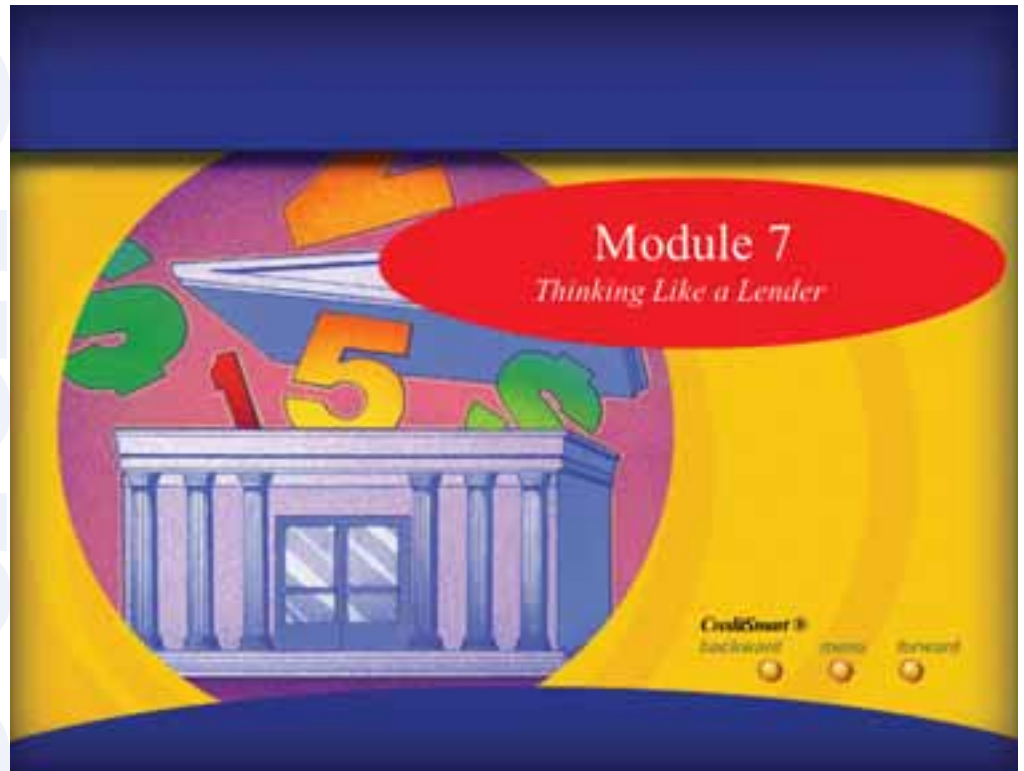


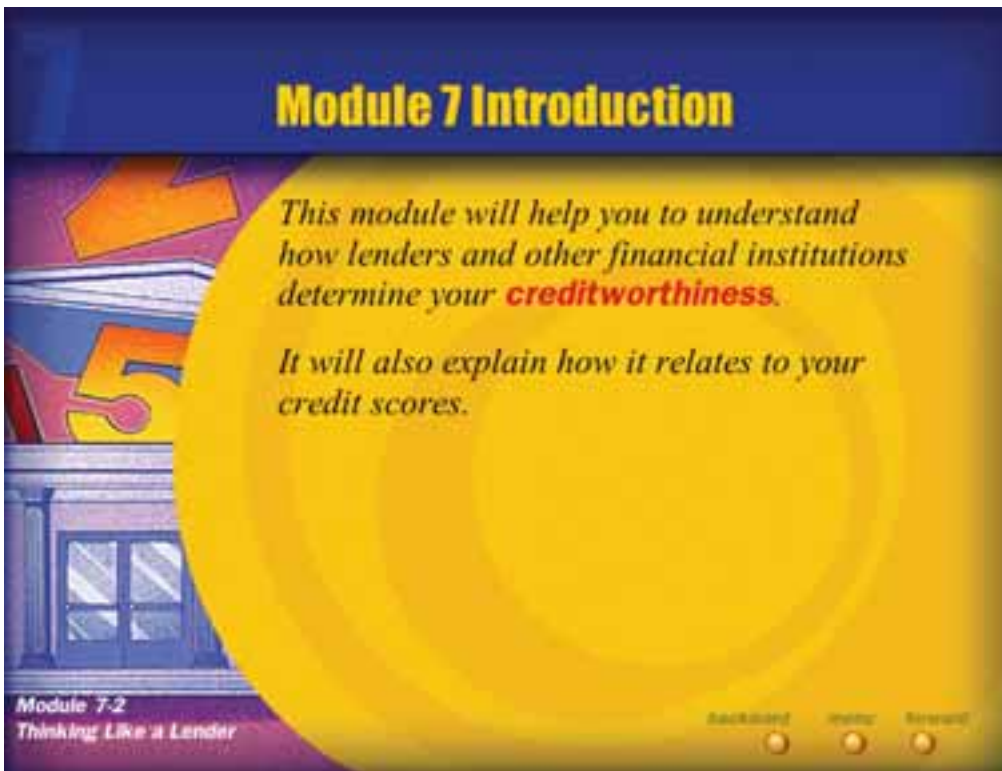
Module 7
Thinking Like a Lender





Module 7: Thinking Like a Lender

Although this module is fairly short, it contains some critical information regarding credit through the eyes of a lender.



Module 7 Introduction

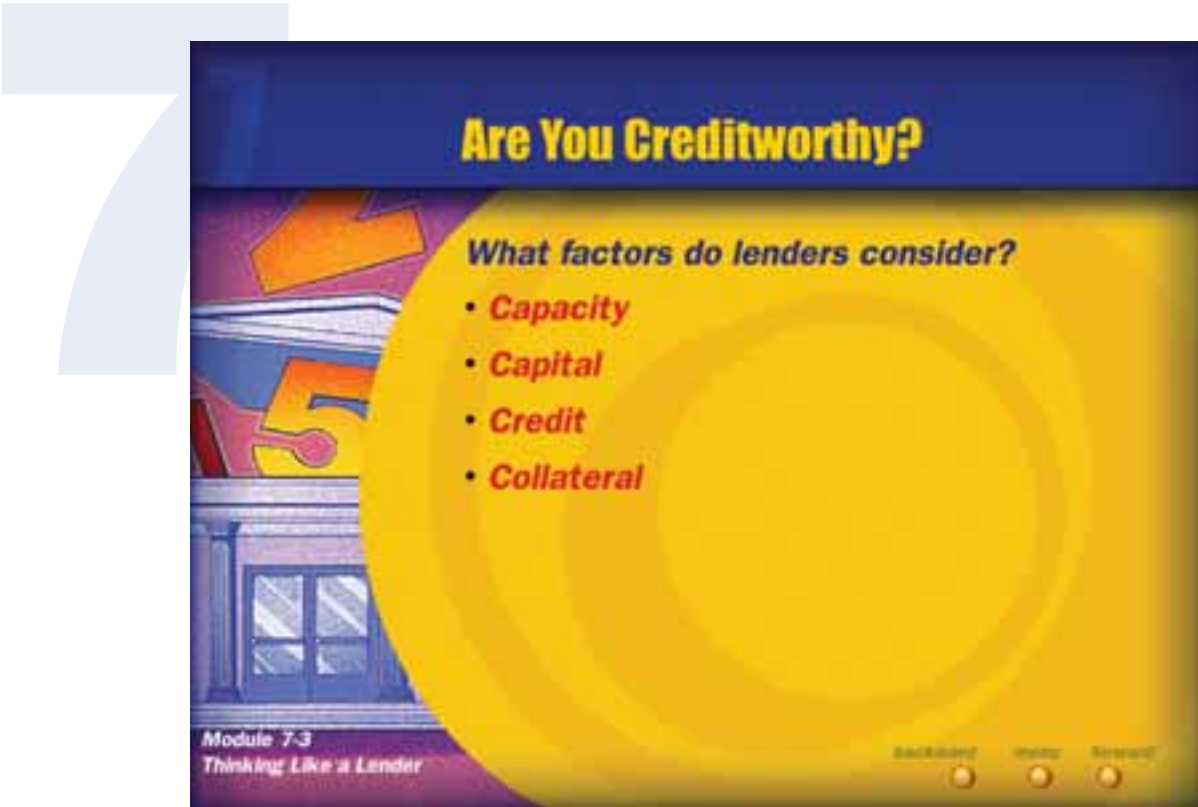
This module was developed in an effort to help you to better understand some of the key credit-related factors evaluated by creditors and lenders.

Consumer Workbook Materials for Module 7: Thinking Like a Lender

- *Verifying Income Through Tax Returns* (page 113)
- *Calculating Your Debt-to-Income Ratio* (page 114)
- *Mortgage Affordability Worksheets* (pages 115–117)
- *Debt Worksheets* (pages 118–119)
- *Cash and Asset Worksheets* (pages 120–121)
- *Sample Financial Statement* (pages 122–125)

These materials are also included in *Your Credit, Your Home, and Your Future* for Module 7: Thinking Like a Lender

- *Debt Worksheets* (page 41)

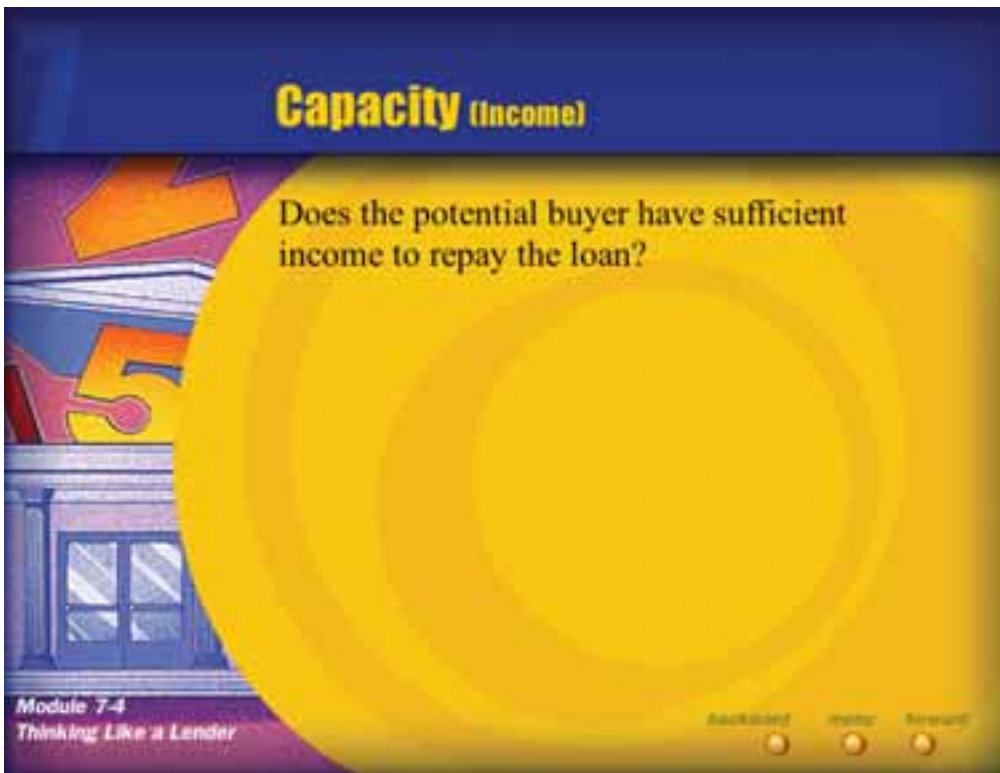


Are You Creditworthy?

Take a minute and think about the following questions:

- What does creditworthy mean to me?
- Can anyone obtain credit? If so, at what cost?
- Is credit a right or a privilege? Do lenders owe me a loan (money)?

Very simply put, lenders and creditors consider four primary factors. These include capacity, capital, credit, and collateral. Each of these factors is examined further on the following four slides.



Capacity (Income)

Your capacity is critical to the approval of a loan—that is, is your income sufficient to make the monthly payments?

With the extension of credit, lenders and creditors want to feel confident that you have adequate income to take on new or additional debt.

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.)

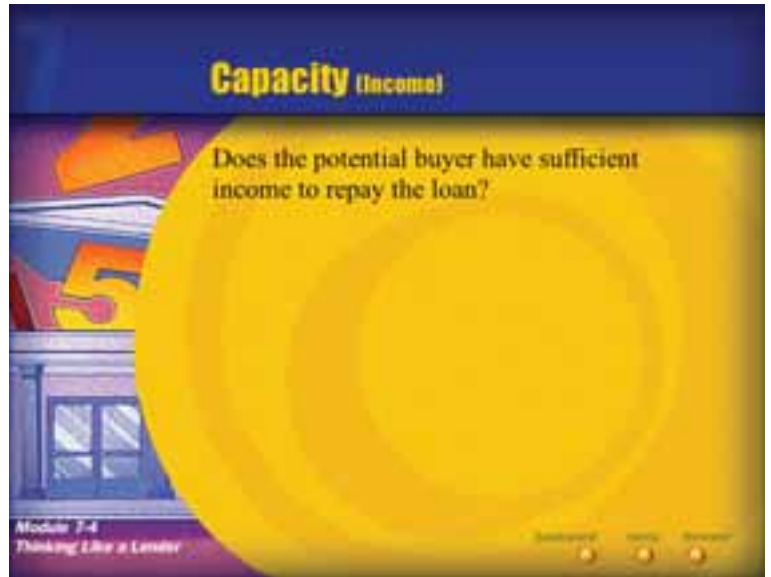
If you work for an employer, a certain portion of your pay will be subject to “withholding” and be remitted directly to the federal and state governments before you receive your paycheck. If you work for yourself, you are expected to make estimated tax payments in advance to the IRS and state tax department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

7



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.

More on having sufficient income . . .

Who would you be more likely to loan money to?

- 1) Your friend who is without income and has no ability to pay you back?
- 2) Your friend who is working and has enough money left over to pay you back?

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

For example, 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 other monthly debts. (Lenders consider your monthly debts as the amounts you owe on your loans and credit cards. Lenders do not require you to disclose the amount of any financial obligations you send back on a monthly basis to relatives who live in another country. However, it’s wise for you to consider these monthly remittances as part of your overall debt so that you can afford and be comfortable with your monthly mortgage payments over the long-term.)

It is also important to note that in addition to PITI, homebuyers who pay less than 20% down may be required to purchase mortgage insurance. A more detailed explanation of mortgage insurance, as well as sample mortgage qualifying worksheets, can be found in Module 7 of the *Consumer Workbook*.

Refer to the Consumer Workbook:

- *Verifying Income Through Tax Returns* (page 113)
- *Calculating Your Debt-to-Income Ratio* (page 114)
- *Mortgage Affordability Worksheets* (pages 115–117)

► **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.)

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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
		<hr/>
Times 28% (this percentage varies with the type of loan product)	x	0.28
		<hr/>
Equals	=	\$ 840
		<hr/>

Step #2:

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

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		<u>\$ 3,000</u>
Times 28% (this percentage varies with the type of loan product)	x	<u>0.28</u>
Equals	=	<u>\$ 840</u>

Step #2:

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

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	=	\$	_____

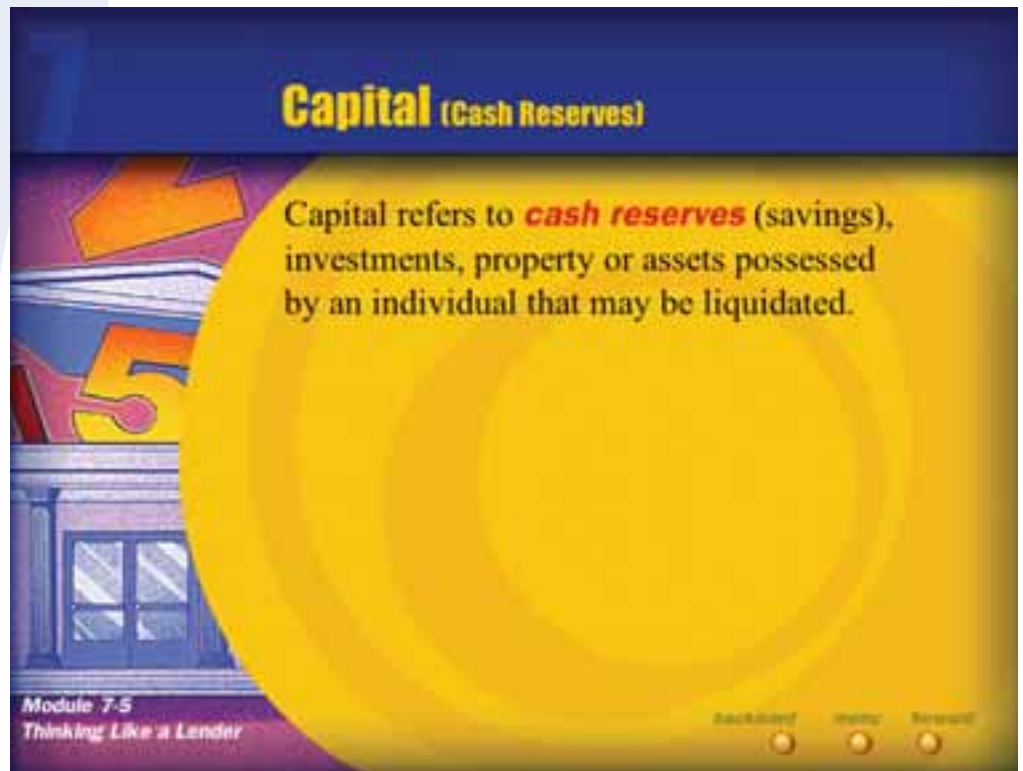
Step #2:

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 long-term debt.



Capital (Cash Reserves)

Capital is another term for cash reserves and includes possessions (property that could be liquidated). Lenders will look more favorably upon your application for credit if you can verify that you have cash reserves. Cash reserves may take the form of savings, money market funds, or other investments that can be converted to cash.

Cash reserves demonstrate to the lender that you have managed your money in a way to set aside extra funds and have resources other than your income to repay the debt.

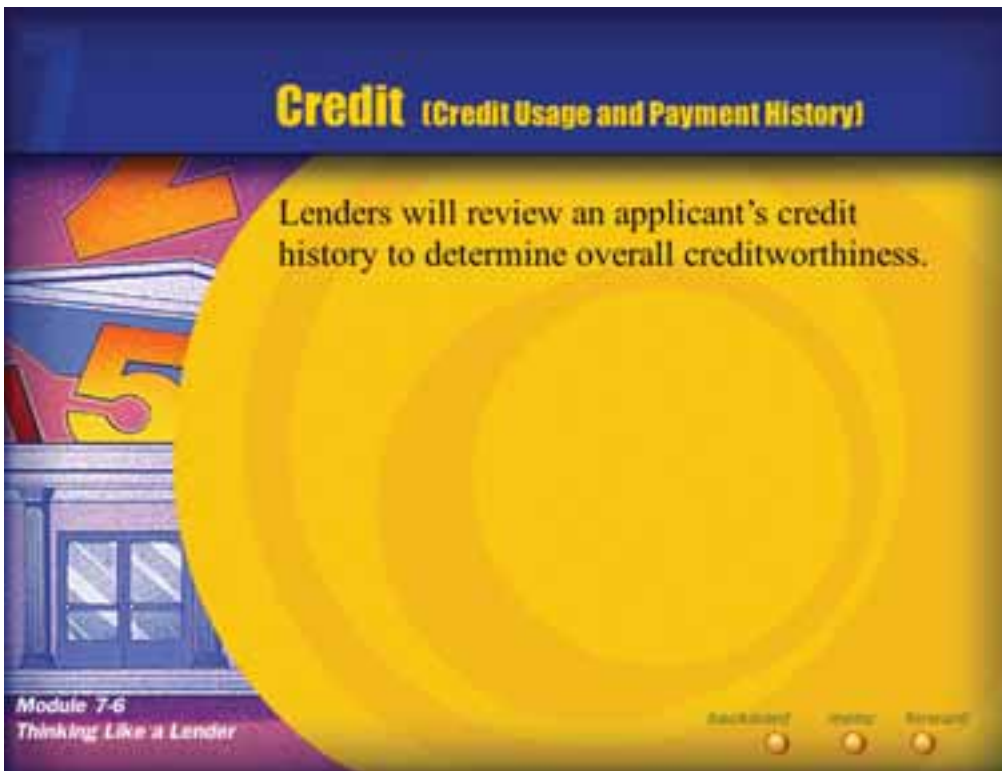
Think of it this way:

Who would you be more likely to loan money to?

- 1) Your friend who is always “out of money?”
- 2) Your friend who has \$3,000 in the bank?

Important note about investments: Lenders consider investments to be Individual Retirement Accounts (IRAs), certificates of deposit (CDs), stocks, bonds, and the like. Lenders do not consider pyramid scheme mechanisms as viable investments in any way.

Pyramid schemes operate on the principle that each member of a group will receive a profit or cut from recruiting others to join the scheme. It also assumes that every contributor participating in the pyramid would make full and timely investments each and every time. As the pyramid of contributors grows, it takes an increasingly vast pool of people to make sure everyone makes money; ultimately, it cannot be done. Remember that if you participate in a pyramid mechanism with your family and/or friends, a lender will not consider this a viable and secure means of savings or investments.

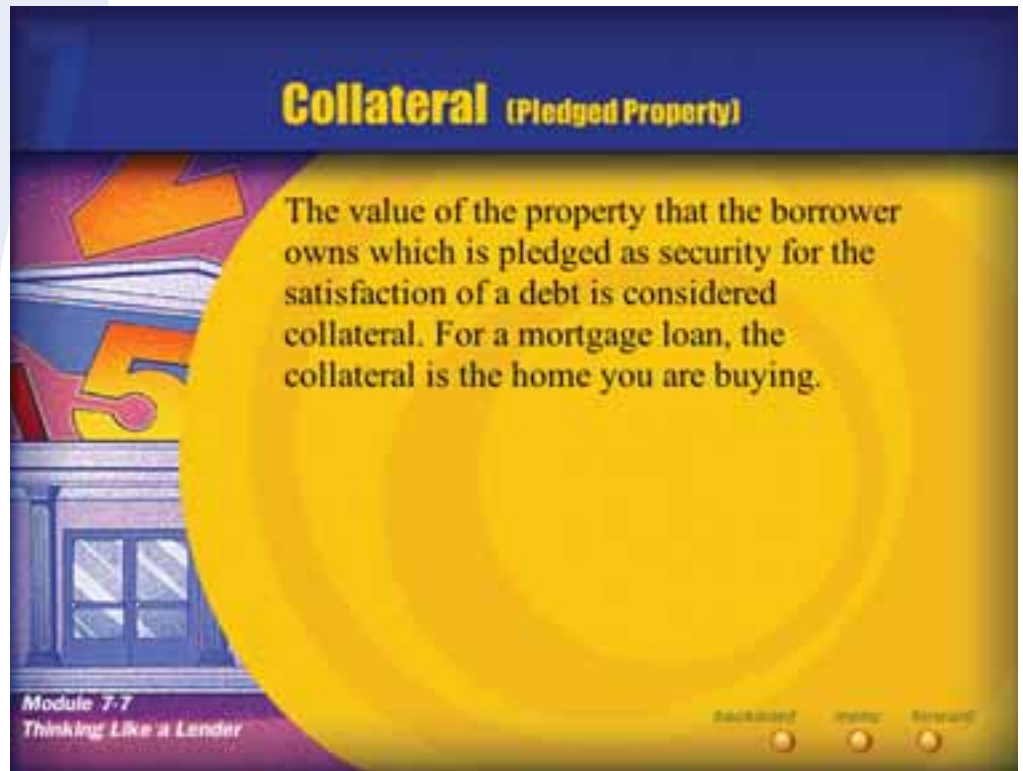


Credit (Credit Usage and Payment History)

As has been stressed in previous modules, one of the primary factors considered by lenders and creditors is your credit report. A careful examination and review of all of the information contained in the report will be made to determine your credit usage and payment history.

If the lender or creditor finds that the credit report contains several late payments or other negative factors—such as public record items, like a lien against your property or you have foreclosed on your previous home—your ability to secure loan approval will be severely hindered.

Furthermore, lenders and creditors will review the credit report to determine if you currently have “access” to too much credit. In other words, how many lines of credit or accounts are “open” and available to you? If, for example, you have several open accounts, even with a zero balance, you may be at risk of having the credit application questioned or denied because you could become overextended.



Collateral (Pledged Property)

Collateral, which is the value of your personal possessions and/or property, is another factor considered by lenders and creditors. Possessions may include such things as personal possessions of value, an automobile that is paid for, and real estate holdings. Even though these items would need to be sold or liquidated, their value may be considered as a factor in determining the strength of a loan application.

For example, if someone is seeking to borrow money and has very few assets (cash reserves) but recently inherited their grandfather's house and is willing to offer the property as collateral, they may be a better credit risk. This is because despite the fact that the loan applicant may have limited cash reserves, the possession of the real estate may make the application very strong and thus a better credit risk.

The term commonly used for this type of situation is called "compensating factors." If an applicant is very strong in one area, yet weak in another, compensating factors may be considered. Another example of a compensating factor may be having limited investments, but a high income.

Relative to a home mortgage approval, a large down payment (for example, more than 20%) may be a compensating factor for some credit imperfections.

Evaluating Credit Risk

Another tool used by lenders to evaluate credit and "*credit risk*" is credit scoring.

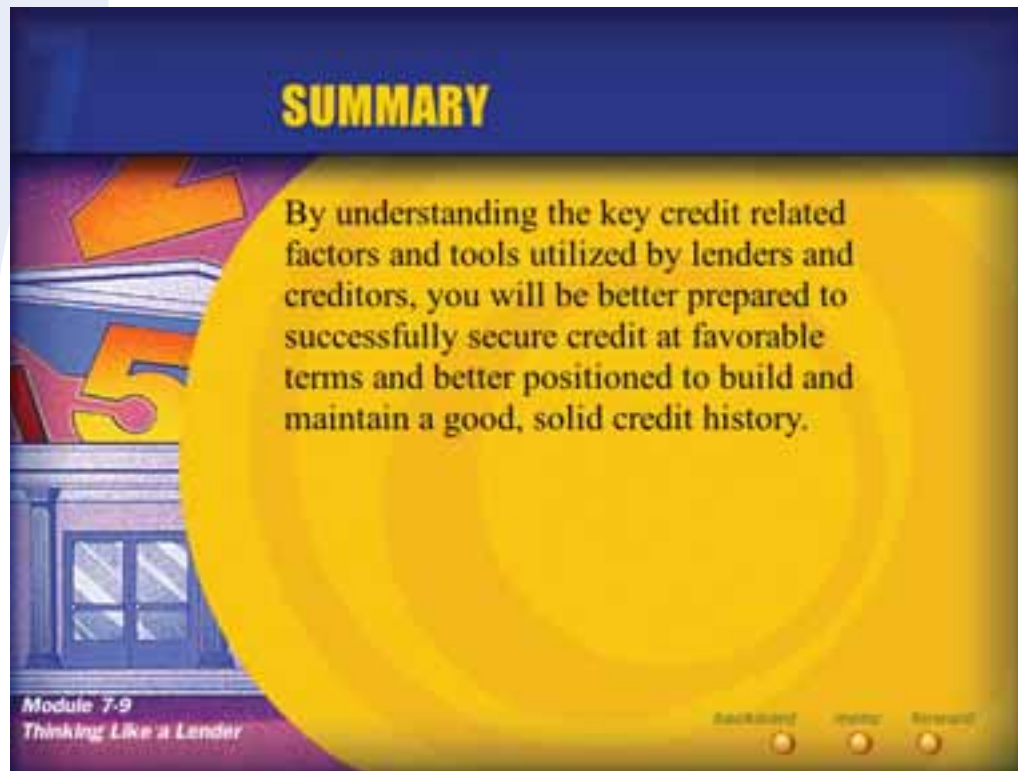
Credit scoring uses information contained in your credit report and provides the lender with a *credit score*.

Module 7-B
Thinking Like a Lender

Backward Home Forward

Evaluating Credit Risk

As it was discussed in Module 6, one of the primary methods of determining credit risk is with the use of a computerized model called credit scoring.



SUMMARY

Given the factors analyzed by lenders and creditors, this slide provides a few practical tips on how to avoid falling into a debt trap, which can limit your financial options and severely impact your ability to secure funds at reasonable terms and conditions.

Additional worksheets (and samples) on calculating debt, cash and assets, and financial statements are available.

Refer to the Consumer Workbook:

- *Debt Worksheets* (pages 118–119)
(*Your Credit, Your Home, and Your Future* page 41)
- *Cash and Asset Worksheets* (pages 120–121)
- *Sample Financial Statement* (pages 122–125)

▶ 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

▶ Debt Worksheet

Use this worksheet to list all of your debts (financial obligations) which you normally pay on a monthly basis, such as car loans, student loans, credit cards, or other loans. Include the name/type of the account, the interest rate, the monthly payment, and the balance remaining on the loan.

This worksheet will help you to calculate your total monthly debt payments and your total overall indebtedness. 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
TOTAL MONTHLY DEBT PAYMENTS: (add the numbers in column C)			\$ _____
TOTAL INDEBTEDNESS: (add the numbers in column D)			\$ _____

► **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: _____



Key Terms to Remember

Refer to the Consumer Workbook:

Glossary of Terms (pages 213–222)

(Get Credit Smart! pages 73–83)