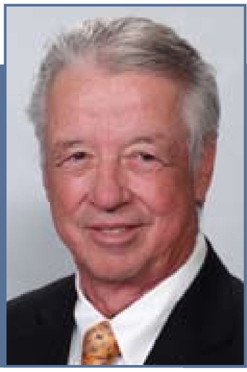

FUTURE TRENDS - BY ROGER GUDOBBA

Underwriting Intelligence

Moving from a document-oriented mortgage process to a data-oriented process is something we all have to do.

How does the lender evaluate your mortgage loan application? Ultimately the Lender wants to know:

<< Is the borrower willing and able to repay the loan?

<< Is the property value sufficient to cover the loan amount?

The evaluation is the role of the mortgage underwriter. How is this accomplished?

THE FOUR C'S OF UNDERWRITING

<< Credit: The willingness of a borrower to make debt payments on time. Lenders determine this by examining the borrower's credit history. (Creditworthiness)

<< Capacity: The current and future ability of the borrower to pay the monthly mortgage. Lenders determine this by examining the borrower's income/ employment and debt.

> It's not enough today **to simply** validate the **borrower's identity**, credit, assets and income/employment using the traditional methods.

<< Collateral: Assets that are pledged as security for a debt, such as real estate pledged as security for a mortgage.

<< Capital: The total assets, including cash and property, that a borrower has available for obtaining a mortgage and paying debt. Lenders will evaluate your application more favorably if you can verify that you have cash reserves. Cash reserves show the lender that you can manage your money well and that you can count on other funds, in addition to your income, to pay the debt.

Borrower: Based on the information on the residential loan application, the processor/underwriter validates the borrower's identity- for example driver license, passport. The processor/underwriter asks the borrower to supply documents- W-2s, paycheck stubs, tax returns, bank statements. The documents are visually reviewed and compared to the numbers on the application. Debt to income and loan to value ratios are calculated. Credit reports are pulled. Credit scores range from 300-850 and became the primary factor in determining the borrower's willingness to pay. For example, a credit score of 670 is in the 30th percentile of all scores. Consumers with this score have proven to be three times more likely to be 90 days late on payments than those with average scores.

Property: An appraisal is used to determine property value and may include a number of judgment calls by the appraiser. They rely heavily on the "comparable-sales" method to determine market value and prices are adjusted to reflect specific differences from the subject property. Today this is a difficult task because of the housing market- foreclosures and short sales.

The size of the down payment, indicating the borrower's stake in the property, typically used 20% as a barometer. More is better and less usually required private mortgage insurance or second mortgages. The reliability of automated credit scoring has reduced lender reliance on down payment and collateral over the past 10 years. Recently there are indications that now down payment and home value are important again in determining mortgage risk.

The concept of an arm's length transaction in the real estate market is to ensure that both parties in the deal are acting in their own self-interest and are not subject to any pressure or duress from the other party. When determining the fair market value of a piece of property, the price for the property must be obtained through a potential buyer and seller operating through an arm's length transaction, otherwise, the agreed-upon price will likely differ from the actual fair market value of the property.

An additional evaluation is determining if there is a possibility of fraud. The definition of fraud is "Deliberate deception perpetrated for unlawful or unfair gain." Mortgage fraud falls into two categories.

According to Crimes Enforcement Network (FinCEN) Mortgage Loan Fraud; An Industry Assessment based upon Suspicious Activity Report Analysis, "Fraud for property generally involves material misrepresentation or omission of information with the intent to deceive or mislead a lender into extending credit that would likely not be offered if the true facts were known."

The borrowers intend to make payments, but misrepresent their income, assets or intent to occupy. They may supply false or forged employment verifications, tax returns, pay stubs, W-2s, bank statements. They may not disclose a second mortgage or represent the loan as a gift. According to FinCEN, "Fraud for profit, the motivation behind is money. Fraud for profit is often committed with the complicity of industry insiders such as mortgage brokers, credit bureaus, real estate agents, property appraisers, and settlement agents (attorneys and title examiners)."

Most perpetrators never plan to make full payments. The entire file may be fraudulent -no borrower / no property. Many participants are usually involved.

It's not enough today to simply validate the borrower's identity, credit, assets and income/employment using the traditional methods. There is too much reliance on documents from third parties. In fact, there are companies that will create fraudulent asset or income documentation. They will supply a client with payroll check stubs, 1099's, W-2's. They even offer toll-free numbers for verifications. One company has an asset rental program that places funds in an account so they can be verified. The borrower pays a fee based on the amount and time. The funds are returned to the company after the loan has closed. This is a little more elusive than getting a temporary loan from a friend or relative. Fraudulent appraisals are a major concern. When you understand how fraud is perpetrated you realize how a thorough loan evaluation should uncover those plots.

There is no doubt that Automated Underwriting Systems, like credit scores, have improved the loan process. But we forgot that it is just a tool. What is missing is the underwriter's common sense and reasonability. What do I mean?

The 36% debt-to-income ratio was always the standard but recently we approved loans with higher ratios. An experienced underwriter would ask is there enough residual income? What is left at the end of the month, to pay utilities, groceries and incidentals like eating out, dry cleaning, unexpected house and car repairs, etc.? Will they be forced to tap into their savings; 401-K's? Or add credit card debt?

The end result is to examine **the character,** lifestyle, financial behavior of the borrower and do a thorough analysis of the collateral using **data analytics.**

What does the future hold?

Unfortunately, we will be dependent on documents for some time. The key is to convert that information to data.

For example, a recent article stated that when borrowers order pizza online they become part of a vast database that lenders could access. It's not about their lifestyle, it's where the pizza was delivered and could be used to validate where they reside. All sorts of data reservoirs exist today and none of them are off limits to lenders. The only caveat is whether or not the information can be accessed legally.

There are a number of major changes in appraisal management. There is some interesting work being done at organizations like Core Logic that has a risk-behavior scoring concept that will assess the global risk of a mortgage transaction including collateral, third-party and borrower-related risks. We will talk about these topics in a future article.

The end result is to examine the character, lifestyle, financial behavior of the borrower and do a thorough analysis of the collateral using data analytics, as well. ❖

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