Focus on Credit and Liabilities

August 17, 2021

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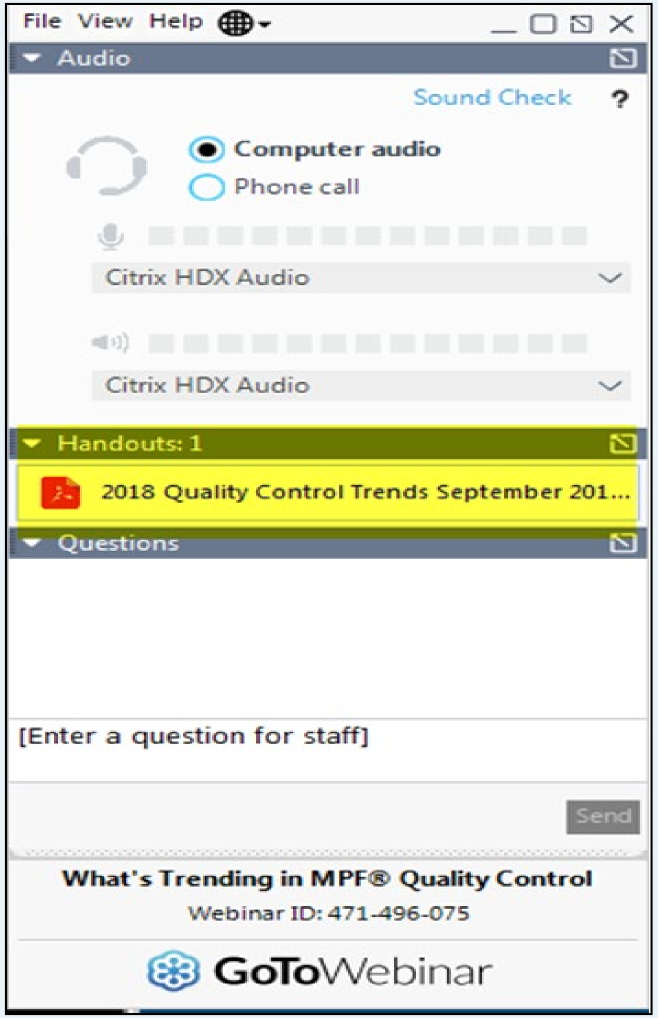

Topics Covered

- **Common Liability Types and Payment Considerations**
- **Credit Inquiries and Undisclosed Liabilities**
- **Non-Traditional Credit**
- **Adverse Credit Events**
- **Did you Know?**

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Before We Begin

Credit guidelines may vary between manually underwritten loans and loans underwritten with an automated underwriting system (AUS) like Desktop Underwriter® (DU®) and Loan Product Advisor® (LPA)

MPF® Traditional Products

- Manually underwritten loans follow what is published in the MPF Traditional Selling Guide.
- Loans underwritten with DU or LPA follow the applicable agency guidelines*.

MPF Xtra® Product

- Loans underwritten with DU follow the findings received and Fannie Mae Guidelines
- Manually underwritten using Fannie Mae Guidelines.
- LPA is no longer an accepted AUS under the MPF Xtra product

* See the MPF Traditional Selling Guide for specifics related to the use of DU and LPA.

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Credit and Liabilities Overview

A borrower's credit profile must be reviewed for at least the following:

- Determine if the borrower's credit score is adequate for the product and transaction type.
- Review all monthly obligations listed on the credit report to determine if the total obligations meet debt-to-income ratio requirements.
- Determine if there are any undisclosed liabilities or liabilities missing from the credit report.
- Research any credit inquiries made in the past 90 days to determine if new credit was established.
- Carefully review any adverse credit items and if necessary, determine that any requirements to re-establish credit after a major adverse credit event have been met.
- Address any items such as collections, liens and judgments to determine if they must be paid at or prior to closing.

Debt to Income Ratios

A borrower's ability to manage their monthly obligations plays a crucial role in a mortgage's overall risk profile

Manually underwritten MPF Traditional loans cannot exceed a total DTI ratio of 43%

Manually underwritten MPF Xtra loans should not exceed a total DTI ratio of 36% but if loans meet the credit score and reserve requirements outlined *in Fannie Mae's Eligibility Matrix* they can go as high as 45%

If using DU to underwrite the maximum DTI ratio is 50%

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Common Liability Types and Payment Considerations

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Knowledge Check

Which of the following liability types do not have to be included in a borrower's monthly debt-to-income ratio calculation?

a. Credit cards/revolving debt
b. Automobile leases with less than 10 payments left
c. Automobile loan payments with more than 10 payments left
d. Cell phone payments
e. Monthly payments for gas/electric service

Both d and e, monthly utility payments do not have to be included in the borrower's monthly DTI ratio.

Common Liabilities

Revolving debts – use the minimum payment due reflected on the credit report.

- If no payment is noted, use 5% of the outstanding balance.
- If the outstanding balance is less than $200, unless otherwise noted, use a payment of $10.00.
- If the account is paid off by the borrower at or prior to closing, the payment is not required to be included in the debt-to-income ratio (DTI).

Debts repaid on a schedule other than monthly (i.e. annual or quarterly payments):

- Payments must be reflected as a monthly amount. For example, a debt paid on a quarterly basis must converted to a monthly amount for calculation purposes.

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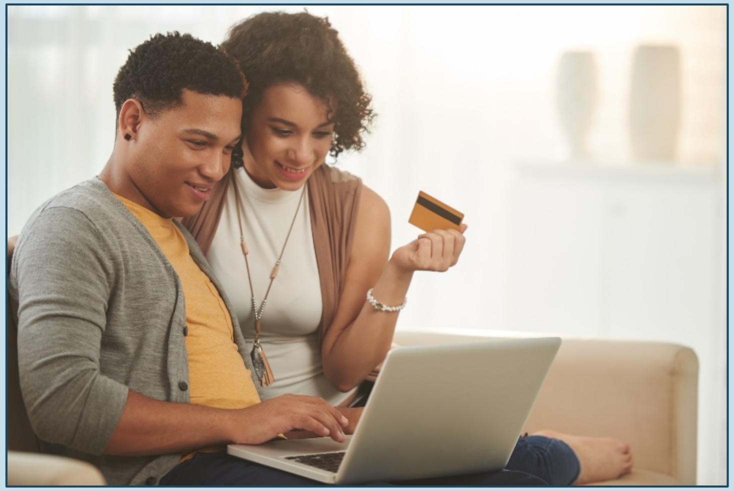
Common Liabilities

Open-ended/ 30-day accounts (i.e. American Express)- accounts with a balance, regardless of the apparent number of payments remaining, must be included in the borrower's long-term debt-to-income ratio calculation.

- For manually underwritten MPF Traditional loans, if the balance is paid off at or prior to closing, the payment does not have to be included in the DTI.

- Under Fannie Mae and Freddie Mac guidelines, if the borrower has sufficient verified funds to cover the payment, it can be excluded from the debt obligations.



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Common Liabilities

Installment debt with <10 payments remaining may be excluded unless the payment affects the borrower's ability to repay the mortgage during the months immediately after closing, especially if the borrower has limited cash reserves.

- If manually underwriting a MPF Traditional loan and no payment is noted on the credit report, use 2% of the balance or obtain written evidence of the monthly amount from the borrower (statement or disclosed loan terms).

- Fannie Mae and Freddie Mac guidelines no longer provide a percentage for calculating a payment (unless it's a student loan). Documentation must be obtained to confirm a payment.

Common Liabilities

Student loans- Student loans with more than ten payments remaining must be included in the DTI ratio

Fannie Mae: If no payment provided on the credit report, 1% of the outstanding balance or obtain evidence of the actual payment amount.

- If the borrower is on an income-driven plan and the payment is reflected as zero, a payment does not have to be held against them.

Manually underwritten MPF Traditional loans allow student loans in *deferment* for a 12 or more months beyond the closing date to be excluded from the DTI ratio.

- Use 1% of the balance or an actual payment amount if the payment is zero or not reported.

Freddie Mac: If the monthly payment amount reported on the credit report is zero, use 0.5% of the outstanding loan balance, as reported on the credit report.

Common Liabilities

Automobile leases - must be considered no matter how many payments remain unless the borrower is able to provide **sound evidence** that they are not entering into a new lease.

Home Equity Lines of Credit (HELOCS)- use the payment provided on the credit report.

- If there's a balance but no payment provided, the greater of 5% of the outstanding balance or $10 must be used.
- A payment amount may also be evidenced by a monthly statement or loan documentation.
- A payment amount is not required for a HELOC with a zero balance.

Common Liabilities

Balloon-payment notes that come due within 12 months of the closing must be considered in the underwriting analysis.

Debts secured by financial assets (401k loans, margin accounts or CD loans) that can be repaid by liquidating the asset may be excluded from the DTI ratio.

- When listing the asset on the 1003, do not include the balance of the loan in the total value of the asset.

Common Liabilities

Alimony/child support payments- if more than ten payments remain, those payments must considered as part of the borrower’s monthly obligations

- Voluntary payments do not need to be considered, only those that are part of a written legal agreement.
- For **alimony** obligations only, Fannie Mae and Freddie Mac guidelines (MPF Xtra product or MPF Traditional with DU/LPA underwriting) provide the option of reducing the borrower’s monthly qualifying income by the amount of the monthly alimony payment.
- Watch for obligations that may be appearing on pay-stubs or as deductions from bank accounts.

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Common Liabilities

Business debt in the borrower's name- self-employed borrowers with business-related items on their credit report (i.e. Small Business Association Loan) may be excluded from the borrower's DTI ratio if:

- The account does not have a history of delinquency.
- Evidence is provided to prove the obligation is paid out of company funds (such as 12 months of canceled checks).
- The lender's cash flow analysis of the business takes the payment into consideration.
- ***The sourcing of the debt payments is often missed in loan files.***

NOTE: The **MPF Traditional product guidelines (manual underwriting)** specifies that only 12 months proof of payment are required to exclude business debts. There is also a comment stating that borrower's may also be personally liable for business debt that may not appear on a credit report.

Knowledge Check

Four years ago, Lou and his brother Fred purchased an investment condo that is currently rented. Fred makes all of the payments on the condo. Lou wants to purchase a new home. Which of the following is <u>not true</u>?

A. The PITIA on the condo can be excluded from Lou's DTI if it can be evidenced that Fred has made the last 12 payments on time.
B. The condo should not be considered in Lou's total financed property count.
C. If the PITIA on the condo is excluded from Lou's DTI ratio, rental income from the unit cannot be used for qualifying.
D. Fred must be obligated on the condo mortgage debt.

The answer is B. Lou does need to include the property in his total property count.

Credit Inquiries and Undisclosed Liabilities

Knowledge Check

Which type of inquiry won't affect your credit score?

A: An application to purchase a new car
B: An application for a bank credit card
C: An application for a store credit card
D: An application for employment
E: An application for a graduate school loan

The answer is D, an application for employment

Credit Inquiries

There are two types of credit inquiries:

1. **Hard inquiries** occur when a potential lender is reviewing credit because a borrower has applied for items such as a mortgage, auto loan or credit card.

    - Requires the borrower's permission.
    - May impact a credit report/score.
    - May stay on a report for up to two years.
    - There's a grace period before certain inquiries are reflected in a credit score (this allows borrowers to shop with multiple lenders for the same type of loan).

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Credit Inquiries

2. Soft inquiries or a *soft pull of credit* do not impact credit scores and occur when creditors check credit without the consumer's permission for reasons such as:

- Pre-approved credit cards or promotions.
- Background checks by employers or landlords.
- **As a follow-up to a hard inquiry to ensure there have not been major changes to a credit profile during the application process.**

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Recent Credit Inquiries

All credit inquiries made within 90 days of the date of the credit report are considered recent and must be investigated

- **MPF Traditional (manual underwriting)** guidelines state that all inquiries made in the past 90 days must have a detailed explanation from the *inquirer* that addresses both the purpose and outcome of the inquiry.

- Guidelines for **MPF Xtra and MPF Traditional** loans underwritten with an **AUS** are a bit more general and state that the lender "must confirm that the borrower has not obtained any additional credit that is not listed on the credit report".

- In all cases, if a new account has been established, the terms, balance and monthly payment must be obtained and verified.

Undisclosed Liabilities

Borrowers are sometimes tempted to make substantial purchases for their new home which could cause a loan to be ineligible for purchase!

Starts with the Loan Officer/Originator

- Educate the borrower at the time of application.
- Most borrowers are unaware of the impact, especially after the loan has been "approved".

Making a soft inquiry just prior to closing can help identify if new debt was established.

- Any large increases to existing revolving debt may have to be reviewed.
- Does not effect the borrower's credit score.

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Verifications of Deposit

Verifications of Deposits (VODs) should be reviewed thoroughly as they may show liabilities that may not appear on the credit report

To Be Completed by Depository

Part II — Verification of Depository

10. Deposit Accounts of Applicant(s)

Type of Account	Account Number	Current Balance	Average Balance For Previous Two Months	Date Opened
		$	$	
		$	$	
		$	$	

11. Loans Outstanding To Applicant(s)

Loan Number	Date of Loan	Original Amount	Current Balance	Installments (Monthly/Quarterly)	Secured By	Number of Late Payments
		$	$	$ per		
		$	$	$ per		
		$	$	$ per		

12. Please include any additional information which may be of assistance in determination of credit worthiness. (Please include information on loans paid-in-full in Item 11 above.)

Non-Traditional Credit

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Non-Traditional Credit

Non-traditional mortgage credit reports are permitted for borrowers with limited or no traditional credit history.

- If one or more borrowers do not have a credit score due to insufficient credit, the lender must establish an acceptable non-traditional credit profile.
- The lender can document the borrower's non-traditional credit history directly from the borrower or the creditor, or by obtaining a nontraditional mortgage credit report from a consumer reporting agency.
- Non-traditional credit may not be utilized to off-set derogatory credit histories.
- **If all borrowers on the loan are relying solely on non-traditional credit to qualify (MPF Xtra or MPF Traditional with DU), at least one borrower must complete homeownership education prior to loan closing.**

Required Credit Sources

<table>
<tr><th>Underwriting Method</th><th>Non-HomeReady Loans</th></tr>
<tr><td>Manual Underwriting</td><td>Four sources for each borrower without a credit score</td></tr>
<tr><td rowspan="2">Loans Underwritten with DU</td><td>If no borrower has a credit score: At least two sources for each borrower</td></tr>
<tr><td>•If the borrower(s) with a credit score contributes
• 50% or less of qualifying income, at least two sources for each borrower without a credit score.
• More than 50% of qualifying income, then no nontraditional credit history is required for the borrower(s) without a credit score.</td></tr>
</table>

Refer to the applicable guide for HomeReady requirements and LPA for MPF Traditional loans

Sources

- **Loans underwritten through DU** where a nontraditional credit history is required must include rental housing payments as one source of nontraditional credit.

- **Manually underwritten MPF Xtra** loans do not require that one source of nontraditional credit be rental housing payments. However, if no borrower on the loan is able to document a rental payment history, a minimum of 12 months' reserves must be documented.

- **Manually underwritten MPF Traditional** loans require a 12-month mortgage or rental payment history for all properties owned or rented in the most recent 12 months and must be verified using:
  - ✓ Copies of the Borrower's cancelled checks for last 12 months; or
  - ✓ A Verification of Mortgage or Verification of Rent

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Non-Traditional Sources

- Utility payments
- Cellphone bills
- Renter's insurance payments
- Life insurance or other insurance payments
- Payments to department stores (layaway plans)
- Child care
- School tuition
- Medical bill payments
- Payments on personal loans (documented with a formal agreement)
- Rental payments for durable goods
- Checking account, savings account, voluntary payments made to a payroll savings plan or contributions to a stock purchase plan, provided the records reflect an increasing balance as a result of periodic deposits over at least the most recent 12 months. Contributions must have been made no less than quarterly.

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Adverse Credit Events

Past Due, Collections and Charge-Offs

- **MPF Traditional** (manual underwriting) requires that single events like a past judgment, tax lien, collection, charge-off, or repossession of $250 or more, and multiple events with past due amounts totaling more than $1,000 be paid in full at or prior to closing.

- If **DU or LPA** are used, and requires that the amount be paid, the AUS rule supersedes these requirements.*
  - Accounts reported as past due (not reported as collection accounts) must be brought current.
  - Outstanding collections or non-mortgage charge-offs do not have to be paid if the property is a one-unit primary residence.
  - Outstanding collections and non-mortgage charge offs totaling more than $5,000 must be paid in full prior to or at closing if the property is a two-four-unit or second home.

*If the account is marked *Paid By Close*, DU will issue a message stating that the collection must be paid.

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Adverse Credit Events

Derogatory Event	Waiting Period	Waiting Period with Extenuating Circumstances
Chapter 7 or 11 Bankruptcy	**Four years**	**Two years**
Chapter 13 Bankruptcy	Two Years from discharge date Four Years from dismissal date	Two years from discharge date Two years from dismissal date
Multiple Bankruptcy Filings	Five years if more than one filing within the past seven years	Three years from the most recent discharge or dismissal date

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Adverse Credit Events

Derogatory Event	Waiting Period	Waiting Period with Extenuating Circumstances
Foreclosure	Seven years	Three years Additional requirements after three years up to seven years: • 90% max LTV • Purchase, principal residence • Limited cash-out refi, all occupancy types *Note: the purchase of second homes, cash-out refinances (any occupancy type) are not permitted until the seven year waiting period has elapsed.*
Deed-in-Lieu or Pre-Foreclosure/Short Sale	Four years	Two years

Adverse Credit Events

Re-establishing credit following a major incident such as a bankruptcy or foreclosure-related action:

- A minimum of four accounts with at least one traditional credit reference on the credit report and one housing-related reference.
- At least three of the four accounts must have been opened and active for the most recent 24 months.
- For installment and revolving accounts, no more than two (2) 30-day late payments during the past 24 months.
- No housing late payments since the major credit incident.
- No new bankruptcies, foreclosures, unpaid judgments or collections.
- All payments on the credit report must be current at the time of application.

Borrowers who have been through credit counseling, require 12 months of re-established credit from the conclusion of the counseling.

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Did You Know?

- Bankruptcies can stay on a credit report for ten years, while other items may drop off after seven years.

- Positive information can remain on a credit report indefinitely but most closed accounts that were paid as agreed age off after ten years.

- Bankruptcies can cause a score to drop 130 – 150 points. If credit is re-established, it can take around five years to go back to the pre-bankruptcy score range.

- Negative items vary. The Fair Reporting Credit Act (FRCA) covers most time limits for reporting negative items but they may vary due to state law.

- Late payments may be reported for up to seven years from when the delinquency occurred.

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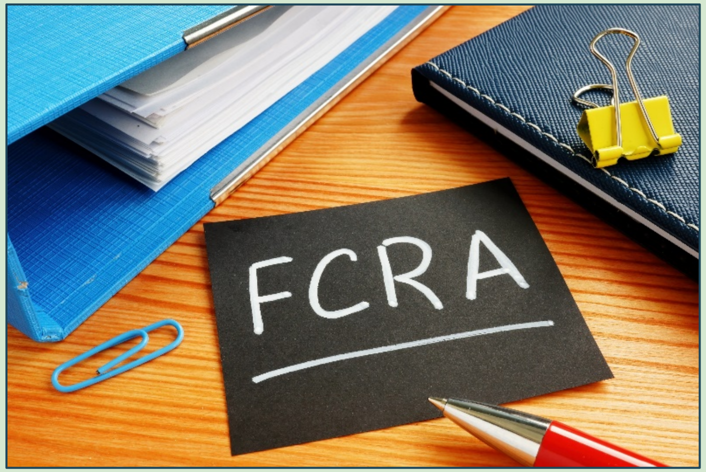
Knowledge Check

Which Act gives consumers access to a free annual credit report?

A: **FACTA** (Fair and Accurate Transactions Act)
B: **FCRA** (Fair Credit Reporting Act)
C: **ECOA** (Equal Credit Opportunity Act)
D: **FIRREA** (Financial Institution Repair Recovery and Enforcement Act)



FCRA provides that all consumers are entitled to one free disclosure every 12 months from each nationwide credit bureau.

Visit www.consumerfinance.gov/learnmore for additional information.

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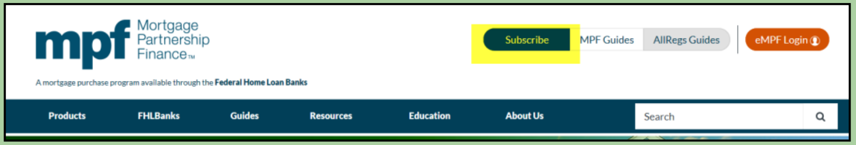

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