4 C's of Lending

Version 2.1

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- Online Recording - Main Site 4 C's -

Capacity

- Qualifying Income
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Qualifying Income

Although there is some flexibility and interpretation, qualifying income is the amount of monthly income that the lender will consider to repay the mortgage. Generally the investors want to see a two year history of work in a related field. If someone recently graduated from college with a degree in a specific area such as an accountant or attorney, the lender would still consider this as qualifying income even though they do not have a two year employment history. The lender would use the current base income and a two year average of overtime, bonuses or commissions to calculate qualifying income. If you do not have two years with the same employer the lender will most likely only use your base income. This is the gross income prior to any deductions for 401K, health insurance, or any type of other deductions that may show up on your pay stub.

For self-employed borrowers the lender would take a two year average of income that shows up on the federal tax return after expenses. Many borrowers who are self-employed if you ask them how much they make will tell you their total income before expenses. Depending on their tax returns and what items they expense this could be a significant difference. If you own 25% or more of a business or partnership, you are considered self-employed for mortgage purposes.

Some lenders require the borrower's tax returns or transcripts even for a borrower who claims he only gets W-2 income. They will reduce the income by any business expenses that show up on schedule A of the tax return. Any additional income or loss that may show up on the tax return will be added or subtracted from the qualifying income. For example a spouse my sell cosmetics, cut hair or provide child care and this income or loss will be used, even though some borrowers may not even mention this when they fill out an application.

Debts

Debts for mortgage purposes are considered the liabilities that show up on your credit report. So items like car insurance, gas, maintenance, food, contributions to a retirement account, life insurance, contributions to a church, or payments for education are not considered debts for mortgage purposes since these expenses are already factored in or are expenses that you could eliminate. The lender is really only looking at the minimum monthly payment on a debt and not the amount owed.

If the payment is deferred such as a student loan, and no payment shows up on the credit report, a projected payment will be verified and used as an additional debt. If an installment loan such as a car loan or boat loan has less than 10 payments to go it will not be counted as part of the monthly debt payments since it is short term.

The other debt that will be considered for qualification is the housing debt. This will include the principal, interest, taxes, homeowners insurance, flood insurance (if applicable), private mortgage insurance (if applicable) and any association dues.

Private mortgage insurance also known as PMI is required on conventional loans with less than 20% down. Private mortgage insurance can be paid upfront in a lump sum or can be paid on a monthly basis. If paid on a monthly basis it is considered part of the house payment. Both FHA and Rural Development loans have upfront mortgage insurance that is added to the loan and monthly mortgage insurance. VA loans only have upfront mortgage insurance known as a VA funding fee.

Debt to Income

There are two debt ratios considered in qualification. Your housing ratio which is your total monthly projected housing payment (including taxes, homeowner's insurance, private mortgage insurance (if applicable) and association dues (if applicable) divided by your total monthly gross qualifying income. The other ratio is your total debt to income ratio. Your projected total housing payment is added to the monthly payments that show up on your credit report plus child support and or spousal support (if applicable) divided by your monthly qualifying income to calculate your total debt to income ratio.

The guideline for the investors is to keep the housing ratio at about 28% of your gross monthly income and total debt ratio at about 36%. Depending on a number of factors these debt to income ratio guidelines can be exceeded if you have good credit, a larger down payment, or reserve cash after closing. Each mortgage program has different maximum debt ratios. FHA is probably the most lenient and many lenders will let the borrower go up to a total debt ratio of 50%. With conventional loans, if you put down less than 20% the investor requires private mortgage insurance and most private mortgage insurance companies will limit the debt ratio to 45%. VA loans do not qualify the borrower on debt ratios. Instead they take the qualifying monthly income minus income taxes, social security, projected house payments, estimated utilities, and monthly payments that show up on the credit report and the balance that remains is considered residual income. As long as they meet the minimum residual income required, VA will approve the loan.

All of these loans are submitted to investor software commonly known as DU (direct underwriter) or LP (loan prospector). These software programs can not deny a loan, but they can approve loans at the higher debt to income ratios. So even though they like to see a housing debt at 28% the software may approve a loan with a housing debt of 33% or a total debt to income ratio of 45%. If it is not approved it is sent to an underwriter for further review, but in many cases these loans will not be acceptable to the investor.

Most borrowers want to know the maximum sales price they qualify for but really the lender can only give the borrower a maximum house payment they can afford. Property taxes can vary dramatically based on the location and the taxable value on the home. Insurance can also vary depending on the company, coverages, and the amount of the deductible. So the lender actually provides the borrower with a maximum mortgage payment and **estimated** maximum purchase price.