

More on Mortgages: Understanding the Underwriting Process

Even though it's probably the largest purchase they'll ever make, few consumers take the time to really go "behind the scenes" to more fully understand the complex world of mortgage lending.

Qualifying For a Mortgage

Whether you're looking for a first mortgage on a new home, refinancing an existing mortgage, or take out a second mortgage, the interest rate you'll be offered depends on the same factors:

Your total monthly household income compared to both the mortgage payment alone (known as the "front-end ratio") as well as all of your monthly obligations including the mortgage (total debt-to-income ratio);

The value of your property compared to the liabilities placed on it (otherwise known as the "loan to value," or LTV); and

Your credit report from the various credit reporting agencies such as Equifax and Fair Isaac (which compiles the well-known and commonly used "Fico score").

The "processing" of your loan is the preparation of all relative documents to verify, prove, and package together all information pertinent to these factors.

"A" vs. Sub-Prime First Mortgages

There are strict requirements to qualify for so-called "Conforming A" loans, which generally offer the lowest rates and terms available. Those who do not meet these requirements have a great many options available to them in qualifying for "Non-Conforming A" mortgages or Sub-Prime mortgages, at rates somewhat higher than Conforming rates.

The best rates are usually available to low-risk borrowers - those who meet Conforming A loan standards. Generally speaking, requirements for Conforming A loans include credit scores in excess of 620 points, income ratios between 28% and 40%, and loan to value ratios below 95% on new home purchases and no-cash-out refinances and below 80% on cash-out refinances. A Conforming A loan must also be at or below a maximum amount specified by the two federally chartered repurchasers of home loans, Freddie Mac and Fannie Mae. For 2006, this limit is \$417,000; loans above this amount are called "jumbo" mortgages and generally carry a slightly higher interest rate.

In the next tier are Non-Conforming A loans. These are borrowers with good credit and loan-to-value ratios, but whose income is either insufficient to accommodate a Conforming loan or is not easily verified. These loans are ideal for self-employed individuals or small-business owners whose income is variable or difficult to verify.

For those who have credit difficulties there are dozens of levels of credit rated from A- down to C-, known as Sub-Prime mortgages. Rates on Sub-Prime mortgages vary widely based on the borrower's individual credit scores, number of late payments in the last two years, loan to value



ratio, and other key factors.

When Does A Second Mortgage Make Sense?

A second mortgage is a loan made to you in exchange for a lien against your property. This lien is subordinate to the holder of your first mortgage - in the event of a default, the first lienholder must be repaid in full before subsequent lienholders are repaid. This makes the second mortgage a more risky investment for the lending institution, and this risk is typically reflected in a higher interest rate.

Second mortgages are not associated with the purchase of a new home, but rather are often taken out simultaneously with a refinanced first mortgage or independently of any other mortgages. The main reason for taking out a second mortgage is to take equity from your home and turn it into cash in pocket. This cash is often used to consolidate higher interest rate loans, pay late bills, pay taxes, purchase vehicles or rental property, fund college expenses, and other uses.

It usually does not make good financial sense to take out a second mortgage if you are having trouble servicing all of your current debts, or if the second mortgage pushes you above the 80% loan-to-value mark. Since interest on a second mortgage is generally tax deductible, a home equity loan or line of credit can be a cost-effective way to fund big-ticket items that would have to be purchased instead

Ins and Outs of Mortgage Insurance

Mortgage insurance (MI) is a monthly payment added to your mortgage used to establish a pool of funds to indemnify lenders against default on first mortgages with "high" loan-to-value ratios. Generally speaking, any first mortgage with a loan-to-value ratio in excess of 80% requires mortgage insurance.

When refinancing a first mortgage the same 80% ratio applies, unless cash is being taken out as well - in such cases mortgage insurance is required for first mortgages with loan-to-value ratios in excess of 75%. The cost of mortgage insurance increases as loan-to-value increases, and the less equity you own in your home, the greater the mortgage insurance payment.

Before you make any decisions regarding your current mortgage, it's wise to review your current financial situation, goals, and time horizon. Understanding more about how mortgages work will help you make the best decision for your situation. As always, feel free to contact us if you would like assistance.

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