

## A closer look at underwriting borrower capacity

At Freddie Mac, one of our priorities is to work with you to rebuild a strong mortgage finance system. We're doing this by promoting responsible lending standards that withstand fluctuations in the market to ensure that you and your borrowers are successful throughout the entire life of their mortgage.

Using disciplined underwriting and good judgment, is essential to responsible lending and successful homeownership. Let's take a closer look at how you can properly evaluate a borrower's capacity to repay the mortgage.

### Basic guidelines for evaluating borrower capacity

The fundamental guideline that every underwriter must embrace is that the borrower must be able to repay the loan. For this reason, it is critical to both your business and the borrower that you closely examine all known factors that may affect a borrower's capacity to repay the mortgage.

To determine a borrower's ability to make mortgage payments, you must analyze the borrower's income, employment, assets and liabilities, and gather documentation that validates the borrower's financial situation.

- **Income.** The amount and stability of income is one of the most important aspects of borrower capacity and should be closely examined. Stable monthly income is the borrower's gross monthly income from all acceptable and verifiable sources that can reasonably be expected to continue at the level used to qualify the borrower for at least the next three years. A two-year history of receiving income is also required in most instances, in order for the income to be considered stable and used for qualifying. It is critical for you and your staff to know how to calculate a borrower's gross monthly income, especially when income comes from different sources (employment and non-employment sources) and/or is received at varying frequencies (hourly, weekly, twice a month, monthly, etc).
- **Employment.** Income stability is largely determined by the borrower's employment. Employment is typically reviewed for the type of work and length of employment. Stable monthly income may be from primary and secondary employment, including base earnings plus consistent and documented secondary income, such as bonuses, commissions, overtime, additional part-time employment, or seasonal employment. Evaluating self-employed borrowers requires a closer examination of risk since such borrowers are typically responsible for the debt and well-being of the business in addition to their personal obligations. The calculation of a self-employed borrower's income must be based on a thorough review and detailed analysis of the borrower's individual tax return, complete business tax returns, and other additional documentation, if necessary.
- **Assets.** Verification of sufficient assets to close and the source of those assets is critical. Insufficient assets to close or an unknown source of funds, or undocumented sources of large deposits may indicate that the borrower took on additional unverified debt. It is also important to make sure a borrower will have enough reserves even after closing. This indicates that the borrower will have the means to continue paying the mortgage if the flow of income is suddenly disrupted. In addition, borrowers who make down payments from their own assets are less likely to walk away from their mortgage.

### Issues we encounter when reviewing the mortgage file for borrower capacity:

- Incorrect calculation of income and debt-to-income ratios
- Income claimed is insufficient or not supported
- Decreasing income not addressed
- Questionable seller concessions
- Reserves do not meet minimum requirements
- Verified funds insufficient to close
- Excessive obligations
- Undisclosed or insufficient documentation of liabilities
- Possible misrepresentation of occupancy

- **Liabilities.** All loans, credit card debt, and other financial obligations (such as alimony or child support) must be verified and factored into the debt calculation when determining the debt-to-income (DTI) and total DTI ratios. It is important that all debt, including installment debts with deferred payments, is considered when qualifying the borrower, and that all debt is verified in the mortgage file. When evaluating financial liabilities, you must consider the applicant's short-term and long-term ability to repay the mortgage.
- **Documentation.** Sufficient and accurate documentation of a loan applicant's financial information (income, employment, assets, and liabilities) is necessary to determine the applicant's ability to repay the mortgage. A complete list of Freddie Mac's documentation requirements can be found in Chapter 37 of our *Single-Family Seller/Servicer Guide* (Guide), including requirements for loans evaluated with Loan Prospector®, our automated underwriting system (AUS). Use our *Loan Prospector Documentation Matrix* to help you gather the required documents to verify employment, income, assets, and liabilities.

## Strengthening your underwriting processes with best practices

To help strengthen your origination processes and enhance the quality of the mortgages you sell in the secondary market, we encourage you to adopt the following best practices:

- **Knowledgeable underwriters and processors are the best controls.** You can be more effective and efficient in your underwriting processes by having qualified personnel on the job who know how to compile, document, validate, and evaluate the information in a loan file. Experienced personnel can quickly identify and assess critical data points that could materially affect an underwriting decision. Keep in mind that regular training for your underwriting staff is also important because requirements, guidelines, and regulations frequently change.
- **Do your due diligence to ensure accuracy and completeness.** Accurate and complete data and data entry are critical in all aspects of the origination process. If you intend to sell the mortgage to Freddie Mac, you must have processes in place to ensure accurate and complete data entry into both Loan Prospector and the selling system, and that the data matches the information in the mortgage file. Inaccurate data or data entry may result in assessment of additional delivery fees or invalidate the automated underwriting decision that could result in Freddie Mac's refusal to purchase a mortgage or a required repurchase of the mortgage.
- **Review the loan from a total perspective ("the big picture").** While the data you gather may be correct, thoughtful analysis and examination of all information will help you capture some underlying risks. Disciplined underwriting includes reviewing the data for inconsistencies, discrepancies, and reasonableness when information in the entire mortgage file is taken into consideration. For instance, check for loan characteristics that may contribute to layered risk. An ARM or a balloon/reset mortgage adds an additional layer of capacity risk especially when combined with a mortgage made to finance an investment property or a cash-out refinance mortgage.
- **Balance technology with the human touch.** Use the efficiency of Loan Prospector to help streamline your process, but remember that there are aspects of underwriting that are beyond the scope of automated underwriting. For instance, your knowledge of local employment trends and the fraud practices in areas you serve will help raise red flags requiring additional investigation. If something does not look right, validate, verify, and reassess what's in the mortgage file. Remember it's about data integrity, and if you need to correct any data, make sure to resubmit the loan information to the AUS for a decision based on the corrected data.
- **Complete documentation is crucial.** Freddie Mac needs to understand the thought process behind your underwriting decisions. Document key findings and explain how you arrived at them. At the minimum, the file must include how the income was calculated.

### The 3 Cs of underwriting used in Loan Prospector's assessment

- Credit reputation
- Capacity
- Collateral

If one of these components is not acceptable or if there is excessive layering of risk across components, the mortgage may not be acceptable for sale to Freddie Mac.

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- **The HUD-1 Settlement Statement and other closing documents can reveal additional information not in the original mortgage file.** For example, seller concessions that should have been considered in underwriting may become apparent in the closing documents. The most typical examples of concessions are credits from the sellers, including sellers paying the homeowners association fees or mortgage payments for a period of time, or any excessive seller contributions that may affect the LTV/TLTV ratio. It is critical to carefully review all documents prior to closing.
- **Check for misrepresentation of occupancy.** Look closely at all documents to make sure the borrower's occupancy on the loan application has not been falsely represented. Some of the red flags you should investigate are: unrealistic commuting distance from the property to the applicant's place of employment, the borrower buying a smaller or less expensive home than their current primary residence; the borrower does not document the intent to rent or sell their current residence or the appraisal report reflects "occupant" as the tenant or as "vacant" on an owner-occupied refinance application.

## For more information

To learn more about Freddie Mac requirements and to keep abreast with changes in our policies and underwriting requirements:

- Visit the Freddie Mac Learning Center for a variety of learning opportunities on underwriting, including recorded webinars, live classroom sessions, and quick references.
- Review the *Single-Family Seller/Service Guide* (Guide) that details all the requirements for doing business with Freddie Mac. Access the Guide through the AllRegs® link on FreddieMac.com.
- Use our *Loan Prospector Documentation Matrix* as a reference to document your loans submitted to Loan Prospector.