liquid assets		\$
		\$
		\$
Total Net Worth:		\$

► Sample Financial Statement

This worksheet contains the types of information most commonly requested by lenders when making application for credit.

Amount Requested	
Purpose of Loan	

1. Co-Applicant/Applicant 18 and Over Information

Name	
Date of Birth	
Social Security Number	
Driver's License Number	
Street Address	
City	
State	
Zip	
Years at Current Job	
Home Phone	
Number of Dependents	
Previous Address <i>(if less than five years at present)</i>	
City	
State	
Zip	
Years There	
Employer's Name	
Employer's Address	
Position	

Business Phone	
Years There	
Annual Salary	
Other Income	
Previous Employer	
Position	
Annual Salary	
Years There	
Nearest Relative Not Living With You	
Address	
Phone	

2. Additional Co-Applicant

Name	
Date of Birth	
Social Security Number	
Street Address	
City	
State	
Zip	
Years There	
Home Phone	
Employer's Name	
Position	
Business Phone	

Years at Current Job	
Annual Salary	
Other Income	

3. Bank References

Bank	
Checking Account Number	
Bank	
Savings Account Number	

4. Assets

Cash, Savings, Checking, Money Market Funds	
Stocks and Bonds	
Real Estate Owned	
Car	
Other	
Total Assets	

5. Liabilities (Credit Obligations)

Home Financed by: (OR) Rented From:	
Account Number	
Original Amount	
Balance	
Monthly Payment	
Car Loan Held By	
Account Number	

Original Amount	
Balance	
Monthly Payment	

6. Other Credit Obligations (Loans, Credit Cards, etc.)

Company	
Amount Owed	
Monthly Payment	
Company	
Amount Owed	
Monthly Payment	
Company	
Amount Owed	
Monthly Payment	
TOTAL AMOUNT OWED	
TOTAL MONTHLY PAYMENTS	

Have you ever been the subject of a bankruptcy proceeding or are there any unsatisfied judgments against you?
(Yes or No)

Everything I have stated in this application is correct to the best of my knowledge. I understand that XYZ Bank will retain this application whether or not it is approved. I authorize the bank to check my credit and employment history and to answer future questions about its credit experience(s) with me.

Signature: _____

