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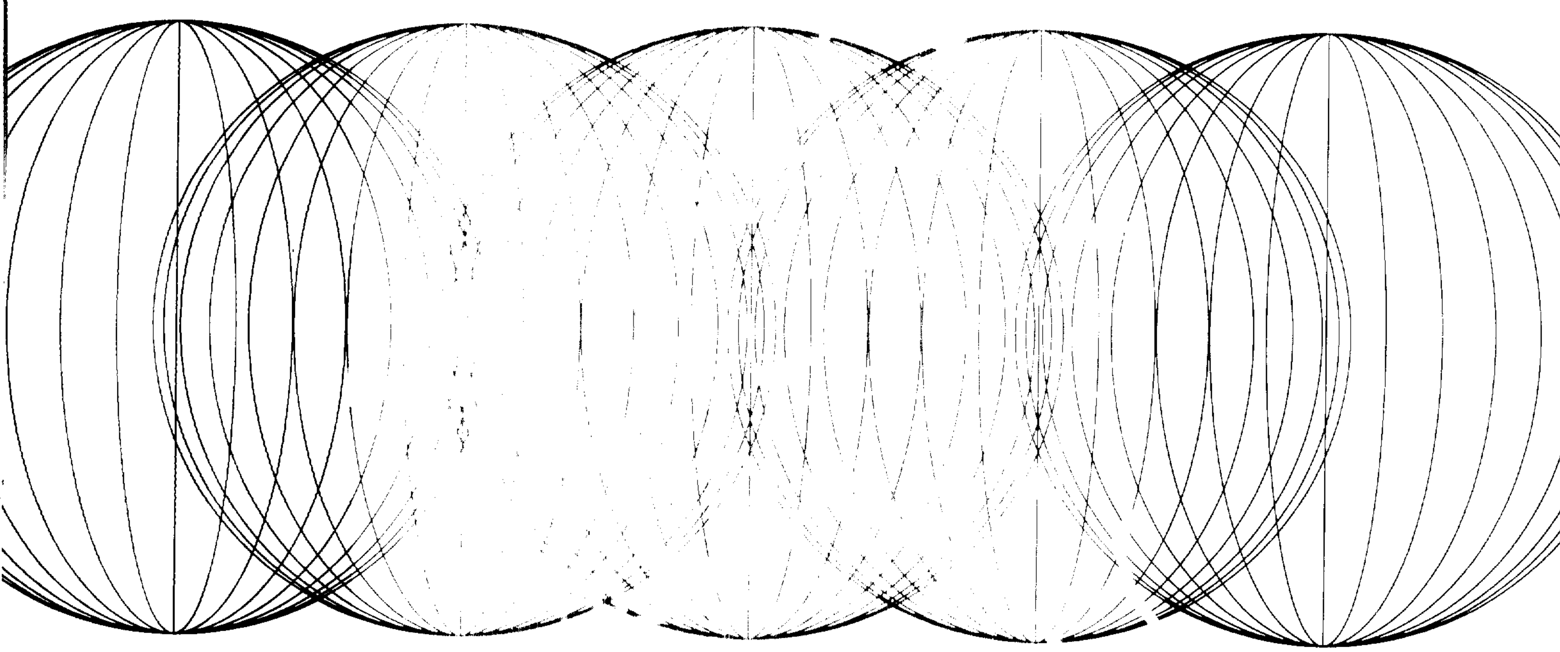
HOUSING IN EASTERN EUROPE

MORTGAGE LENDING TRAINING COURSE: ADVANCED UNDERWRITING AND SERVICING

INSTRUCTOR'S GUIDE AND TRAINING MATERIALS



THE URBAN INSTITUTE

Prepared for the Office of Housing and Urban Programs (USAID)

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MORTGAGE LENDING TRAINING COURSE: ADVANCED UNDERWRITING AND SERVICING

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Prepared by

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2100 M Street, NW
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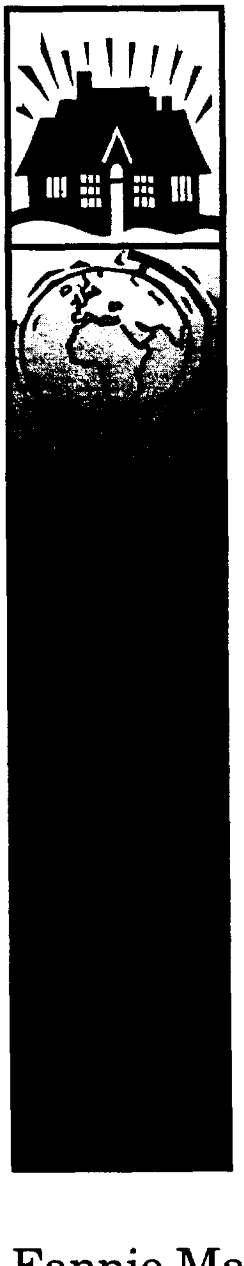

by

Margaret Grady
Lucian Hodges

Task Order No. 10
Association of Mortgage Banks
Advanced Underwriting and Servicing Course

October 1995

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Fannie Mae International Housing Finance Services

Washington, DC, USA

-2

Advanced Underwriting And Servicing

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- 3

Advanced Underwriting and Servicing

Monday	Tuesday	Wednesday	Thursday	Friday
Session 1* Basic Mortgage Lending Concepts (Suchkov)	Session 5 Originating Residential Mortgages 1.25 hours (Hodges)	Session 6 Underwriting Residential Mortgages 1.5 hours (Grady)	Session 7 Servicing Residential Mortgages 1.25 hours (Grady)	Review Quiz
Break	Break	Break	Break	Break
Session 2 Mortgage Lending in the United States 1.5 hours (Grady)	Practice Exercises 2 hours	Lecture/ Discussion 1 hour Case Study 1 hour	Session 8* Introduction to Servicing Software (Ozerov)	
Lunch	Lunch	Lunch	Lunch	Lunch
Session 3* Legal Basis for Mortgage Lending in Russia (Platkin)	Lecture/ Discussion 1.25 hours Practice Exercises 2 hours	Case Studies (continued) 2.5 hours	Practice Exercises	Session 9* Experiences of Russian Banks (Cook)
Break	Break	Break	Break	Break
Session 4* Description of the DAIR (Klimenko)	Lecture/ Discussion 1 hour	Lecture/ Discussion 1 hour		Certificates Evaluation

* Training materials for these sessions were prepared in Russian only.

Session 2
Mortgage Lending in the United States: A Working Model

Time: 1.5 hours **Format: Lecture and discussion**

Introduction

This session covers the following topics as part of describing a working model of mortgage lending in the United States:

- primary and secondary mortgage markets
- Fannie Mae's business
- types of lending institutions
- the mortgage contract and products

Introduce the session by reviewing the topics to be covered. Tell students that each person should expect to participate and contribute, through discussion, and to make this a joint learning experience. Say something like:

> **"In this session we will look at a working model of mortgage lending in the U.S. To make sure that we all understand how the model can be applied in Russia, your participation is critical. Now and then, I will stop and ask you to link the**

5

information to our market and our environment. Through discussion and sharing, we can all benefit. After all, you have a great deal of valuable insight, experience, and information that can help us all implement an efficient, profitable mortgage lending system in Russia."

Do not feel that you as the instructor must carry the entire session. While you will need to communicate information about the U.S. model, the most important objective is to make sure that students think about and discuss how this information can be applied to their own institutions and to their environment. So, keep your lectures brief and allow time for interaction.

Encourage everyone to participate—do not allow one or two individuals to dominate the entire discussion. Remind students that everyone's opinion counts. Be sure students listen to each other and that they acknowledge the other person's point of view, even when disagreeing.

As the instructor, resist the urge to favor one position over another. It is better to let students work through issues and differences of opinion as a group. You should not appear arbitrary or to favor one individual over another. Finally, thank individual students for their contributions. This will encourage others to join in.

6

In December 1993, President Yeltsin signed a decree that established the basic institutional framework for mortgage lending in Russia. Among other things, the decree created the Federal Agency for Mortgage Lending.

Stop here and ask students what was so significant about this decree. Also ask if anyone knows what the decree entails. Confirm with the information below.

Up to this point, no governmental body had clear responsibility for fostering and regulating mortgage lending.

The decree gives the Agency two primary responsibilities:

- to serve as a source of liquidity for mortgage lenders by purchasing the mortgages they originate; and
- to infuse capital into the housing finance system by issuing mortgage-backed securities.

The decree also charges the Agency with the responsibility of working with trade groups, such as the Association of Mortgage Banks, to develop the necessary training for bankers engaged in mortgage lending; and of working closely with the Central Bank of Russia to set standards for the industry.

- 1'

Stop here and ask students why setting standards is important for the banking industry in Russia. Why not wait until the industry is more mature to establish standards?

The roles established for the Central Bank are similar to those that agencies in the United States, such as the Federal National Mortgage Association (Fannie Mae), play in the U.S. housing finance system.

For the next five days, we will be examining one model for making successful mortgage loans—loans that are affordable for borrowers (helping them to purchase their own homes) and that are also safe and profitable investments for the banks making the loans.

While the housing finance system in the United States is just one of many types of systems that have been developed and implemented in countries around the world, it is one of the most successful.

The approach to mortgage lending that we will be examining in this course is patterned on the U.S. housing finance system, but it has been adapted to reflect our own specific needs as Russian bankers.

Stop here and ask students what they feel the unique needs of Russian bankers are. Say something like:

> **"To make sure that we relate this information to our own institutions and markets, tell me what you feel the unique needs of Russian bankers are. I'll write these down, and we can refer to the list periodically to make sure that we are relating the model to our needs here in Russia."**

Write the list on a flip chart or board and make sure the list is visible throughout the session.

The model we are going to look at offers a sound approach to mortgage lending—an approach that has served the United States well for more than 60 years. Over this time, this form of mortgage lending has provided substantial earnings to banks; has helped millions of borrowers to purchase their own homes; and has helped to stabilize and strengthen the national economy.

We hope that by studying this model, and by taking from it what is useful to you, you will find some worthwhile answers to the crucial questions with which we are faced as we strive to make decent, affordable housing available to all Russian citizens.

9

How it works

The housing finance system in the United States is a two-tiered system, consisting of a primary market and a secondary market.

(Show OH 2-1 The Primary Market)

The primary market

The primary market is the financial institution to which potential home buyers come to borrow the money they need to purchase a home. Thus, the primary market operates at the local level of the economy.

(Show OH 2-2 The Secondary Market)

The secondary market

The secondary market operates on the national level of the economy. It is the market in which mortgages originated in the primary market are bought and sold.

Primary market lenders can sell their mortgages in the secondary market for cash, thus replenishing their supply of funds for additional lending.

Primary market lenders can also use the secondary market to swap a pool of mortgages for a mortgage-backed security. They can then hold the security in their own investment portfolio or sell it to an investor in the capital market.

Stop here and make sure students understand the difference between the primary market and the secondary market. This differentiation is critical. Ask another student to summarize.

The capital market

The capital market—which also operates on the national level—is the market where long-term investments, such as mortgage-backed securities and government bonds, are bought and sold.

It is the secondary market that provides lenders at the local level with access to investors at the national level.

By giving primary market lenders access to the capital market, the secondary market serves three purposes:

- it makes lenders less dependent on fluctuations in their local economies;
- it increases the availability of funds nationwide; and
- it stabilizes the entire economy.

Stop here and ask students if they can think of other benefits for Russia of a similar arrangement.

Fannie Mae

The Federal National Mortgage Association, more commonly known as Fannie Mae, is the oldest and largest secondary market investor in home mortgages in the United States.

It is a privately owned company charged with a public mission—to help make the dream of homeownership a reality for more American families, especially those of modest means.

Like the Russian Federal Agency for Mortgage Lending, Fannie Mae was originally established (in 1938) as an agency of the federal government.

In 1958, Fannie Mae became a privately-owned company, although it continues to operate under a unique federal charter.

Stop here and make sure students know that Fannie Mae is not the only participant in the secondary mortgage market in the U.S. However, Fannie Mae is the key player and has set the standards for lending and underwriting in the U.S.

12

Fannie Mae's Corporate Mission

Fannie Mae's corporate mission is to provide financial products and services that increase the availability and the affordability of housing for low-, moderate-, and middle-income Americans—while at the same time consistently earning good profits in order to provide a reasonable rate of return to shareholders.

Fannie Mae fulfills its mission by creating an efficient and reliable secondary market for residential mortgage loans.

Fannie Mae's Business (how it makes money)

Fannie Mae is basically engaged in two lines of business:

- purchasing mortgages for its portfolio (mortgage portfolio investments); and
- issuing Mortgage-Backed Securities.

Stop here and ask students how they think Fannie Mae makes money by purchasing mortgages and issuing Mortgage-Backed Securities. Encourage students to discuss this before you go on to confirm how it works.

13

Mortgage Portfolio Investments

Fannie Mae purchases mortgages for its portfolio from its nationwide network of more than 2,900 approved mortgage lenders.

The corporation funds these purchases by issuing debt (bonds) in the domestic and international capital markets.

The corporation derives income from the difference, or "spread," between the yield on the mortgage loans in its portfolio and the yield it pays capital market investors on its debt obligations.

Stop here and provide an example: Fannie Mae might earn a yield of 8.5% on mortgages it buys. However, it pays only 8.25% yield to its capital market investors. This leaves a .25% profit.

Mortgage-Backed Securities

Fannie Mae's second major line of business is its guaranty fee business.

Fannie Mae issues securities called Mortgage-Backed Securities or MBS in exchange for groups or "pools" of mortgages from primary market lenders.

Fannie Mae charges lenders a fee called a "guarantee fee," for which Fannie Mae guarantees that investors in MBS will

14

receive principal and interest payments on all of the mortgages underlying the security whether borrowers make their mortgage payments or not.

Mortgage lenders can hold MBS in their own investment portfolio or they can sell them to another investor in the capital market.

Stop here and provide the following example to illustrate MBS: Suppose a primary market lender owns a group of mortgages at 8.5%. To provide security on these loans, Fannie Mae might charge a guarantee fee of .25% and deduct .25% to allow for the servicing fee. The mortgages would then be secured at 8%. Fannie Mae thus earns .25% from the guarantee fee. The security is owned by the mortgage lender or the underlying mortgage investor.

Ask students what the benefits to lenders would be of a Mortgage Backed Securities system versus holding the notes themselves. Would this system work in Russia?

Mortgage lending institutions

There are several types of mortgage lending institutions that operate in the primary market in the U.S. Basically they fall into two categories: depositories and mortgage banks.

15

Depositories

Depositories are financial institutions that act as intermediaries between people who want to save money and people who want to borrow money.

They are the main source of mortgage financing in the United States.

Depositories have two sources of income:

- interest income—the spread between the interest they pay depositors and the interest they charge borrowers; and
- fee income—the fees they charge borrowers for the financial products and services they provide, including the processing of loan applications.

Stop here and provide examples of interest income and fee income. Interest income: the depository pays their depositors 5% interest on savings and charges a mortgage borrower 8.5%. Fee income: the depository charges 1% of the loan amount to process an application.

Mortgage banks

Mortgage banks are the second type of mortgage lending institution in the United States.

Mortgage banks obtain funds to finance their mortgage lending activities by borrowing from depositories.

So, even though they do not accept deposits themselves, their primary source of funds for lending still comes from savings deposits.

Unlike depositories, after mortgage banks originate a mortgage loan they sell it immediately to an investor like Fannie Mae who earns the interest income on the mortgage.

However, the mortgage banks continue to service those mortgages on the investor's behalf—that is, they manage the relationship with the borrower throughout the life of the loan.

For example, they collect the borrowers' monthly mortgage payments and provide assistance to borrowers who may be experiencing financial difficulty that is interfering with their ability to make their mortgage payments.

In compensation for these services, lenders receive a monthly servicing fee from the mortgage investor.

Mortgage banks' primary sources of income are these servicing fees and the origination fees they charge borrowers for processing their applications.

Stop here and ask students why they think mortgage banks immediately sell their mortgages to investors.

> **(Answer: To generate more money so they can finance more mortgages.)**

Ask students what they think would be the challenges involved in servicing loans in Russia. How can banks address some of those issues? Tell students that servicing isues will be discussed in detail later. Do not let the discussion last more than a minute or two.

The mortgage contract

The most common home financing instrument in the United States is a combination of two legal agreements between a borrower and a lender: the note and the mortgage.

The **note** is the borrower's written promise to pay back the sum of money borrowed to purchase a home at a stated interest rate over a specified period of time.

18

The note is secured by a **mortgage**, which is a separate legal agreement between a lender and a borrower, whereby

- the lender agrees to loan the borrower a sum of money to purchase a home at a specified rate of interest and for a specified period of time; and

- the borrower agrees to pledge the property he is purchasing as security for the full repayment of the loan.

The property pledged as security for the full payment of a loan is called **collateral.**

Stop here and ask students how this system compares to the system in Russia. Are both a promissory note and a mortgage required?

If the borrower is unable to pay back the loan—that is, if the borrower **defaults**—the bank is allowed by law to take ownership of the collateral property and sell it in order to pay off the balance of the loan.

A mortgage signed by both the lender and the borrower establishes a **lien** on the property.

19

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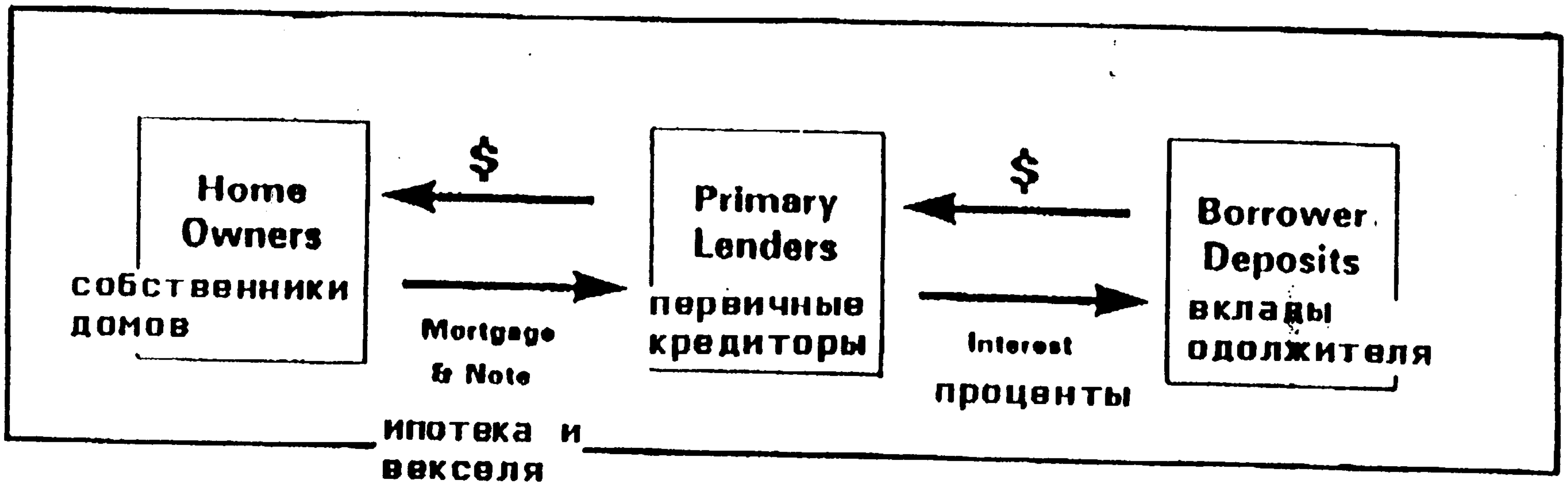
PRIMARY MARKET

Первичный рынок



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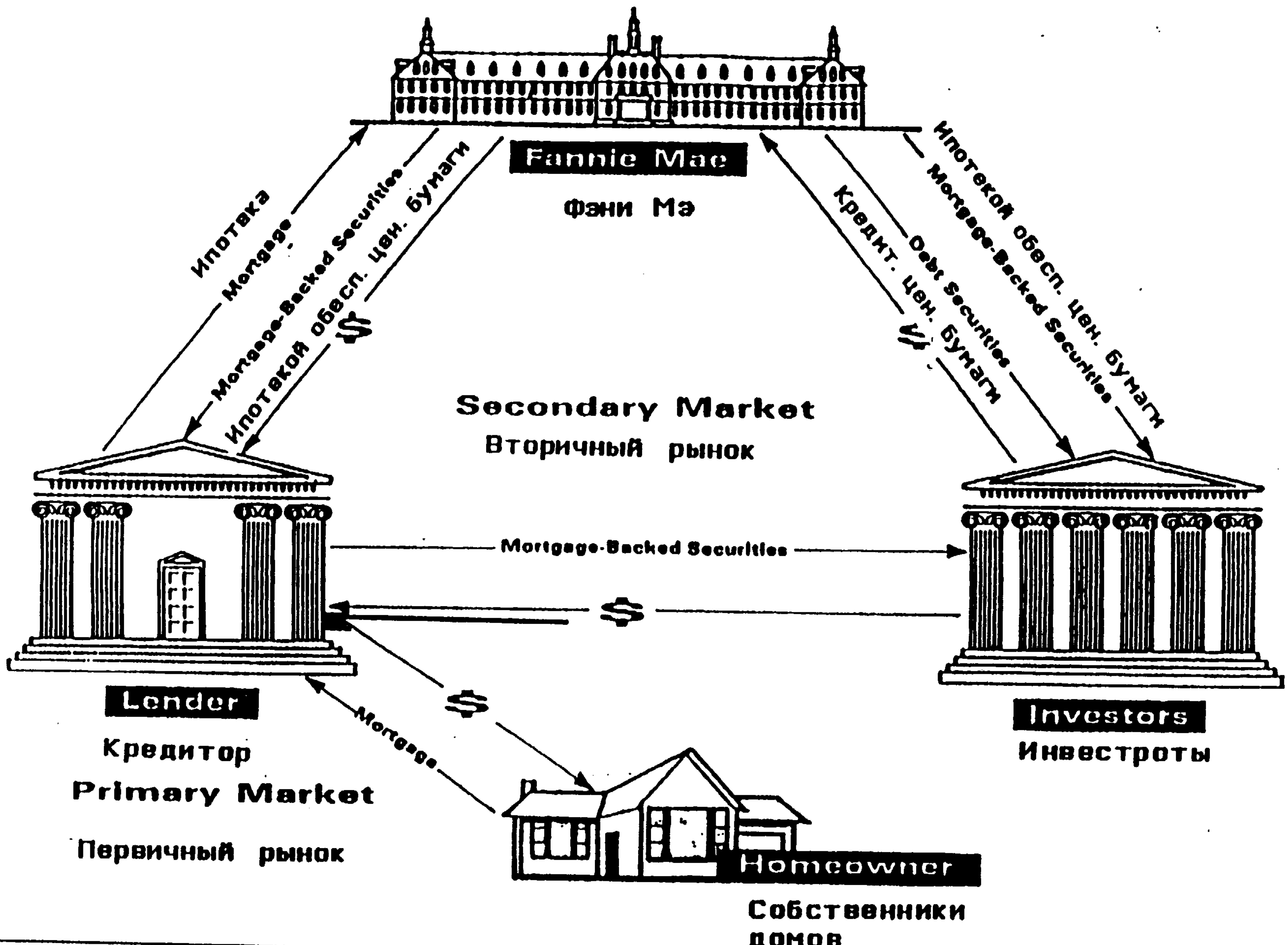

Fannie Mae
Фэни Мэ
Ипотека
Mortgage
Mortgage-Backed Securities
Ипотекой обесп. цен. бумаги
$
Кредит. цен. бумаги
Debt Securities
Mortgage-Backed Securities
Ипотекой обесп. цен. бумаги
Secondary Market
Вторичный рынок
Mortgage-Backed Securities
$
Lender
Кредитор
Primary Market
Первичный рынок
$
Mortgage
Investors
Инвестроты
Homeowner
Собственники
домов

Session 5
Originating Residential Mortgages

Time: 7.5 hours

Format: Lecture, discussion, and practice exercise (3.25 hrs)
Lecture, discussion, and practice exercise (4.25 hours)

Introduction

This session covers the following topics as part of originating residential mortgages:

- conducting the loan interview
- taking the mortgage application
- processing the loan application

Introduce the session by reviewing the topics to be covered. Tell students they will have opportunities to practice conducting the loan interview and taking a mortgage application. Review the day's agenda with the group.

- **conducting the loan interview (lecture)**
- **practice exercise**
- **taking the mortgage application (lecture)**
- **practice exercise**
- **processing the loan application (lecture)**

22

It is also critical to explain the value of their participation in the discussion during the session. Say something like:

> **"Now and then we will stop to discuss certain points. For you to get the most from this training, it is vital that you think about how we can apply the information in Russia today. Interaction and discussion will help us all share effective techniques and will ensure that you can implement the full process for originating residential mortgages when you go back to your offices."**

Keep in mind that students in the class have a great deal of information, creativity, and solutions to share. The burden is not on you as the instructor to carry the entire session. Be sure to encourage ALL students to participate. Guard against letting one or two individuals dominate the conversations. Finally, keep your lectures brief. Students will learn more and remember more by an interactive approach in which they participate.

Conducting the Loan Interview (1.25)

The loan interview is a preliminary step to taking the *Loan Application.* The loan interview has two important purposes.

The first purpose is to **pre-qualify applicants** so that neither they nor the bank will go to the time and expense of making and processing a formal *Loan Application* if they are clearly not eligible for a mortgage.

The second purpose of the loan interview is to **prepare customers for the loan application process** if they pre-qualify.

Pre-qualifying the applicant

Once the applicant has a clear understanding of what entering a mortgage contract entails and if the customer still wants to proceed, the Customer Service Representative should complete a *Pre-qualification Worksheet* [see page 39 in Appendix D of the *Residential Mortgage Loan Manual*] to determine if the applicant will be likely to qualify to borrow the amount of money he needs to buy the home.

When pre-qualifying prospective applicants, Customer Service Representatives should keep in mind that most applicants will not be familiar with this concept.

The Customer Service Representatives should take a few moments to explain that pre-qualifying involves looking at the applicant's financial situation—particularly their income and debts—and their anticipated monthly mortgage payment, to determine if their income is sufficient to meet all their debt obligations.

24'

They should emphasize to applicants that pre-qualifying does not mean loan approval, but is only an indication of whether or not applicants should proceed with the loan application process.

Stop here and ask students what the applicant is probably thinking at this point. What are the applicants concerns, fears, and expectations? Solicit several examples. Then ask students to share with the class exactly how they would explain the pre-qualification process to customers. Solicit 2 - 3 examples. Be sure to thank students for their contributions—this will encourage others to participate throughout the session.

Calculating debt-to-income ratios

After obtaining the necessary financial information from the loan applicant, the Customer Service Representative should examine two ratios called the housing-expense-to-income ratio and the total-debt-to-income ration.

- The **housing-expense-to-income ratio** is the relationship between the applicant's anticipated monthly mortgage payments and the applicant's monthly gross income.

25

- The **total-debt-to-income ratio** is the relationship between the applicant's anticipated total monthly debt (including the mortgage payment) and the applicant's monthly gross income.

Typically, lenders use **amortization charts** to calculate the applicant's anticipated monthly mortgage payment [see page 8 in the *Product Description for the DAIR* for an example of an amortization table].

In calculating the applicant's monthly housing expense, lenders need to include not only the principal and interest, but also an estimate of property taxes, hazard insurance, and condominium or cooperative fees, if appropriate.

The benchmarks currently in use in Russia are that the applicants' monthly housing costs (including mortgage payments, property taxes, and insurance) should total no more than about 1/4 of their monthly gross (before tax) income, and that their monthly housing costs plus other long-term debts should total no more than about 1/3 of their monthly gross income.

These ratios are not rigid rules. They are simply guideposts that enable lenders to make sure that the bank is not taking on undue risk, and that the applicant will be able to handle the debt.

If applicants are close to these percentages, the Customer Service Representative may feel comfortable that other compensating factors will help to offset somewhat high ratios, and that the customer should proceed with the *Loan Application.*

Stop and ask students to list some compensating factors. Do not spend much time on this point since compensating factors will be covered again in the underwriting session

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If applicants are clearly not eligible for a mortgage loan, the Customer Service Representative should explain why they are not eligible and what they must do to become eligible.

Stop here and say something like:

> **"Suppose you have an applicant whose income is sufficient for approval but whose current debt is too high to qualify for a mortgage loan. How would you tell the applicant he is not eligible and what he should do to become eligible?"**

If the Customer Service Representative determines that an applicant might be eligible for a mortgage loan, the loan interview should proceed to the next step. However, the Customer Service Representative should repeat that "pre-qualifying" for a loan is only the preliminary stage in being "approved" for the loan.

Preparing the customer to complete the *Application*

The Customer Service Representative should provide applicants with a list of the information and documentation they will need to have with them in order to complete the *Loan Application* [see Appendix D on page 41 in the RML Manual for "Information and Materials Required to Complete Application"].

The list should include **documents** such as

- bank statements for any funds used in the mortgage transaction;
- pay receipts for the previous month(s);
- statement of yearly income provided by the applicant's employer;
- rent payment book;
- phone payment book;
- utilities payment book; and
- gift letter, if appropriate.

Stop here and discuss with the students how to verify income and expense information in the absence of documents such as those listed above. Write examples on the board or flip chart.

The list of **information** the applicant should have available in order to complete the *Loan Application* should include

- property information (address);
- who will be listed on the title as owner(s);
- loan amount requested;
- internal passport number;
- current address;
- previous address if at current address for less than two years; and
- name, address and telephone numbers of all employers for the preceding two years.

Additional **income information** should include

- average amount of overtime over the last full year;
- average amount of bonus over the last two years;
- average amount of commissions over the last full year;
- interest/dividend information; and
- rental income.

Asset information should include

- name, address and telephone numbers of all banks at which applicant has accounts;
- account balances;
- account numbers;
- accurate account of all stocks and bonds;
- gift information
  - name and address of donor,
  - amount of gift; and
- information regarding all real estate owned.

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Liabilities information should include the name, address and telephone numbers of all creditors, as well as all account balances, monthly payments, and account numbers.

The Customer Service Representative should re-emphasize that by coming to the meeting fully prepared, the applicant can speed up the loan application process, which will lead to faster loan approval.

Stop here and ask students how they think the applicant feels about giving such information. They should agree that many applicants may feel that the CSR is prying into personal matters. Then ask students how they would put the applicant at ease and how they begin to ask for this information. Solicit input from several students.

Scheduling the meeting to complete the Application

Arranging a convenient time and location for completing the *Loan Application* is an important part of quality service.

Some lenders complete the *Loan Application* at a time and place that are most convenient to the customer, whether at the customer's office during the business day or at the customer's home in the evening or on weekends.

If a bank decides to follow this policy, the Customer Service Representatives should ask applicants if they would prefer to meet with them at the bank or at their residence or place of business for the purpose of completing the *Loan Application.*

Stop here and ask students why the location of the meeting is important. Why should you ask the applicants where they prefer to meet?

It should be made clear that all co-borrowers must also be present in order to complete the *Loan Application.*

The Customer Service Representatives should encourage applicants to call or send written correspondence to them if they have any questions.

Completing a *Loan Application* requires much detailed information, and most loan applicants must consult their personal records in order to have at hand all of the information they will need. Also, the loan applicants will have to bring with them supporting documents to verify the information provided in the *Application.*

Creating the mortgage loan file

Finally, the Customer Service Representative should create a loan file for the applicant and insert the completed *Pre-qualification Worksheet.*

Ask students if there are any other issues that should be discussed regarding the Loan Interview. Transition to the Practice Exercise by saying something like:

> **"Now that we have a solid understanding of the purposes for the Loan Interview, you will have a chance to practice conducting an interview with a prospective customer. First, let's take a 15 minute break. Please be ready to start again at ___ (give an exact time).**

Practice Exercise: Prequalifying Loan Applicants

(2 hours)

Introduction:
This exercise utilizes role plays as a learning methodology. Role plays are an excellent way to teach attitudes and interpersonal skills, as well as to test whether students can transfer the facts and concepts they have learned to the real world.

33

Purpose:

This exercise gives students an opportunity to conduct a Prequalifying Loan Interview with a customer. Students work in pairs, with one student playing the role of the Customer Service Representative and the other student playing the role of the customer.

Materials:

You will need to make copies of these materials ahead of time so that you can provide them to the students:

- Instructions for Customer Service Representative
- Prequalification Worksheet
- Instructions for Mortgage Loan Applicant (Mr./Miss Kitov)

Time Required:

2 hours (10 minutes for directions, 10 minutes to read their roles, 40 minutes to conduct the interview and complete the worksheet, 60 minutes for reports)

Directions:

1. Ask students to count off in pairs. Explain they will be working together on the role play exercise.

2. Describe the purpose of the exercise. Say something like:
"In this exercise, you will participate in a prequalifying interview with a customer. Role plays give you a chance to practice using interpersonal skills s well as applying the knowledge you've gained."

3. Ask students to decide who will play the role of the Customer Service Representative and who will play the customer. (Assure them that everyone will get the chance to play the part of the CSR by switching roles in the next exercise.)

4. Explain that they should read only the instructions for their role. Role plays should simulate reality as much as possible, so the CSR needs to interview the applicant to solicit information and complete the worksheet.

5. Tell participants they may refer to their instruction sheets during the role play. The CSR needs to complete the worksheet and determine if the applicant prequalifies.

6. Give students 5 - 10 minutes to read their role plays. Then ask if there are any questions.

7. Tell students they will have 40 minutes to conduct the role play, complete the worksheet, and determine if the customer prequalifies. Explain that both the

CSR and the applicant should be prepared to share their responses to the role play.

8. Begin the role plays. Circulate from group to group to offer assistance if students have difficulty and ask you for help. However, resist the temptation to offer help too quickly. Let students work as independently as possible.

9. When 5 minutes remain, direct students to complete their work.

10. Bring the group back together and ask for reactions to conducting the interview. Start with the applicants. Ask questions like these: What did the CSR do that put you at ease? What questions or information proved most difficult for you to answer? When did you feel most uncomfortable? Then ask the CSRs how they felt about conducting the interview. What information was the most difficult for you to solicit? How did you handle those situations? Did the customer prequalify? If the customer had NOT prequalified, would that be difficult to communicate to the applicant?

11. Make sure each pair of students contributes to the discussion. Begin the discussion by letting volunteers offer their reactions. Then ask specific pairs to join in.

12. Thank the students for their efforts and their contributions.

- 76

Transition:

Transition to the next section on Taking the Mortgage Application by saying something like:

> "Since our applicant has prequalified, let's proceed with taking the mortgage application. After lunch, we'll talk about completing the application, and you'll have an opportunity to practice. Please be back and ready to resume at ___ (give an exact time)."

Taking the Mortgage Application (1.25 hours)

The Customer Service Representative's purpose in taking the *Loan Application* is to gather most of the information that the Underwriter will need to make a sound and prudent judgement about the likelihood of three possibilities:

- whether or not the applicant will be **able** to repay the mortgage;
- whether or not the applicant will be **willing** to repay the mortgage; and
- whether or not the property will provide **sufficient security** (collateral) for the mortgage if the applicant is unable to repay the loan.

In this section, we will examine the steps required to take the mortgage application and to prepare the loan file for handoff to the bank's Loan Processors. These steps include the following:

- completing the *Loan Application* form;
- providing the proper disclosures;
- obtaining the necessary signatures;
- requesting missing information and documentation;
- collecting the application fee;
- assembling the mortgage loan file and forwarding it to the Loan Processing Department; and
- maintaining communication with the applicant.

38

Your students will derive much more benefit from this session if they have an opportunity to refer to a *Loan Application* during your lecture and discussion. Direct the students' attention to pages 42-49 in the Residential Mortgage Loan (RML) Manual for an example of a mortgage *Loan Application*, or distribute a sample *Loan Application* to all students at the point in your lecture that you feel is appropriate.

Completing the *Mortgage Loan Application* form

[Show Overhead 5 - 1: How to take the Mortgage Loan Application]

It will be helpful for the Customer Service Representative to call or contact the applicant prior to the scheduled meeting.

The Customer Service Representative should confirm that the applicant has all of the information and documentation needed to make the application, and should remind the applicant that all co-borrowers must be present when the application is made.

In order to ensure that the *Loan Application* is as complete and accurate as possible before it is handed off to the Loan Processor, it is recommended that the application be completed by the Customer Service Representative in the presence of the applicant and with assistance from the applicant. This arrangement also assures that the application is completed in a timely manner.

Stop and ask students why it is preferred to have the Customer Service Representative complete the *Loan Application.*

Taking a complete *Loan Application* is one of the most important services that a Customer Service Representative can provide to mortgage customers, because a complete *Loan Application* means that customers will get the mortgage funds they need to buy their homes more quickly and easily.

Complete *Loan Applications* are also a service to the bank's Loan Processors and Underwriters, because they enable them to do their jobs more easily and efficiently.

Finally, complete *Loan Applications* also benefit the Customer Service Representatives themselves, because they allow them to devote their time to originating more loans, rather than spending time requesting additional documentation or resolving problems later on due to inadequate information.

Providing the proper disclosures

By "disclosure" we mean all written information that is provided to applicants from the time they apply for the mortgage loan through the time the loan transaction is completed.

Stop here and ask students to name some examples of information that must be disclosed.

Let's consider how disclosure benefits the applicant, the lender, and the market in general.

Write on the board or flip chart: Applicant, Lender, Market. Begin with the applicant and ask students how applicants benefit from disclosure. Write their answers on the board or flipchart. Confirm with the information below.

4\

Benefits to applicant

Providing the loan applicant with full disclosure of the terms of the contract he is entering into protects the applicant from unfair or fraudulent practices by lenders. Proper disclosure also educates the loan applicant about his rights and responsibilities (and those of the bank), and thus can help to prevent delinquencies and the possibility of default later on.

42

Next point to the lender and ask students how lenders benefit from disclosure. Write their answers on the board or flipchart. Confirm with the information below.

Benefits to lender

Disclosure protects the lender, because contract law generally allows for nullification of contracts for fraud, misrepresentation, and false pretenses.

Because the residential mortgage loan is a complex financial transaction and one that is relatively new in Russia, the possibility of allegations of fraud or misrepresentation made against lending institutions may be particularly high.

The bank can lower this risk if the Customer Service Representatives follow a program of adequate written disclosure.

Evidence that the bank follows an appropriate disclosure program helps the bank avoid the appearance of unfair dealing, and distinguishes the bank from those that do not adhere to such high standards.

Finally, as we mentioned earlier, providing the loan applicant with full disclosure about the contract he is entering into is an important customer education opportunity with major implications for preventing delinquencies and controlling default.

Disclosure also decreases the amount of time and trouble involved in the servicing of loans because applicants will know from the start what is expected of them after the loan is approved.

Next ask students how the market in general benefits from disclosure. Write their answers on the board or flipchart. Confirm with the information below.

Benefits to market in general

Disclosure also benefits the market in general because when several types of mortgage products are available in the market, each designed to meet the needs of applicants in different economic circumstances, disclosure requirements help to properly match applicants with the loan that they are best able to support given their economic circumstances.

It is against the interests of applicants and lenders to have applicants taking on loans that they do not fully understand or that they may not be able to afford.

At a minimum, applicants should be provided with the

44

following disclosures:

- a description of the loan process and the **rights and obligations** that may arise;

- an *Estimate of Applicant's Costs* [see page 55 in Appendix D of the RML Manual] explaining every fee and charge that will be collected from the applicant by the lender making the mortgage loan;

  Here, the Customer Service Representative should explain that the amounts listed on the form are only estimates (not a commitment by the bank); that these estimates are based on the amount of the loan the applicant has requested and the prevailing bank rates and prices for services at the date of the estimate; and that these may change prior to loan closing.

45

- a description of the applicant's continuing costs, rights, and obligations once the loan transaction has been completed;

- a written statement that the applicant has the right to be represented by an attorney in connection with the mortgage loan, and that the loan may have meaning and effects that the applicant may understand better with the advice of an attorney;

- an explanation of the interest to be paid by the applicant on the loan, including how the change in rates is calculated for ARMs.

  Here, the Customer Service Representative should tell the applicant in clear language how the rate change would operate under assumed economic conditions [See the *Inflation Adjustment Worksheet*, on page 63 in the RML Manual].

  These economic forecasts should be reasonable and should convey to applicants the potential risks involved with their loan, for example:

  - what index the loan rate is tied to (interbank lending rate);

  - when the interest rate may change (every three months for the DAIR); and

  - a practical example showing how a change in the

46

loan rate will affect the applicant's required monthly payment;

- any changes that can be made to the term (or "maturity") of the loan;

- an explanation, in plain language, of the remaining conditions of the loan (for example, the continuing obligations of the applicant under the loan and the rights of the lender to accelerate the loan and enforce the mortgage or "foreclose on the property"); and

- a *Disclosure of Loan Terms* [see pages 59 - 61 in the RML Manual] including definitions of the following items:

    - Adjustable rate
    - Index
    - Margin
    - Initial interest rate
    - Interest rate adjustments
    - Interest rate maximums
    - Applicant notification

47

- Initial monthly payment
- Monthly payment checks
- Prepayment
- Property taxes
- Property and mortgage insurance
- Assumability
- Rights of the bank

The Customer Service Representative should read through the list of terms with applicants and ask for questions about any items that are unclear.

If there are any changes to the disclosure terms, these should be provided to the applicant no less than five days prior to closing.

It is important to emphasize that the Customer Service Representative should attempt to observe the "spirit of the law" as well as the "letter of the law." In other words, the Customer Service Representative should make every attempt to explain the disclosures orally until the loan applicant fully understands them, and should not assume that by simply providing written disclosures that the information has been conveyed and properly understood.

49

Stop here and ask students how they handle disclosures with customers, since much of the information is very unfamiliar to applicants and potentially very confusing and overwhelming.

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Obtaining the necessary signatures

The Customer Service Representatives should obtain signatures on the following documents:

The locations of these documents in the RML Manual are indicated by page numbers in brackets following each listing. You may want to ask students to refer to these pages as you mention each document.

- *Loan Application [See page 42 ff]*

- *Verifications*
  - *Deposit* [See page 51]
  - *Employment* [See page 53]
  - *Loan and Payment History* [See page 55]

- *Estimate of Applicant's*

- *Closing Costs* [See page 57],

- *Disclosure of Loan Terms* [See page 59], *and*

- Self-Employed Applicant's Statement (if applicable) [See page 62].

The Customer Service Representative should explain to applicants that once they have signed the *Loan Application*, they may be bound to accept the loan if it's offered, or be bound to pay the lender's processing costs if the application is rejected.

The Customer Service Representative should provide the applicant with copies of all signed documents.

Requesting missing information and documentation

The Customer Service Representative should provide the applicant with a list of any additional information needed to complete the *Loan Application*

The Customer Service Representative should use the *Information and Materials Required to Complete Application* form [See page 41 in the RML Manual] that was provided to the applicant during the loan interview to remind the applicant of any missing information that the applicant still needs to provide.

This is the same form that the Customer Service Representative would have given to the loan applicant at the loan interview to help the applicant prepare for the loan application meeting.

Stop here and ask students what information is most often missing, from their experience. What are some ways the Customer Service Representative can get that information quickly and prevent delays in the application process?

Collecting the application fee

The Customer Service Representative should explain the purpose of the **loan application fee.** This fee is meant to cover the cost of the bank's time spent in gathering the information needed to process the *Loan Application.*

Ask students how they explain the loan application fee to customers. Solicit specific examples from students of what to say.

The Customer Service Representative should then collect the fee and forward it to the Servicing Department; and provide the applicant with a receipt for the fee and place a copy of the receipt on the mortgage loan file.

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Assembling the mortgage loan file

[Show Overhead 5 - 2: What is included in a mortgage loan application package]

At the conclusion of the loan application meeting, the Customer Service Representative should place the following documents in the newly-established loan file (together with a copy of the applicant's receipt for the application fee):

- Cover Sheet;
- *Mortgage Loan Application,* completed and signed*;*
- signed *Verification of Deposit;*
- signed *Verification of Employment;*
- signed *Verification of Loan and Payment History;*
- signed *Estimate of Applicant's Costs;*
- signed *Disclosure of Loan Terms;*
- *Self-Employed Borrower's Statement* (if applicable), completed and signed*; and*
- *Inflation Adjustment Worksheet.*

53

The Customer Service Representative should then forward the mortgage loan file to the Loan Processing Department.

Maintaining communication with the applicant

To provide the highest degree of customer service possible —and to ensure that the loan application and loan processing phases run smoothly—the Customer Service Representative should always be the person to maintain communication with the mortgage applicant.

This means that all phone calls and written correspondence from a applicant should be forwarded to the Customer Service Representative who handles that applicant.

If the Customer Service Representative is not able to answer a particular question, he should not forward the applicant's call to other staff members of the bank who may be able to answer the question.

Instead, the Customer Service Representative should inform the applicant that he is not able to provide the information requested at the moment, but that he will call the applicant back with an answer at the earliest possible time.

This concludes the loan application stage of the origination process.

Ask students if there are any other issues that should

be discussed regarding the Loan Application. Transition to the Practice Exercise by saying something like:

> **"Now that we know what is required for the Loan Application, you will now have a chance to practice completing an application with a customer. Let's take a 15-minute break. Please return at _____ (give an exact time)."**

Practice Exercise: Taking the Loan Application

(2 hours)

Introduction:

As with the previous exercise, this one utilizes role plays as a learning methodology. As we noted earlier, role plays are an excellent way to teach attitudes and interpersonal skills, as well as to test whether students can transfer the facts and concepts they have learned to the real world. In taking the loan application, both an understanding of the application process and the best way to facilitate the discussion with the applicant are required.

Purpose:

This exercise gives students an opportunity to work with an applicant in completing a loan application. Students will work in the same pairs as for the previous exercise. This time, they will reverse roles (i.e., the CSR will now play the role of the applicant).

Materials:

You will need to make copies of these materials ahead of time so that you can provide them to students:

- Instructions for Customer Service Representative
- Loan Application
- Instructions for Mortgage Loan Applicant (Mr./Miss Gudonov)

56

Time Required:

2.0 hours (10 minutes for directions, 10 minutes for reading their roles, 40 minutes to conduct the interview and complete the application, 60 minutes for reports)

Directions:

1. Tell students they will be working in the same pairs as in the previous exercise, except this time they will switch roles.

2. Describe the purpose of the exercise. Say something like:

   "In this exercise, you will take the loan application, using information provided by the customer. Remember that role plays give you a chance to practice using interpersonal skills as well as applying the knowledge you've gained. You will be asking very personal questions that the applicant may be uncomfortable answering."

57

3. Explain that they should read only the instructions for their role. Role plays should simulate reality as much as possible, so the CSR needs to interview the applicant to solicit information and complete the worksheet.

4. Tell participants they may refer to their instruction sheets during the role play. The CSR needs to complete the application by asking the appropriate questions of the applicant.

5. Remind students to stay in their roles so they benefit from the experience fully. Tell them not to collaborate or work together to complete the application.

6. Ask if there are any questions. Tell students they will have 40 minutes to conduct the role play and complete the application. Explain that both the CSR and the applicant should be prepared to share their responses to the role play.

7. Begin the role plays. Circulate from group to group to offer assistance if students have difficulty and ask you for help. However, resist the temptation to offer help too quickly. Let students work as independently as possible.

8. When 5 minutes remain, direct students to complete their work.

9. Bring the group back together and ask for reactions to completing the application. Start with the applicants. Ask questions like these:

> "What did the CSR do that put you at ease? What questions or information proved most difficult for you to answer? When did you feel most uncomfortable? Then ask the CSRs how they felt about conducting the interview. What information was the most difficult for you to solicit? How did you do to handle those situations? Were you able to use the application form easily? Where did you have trouble?"

10. Make sure each pair of students contributes to the discussion. Begin the discussion by letting volunteers offer their reactions. Then ask specific pairs to join in.

11. Thank the students for their efforts and their contributions.

Transition:

Transition to the next section on Processing the Loan Application by saying something like:

> "Now that we have completed the loan application, let's proceed with processing it. Let's stand and take a quick stretch break before we do that."

Processing the Loan Application (1 Hour)

In the two previous sections, we examined the first two stages of the loan origination process: conducting the loan interview and taking the loan application.

Stop here and review the purposes of the loan interview. Ask students what the two purposes are. Confirm with the information below.

The purposes of the loan interview are:

- to pre-qualify the loan customer in order to save the customer and the bank the time and expense of completing and processing an application if the customer is clearly not eligible for a loan; and

- to alert the loan customer to the amount and type of information that will be required in the loan application, so that the application process can be fully completed in a timely manner.

Stop here and review the purpose of the loan application. Ask students what the purpose is. Confirm with the information below.

The purpose of the loan application is to obtain the information that the Underwriter will need to determine that the applicant is willing and able to repay the loan.

In this session, we will look at the third and final stage of loan origination—processing the loan application.

As we mentioned earlier in the course, the loan processing function in smaller banks is often handled by the Customer Service Representative. However, in mid-sized to large banks, this function is often handled by a staff of Loan Processors. Throughout this session we will refer to the "Loan Processor," but bear in mind that this may be the Customer Service Representative.

Stop here and ask how many of the students also have processing responsibilities. Ask why it is important for the CSR to understand the processing flow, even if he doesn't have responsibility for it.

The Loan Processor's job is to verify the information on the loan application and to collect any additional information that the Underwriter needs to underwrite the mortgage loan.

Specifically, the Loan Processor's job includes the following responsibilities:

- obtaining the necessary verifications of information in the loan application;
- obtaining a valuation of the property from a Property Valuation Expert;
- requesting missing documentation from the applicant, if necessary;
- assembling the loan file in a specified format so the Underwriter knows exactly where to find each piece of information; and
- forwarding the loan file to the Underwriter.

Stop here and ask students where they think the greatest difficulties are with these responsibilities. Explain that it will be very important to share techniques for collecting and verifying information during the loan processing stage. Encourage students to offer suggestions based on what has worked for them.

Before beginning to process the loan application, the Loan Processor should create a *Comment Sheet* [see page 67 in the RML Manual] on which to record all phone calls, face-to-face conversations, and correspondence regarding the mortgage file. If the Loan Processor is not the Customer Service Representative, then the Customer Service Representative should create and maintain a *Comment Sheet* as well, so that all contacts with the applicant or other individuals are a matter of record for the loan file.

The Loan Processor should also create a *Mortgage Document Log* [see page 66 in the RML Manual] on which to record the sending or receipt of all written correspondence requesting information for the loan file.

Both the *Comment Sheet* and the *Mortgage Document Log* should be kept in the mortgage loan file.

[Show OH 5 - 3: How to process the mortgage loan application]

Loan processing is a fairly straightforward procedure that can be accomplished in five steps. We will examine each of these steps in turn.

Requesting verifications

The Loan Processor's first task is to request Verifications from the loan applicant's banks, employer, and landlord or other creditors. The specific forms for this purpose include the *Verification of Deposits*, the *Verification of Employment*, and the *Verification of Loan Payment and History*.

Verification of Deposits

To verify the applicants' ability to make the down payment and pay closing costs from his own funds, the Loan Processor should call all the banks listed on the application regarding the applicant's asset information.

The Loan Processor should tell the bank contact that he will be sent a *Verification of Deposits* form and that the applicant's signature on the form authorizes the bank(s) to disclose the requested information.

The Loan Processor should then send the *Verification of Deposits* form to the applicant's bank(s) with a cover letter like the sample on page 65 of the RML Manual.

It is essential that the *Verification of Deposits* form and all other verification forms be sent directly to the applicant's

64

banks, employers, creditors, etc., and returned to your bank without any interference from applicants or related parties in order to protect the integrity of the information.

When the Loan Processor receives the *Verification of Deposits* back from the bank, he should look for significant increases in the applicant's account balance.

"Significant" is defined as an amount greater than the applicant's income for a normal pay cycle (weekly, bi-weekly or monthly, depending on how often the applicant is paid).

If there is such a deposit, the Loan Processor should contact the applicant and ask the applicant to send a written explanation of the deposit and proof of its source.

Money that applicants use to pay the down payment and other fees should be derived from personal assets and not borrowed from a lending institution.

Funds used for the down payment or other related fees can be derived from the sale of the applicants' personal assets, but again, a written explanation and proof of the transaction are required.

Verification of cash on hand

If the applicant intends to use cash on hand for any part of the mortgage transaction, the Loan Processor should ask the applicant to furnish a written explanation explaining the source of this cash. (In this and all other requests of the applicant, the Customer Service Representative should serve as the main point of contact with the applicant.)

The Loan Processor also should arrange to physically verify all cash funds to be used for any part of the mortgage transaction.

If the funds were obtained after January 1, 1992, the applicant should provide the tax documents disclosing the source of the funds.

If the applicant indicates that the funds were received prior to 1992, then the source of the funds should be investigated very thoroughly to make sure that the funds were obtained from a legal source.

Verification of Employment

To verify that the applicant has a history of stable employment, and to determine the probability and stability of the applicant's future employment, the Loan Processor should call all of the applicant's employers for the last two years as listed on the loan application.

The Loan Processor should explain to the applicant's employer(s) that the bank will be sending them a *Verification of Employment* form and that the employer is authorized by virtue of the applicant's signature(s) on the

form to release the information being requested.
The Loan Processor should then send a *Verification of Employment* form to all of the applicant's employers.

The Loan Processor should also try to verify verbally the applicant's position or title, and the applicant's length of time with the company.

Verification of Loan and Payment History

To establish an accurate record of the applicant's total liabilities, monthly debts, and previous repayment patterns, the Loan Processor should again start by calling all creditors listed on the application, including the applicant's landlord if the applicant rents from a private individual and not from the state.

The Loan Processor should tell the creditors that the bank is sending them a *Verification of Loan and Payment History* form and that the applicant's signature on the form authorizes the creditors to release the information requested on the form.

The Loan Processor should then send out the *Verification of Loan and Payment History* form to all creditors (and the applicant's landlord, if applicable).

If the applicant rents from the state, the Loan Processor should obtain a copy of the applicant's rent payment book as verification of past rent payments.

If, after receiving the verifications, the Loan Processor determines that the applicant obviously will not qualify for the loan, the Loan Processor should contact the applicant's Customer Service Representative, who will forward the loan file to the Director of Customer Service to be declined.

The word, "obvious," must be stressed, because it is not the responsibility of the Loan Processor to underwrite loans.

"Obvious" reasons for not qualifying might include falsified information in the loan application—such as employment, salary, nonexistent bank accounts or accounts with balances that are far below the balances listed on the application. However, questions about whether or not the applicant is creditworthy or has sufficient funds for the down payment and closing costs should be left to the Underwriter.

If the Director of Customer Service declines the application, it is the responsibility of the Customer Service Representative to send the applicant a *Statement of Credit Denial* [see page 68 in the RML Manual].

Stop here and ask students where the greatest difficulties are in requesting verifications. Use OH 9 listing information that must be verified. Write their responses on the board or flipchart. After the group has generated all the difficulties and obstacles, ask for solutions to these potential problems. Facilitate a

group discussion by taking each obstacle or difficulty in turn and asking the group to suggest alternative methods of verifying the information.

Ordering a *Property Valuation Report*

The Loan Processor should also order a property valuation report from a Property Valuation Expert. The purpose of this report is to provide the bank's Underwriter with the information needed to determine if the property provides sufficient collateral for the loan.

Usually, the Property Valuation Expert is a third party with specialized expertise who is not on the bank's permanent staff.

Stop here and ask students what challenges are involved in providing a property valuation. Ask how they handle those issues.

Requesting missing information and documentation

If any documentation is missing that is needed to continue processing the application, the Loan Processor should deliver a *Request for Missing Documentation* to the applicant via the Customer Service Representative [see page 64 in the RML Manual].

When requesting the documentation, the Customer Service Representative should ask the loan applicant to notify him at the bank when the missing documentation is available, so that the Customer Service Representative can send a messenger to pick up the document(s). This may be necessary to process loans within a reasonable amount of time.

When the information or documentation arrives, the Customer Service Representative should forward it to the Loan Processor, who will update the loan file as each piece of additional information or documentation is received.

The Loan Processor should maintain copies of all requests for documentation until the information or documents requested are received.

Completing the mortgage loan file

Upon receipt of all of the verification forms, the Property Valuation Report, and any other supporting information or documents, the Loan Processor should review the loan file for completeness and accuracy. To do so, the Loan

70

Processor should refer to the checklist on the *Cover Sheet* [see page 56 in the RML Manual] and should check off all completed documents.

In general, the mortgage loan file should have the most commonly used documents near the top of the file for easier access, and the lesser used documents toward the bottom.

In addition, the documents prepared after the processing stage (the *Commitment Letter*, the *Underwriting Mortgage Loan Summary*, etc.) should be placed in chronological order with the most recently completed documents on top.

So, the completed mortgage loan file would look like this:

Left side:

- *Comment Sheet* and *Document Log Sheet* on top
- *Contract of sale*
- *Property Valuation Report*
- *Estimate of Applicant's Costs*
- *Credit Authorization form*
- *Mortgage Application* (original)
- *Pre-qualification Sheet*
- Copy of application fee receipt
- Copy of commitment fee receipt

Right side:

- *Cover sheet*
- *Commitment letter*
- *Underwriting Mortgage Loan Summary*
- *Copy of Commitment Letter or Statement of Credit Denial*
- *Mortgage Application* (duplicate)
- *Request for Missing Documentation*
- *Notes to the File*
- *Verification of Employment* and related documents (income receipts, tax documents for second job, self-employed borrower's statements, etc.)
- *Verification of Deposit* and related documents (bank statements, gift letters, tax documentation on assets, etc.)
- *Verification of Loan and Payment History* and related documents (rent and utilities payment coupon books, other credit/liabilities info.)

When the Loan Processor feels that the application is thoroughly documented, the Processor may want to ask a colleague to review the loan file for accuracy and completeness.

Finally, the Loan Processor forwards the complete loan file to the Underwriting Department for its analysis against the bank's underwriting policies and the loan processing stage is complete.

Close the session by asking students if they have any final comments or questions. Thank participants for their active participation and for sharing with the group. Compliment them on their resourcefulness and expertise.

Tell students that tomorrow's class will be on Underwriting Residential Mortgages. Explain that the afternoon will be devoted to case studies to give them an opportunity to practice what they have learned. Distribute the case studies and ask students to read through them by tomorrow's class. Consult the directions for administering the case studies, provided at the end of Session 6.

[OH 5-1]

How to take the mortgage loan application

Step 1: Meet with the applicant(s) at the scheduled appointment to complete the loan application.

- All co-applicants must be present.

Step 2: Complete the loan application with the applicant's assistance.

Step 3: Provide the applicant with the proper disclosures.

Step 4: Obtain the applicant's signature on the necessary documents and collect the loan application fee.

Step 5: Provide the applicant with a list of any additional information needed to complete the loan application.

Step 6: Provide the applicant with copies of all signed documents, including a receipt for the application fee.

Step 7: Forward the application fee to the Servicing Department's Accounting division.

Step 8: Place the appropriate documents into the loan file.

Step 9: Maintain communication with the applicant.

[OH 5-2]

What is included in a mortgage loan application package

- Cover Sheet
- Mortgage Loan Application
- Verification of Deposit
- Verification of Employment
- Verification of Loan and Payment History
- Estimate of Borrower's Costs
- Disclosure of Loan Terms
- Self-Employed Borrower's Statement (if applicable)
- Inflation Adjustment Worksheet

[OH 5-3]

How to process the mortgage loan application

Step 1: Request Verifications from the appropriate parties.

- *Verification of Deposits* from banks
- *Verification of Employment* from current and previous employers
- *Verification of Loan Payment and History* from financial institutions and landlords

Step 2: Order a valuation of the property.

Step 3: Request any missing documentation from the applicant.

- Update the loan file as additional information and documents are received.

Step 4: Upon receipt of verifications, appraisal, documentation, and required information from the applicant, review the loan file for completeness and accuracy.

Step 5: Forward the completed loan file to the Underwriting Department for analysis against the bank's underwriting policies.

Practice Exercise: Prequalifying Loan Applicants

Contents

- Instructions for Customer Service Representative
  (including *prequalification worksheet*)
- Instructions for Mortgage Loan Applicant (Mr / Miss Kitov)

General Directions

- Choose a role (Customer Service Representative or Loan Applicant)
- Read the instructions for your role only.
- Conduct the practice exercise.
- Be prepared to report on your experiences.

Prequalification Worksheet

Name ______________________ Date ______________

Gross monthly income	Borrower	Co-Borrower
Base salary	________	________
Overtime	________	________
Bonuses	________	________
Commissions	________	________
Part-time pay	________	________
Self-employment income	________	________
Alimony/Child support	________	________
Retirement income	________	________
Rental income	________	________
Other	________	________
Totals:	________	________

Total income for qualifying (add totals from both columns): ______________

Monthly housing expense		**Other fixed monthly expenses**	
Principal and interest	________	Installment loans	________
Taxes	________		________
Mortgage insurance	________		________
Hazard insurance	________	Alimony/Child support	________
Maintenance/Dues	________	Other	________
Total	________	**Total**	________

78

Prequalification Worksheet

Name ______________________ Date ______________

Gross monthly income	**Borrower**	**Co-Borrower**
Base salary	________	________
Overtime	________	________
Bonuses	________	________
Commissions	________	________
Part-time pay	________	________
Self-employment income	________	________
Alimony/Child support	________	________
Retirement income	________	________
Rental income	________	________
Other	________	________
Totals:	________	________

Total income for qualifying (add totals from both columns): ____________

Monthly housing expense		**Other fixed monthly expenses**	
Principal and interest	300	Installment loans	________
Taxes	20		________
Mortgage insurance	10		________
Hazard insurance	15	Alimony/Child support	________
Maintenance/Dues	________	Other	________
Total	345	**Total**	________

Prequalification Worksheet continued

Housing expense-to-income ratio (should not exceed 25%)

Total housing expense
_________________________ = ___________ = _______%
Total income for qualifying

Total debt-to-income ratio (should not exceed 32%)

Total housing expense + Total monthly debt
_______________________________________ = ___________ = ______%
Total income for qualifying

Purchase price of property _____________ **Down payment** ___________

Loan amount ____________ **Closing costs** ___________

Required cash reserves ___________

Borrower's cash on hand _________

Source of down payment and closing costs: ______________________________

____

Instructions for Customer Service Representative

You are a Customer Service Representative with the Russian Home Bank. You are interviewing Mr/Miss Kitov to see if he/she qualifies for a mortgage loan to purchase an apartment.

1. Explain the procedure of prequalification to the loan applicant, emphasizing how it benefits the applicant and the bank.

2. Complete the *Prequalification Worksheet* based on your interview with the applicant.

3. Calculate the applicant's housing-expense-to-income ratio and total-debt-to-income ratio.

3. Determine if the applicant has adequate cash reserves.

4. If the applicant prequalifies, schedule an appointment to complete the loan application. If the applicant does not qualify, tell the applicant what he/she would need to do in order to qualify.

Assumptions:

- Loan-to-value ratio = 50%
- Closing costs = 3% of the loan amount
- Required cash reserves = two months' principal, interest, taxes, and insurance.
- To qualify as monthly income, bonuses, commissions, overtime or part-time work must have a 2-year history. Such income should be entered on the *Prequalification Worksheet* as a monthly average.
- The monthly costs for a $30,000 loan have been entered on the *Prequalification Worksheet* for you.
- Round answers to the nearest dollar or percent.

Instructions for Loan Applicant

You are Mr/Miss Kitov. You have come to the Russian Home Bank to apply for a mortgage loan to purchase an apartment. You have always lived with your mother rent free, but she has now entered a nursing home and you are anxious to have a place of your own. You have found the apartment that you want to buy. The seller's asking price is $60,000, which seems reasonable to you because the apartment is in excellent condition and is located close to your place of work.

Assumptions:

- You know very little about mortgage loans and you have never heard of "prequalification."
- You have worked for Sony Electronics since 1992. You are paid bi-weekly (every other week) and you earn $875 gross income per pay period. You have brought pay stubs to verify this income.
- You received a bonus of $800 in 1992, and a bonus of $900 in 1993. You expect a similar bonus at the end of 1994.
- For the last 11 months you have worked overtime to build up your savings, averaging $400 a month in extra earnings.
- You support your elderly mother. The cost for her care is $200 a month.
- You pay $50 a month for the purchase of a television set and you have 6 payments remaining. Your automobile loan has 10 payments remaining of $75 a month.
- You have $35,000 in savings, but you would like to put aside at least $5,000 of this money for emergency expenses. You assume that $30,000 will be enough to make a down payment on the mortgage loan.

Practice Exercise: Taking the Loan Application

Contents

- Instructions for Customer Service Representative (including *Loan Application*)
- Instructions for Mortgage Loan Applicant (Mr./Miss Gudonov)

General Directions

- Take the opposite role from the one you took in the Prequalifying Practice Exercise
- Read the instructions for your role only.
- Conduct the practice exercise.
- Be prepared to report on your experiences.

83

Instructions for Customer Service Representative

You are a Customer Service Representative with the Russian Home Bank. You have already met Mr./Miss Gudonov and prequalified him/her. You gave her a list of the information and documentation she would need to bring to this meeting. Mr./Miss Gudonov is probably quite nervous and will be asked many questions -- most of which he/she will consider quite personal -- in the course of completing the application. Do everything you can to put Mr./Miss Gudonov at ease.

You, not the applicant, will actually fill out the application with the information he/she provides in response to your questions.

Instructions for Loan Applicant

You are Mr/Miss Gudonov. You have lived with your parents your entire life and have not had to pay any rent. You have, however, been responsible for paying the utilities since you started to work nine or ten years ago. The utilities include heat, electricity and phone. They total an average of $60 per month.

You found an apartment for you and your son that is close to your work and close to your son's school and where both you and he will be able to have rooms of your own. You have gone through the loan interview process and have successfully prequalified. You have now returned to the bank to actually complete the application form. You have brought with you of the information the Customer Service Representative asked you to bring. You have outlined it on the attached pages.

97

You have also brought much of the documentation, you were asked to provide, including

- three of your most recent pay stubs;
- a copy of the divorce decree specifying the amount of child support your ex-husband has to pay and the period of time over which it will be paid;
- tax returns for the past two years (or a statement of yearly income from your employer) verifying not only your salary but also information on the stock that your employer gives its employees as part of its compensation package; and
- a gift letter from your parents.

The only thing you have forgotten to bring are the payment coupon books for the utilities you have been paying at your parents' apartment.

Take a few minutes to familiarize yourself with the information below.

Applicant

Name:	Margaret Gudonovski
Internal Passport #:	026-32-5988
Current Address:	Kutuzovsky Prospect 21 104879 Moscow
No. of Years:	30 years
Own/Rent:	Lives with parents and her child in recently privatized apartment (no rent)
Telephone:	7 095 131-8621
Age:	30 years
Yrs.of School Completed:	18
Marital Status:	Divorced
No. of Dependents:	One child

91

Subject Property

Property Address:	Beloveshskaya Pereulok 7 104968 Moscow
Description:	Four room apartment close to metro station "Kuntsevskaya". 11th floor of 16 story building. 71.3/49 sq. m., kitchen - 8 sq.m.. Fitted cupboards. Parquet Floors. Telephone Line installed. All facilities in good repair.
Property Contact Person:	Christiana Domovoy, Ivanitchka Realty, 7 095 244-2662
Selling Price:	$120,000

98

Loan Information

Loan Amount Requested:	$60,000
Type of Loan:	DAIR
Source of Downpayment:	$15,000 personal savings $30,000 sale of stock $15,000 gift from parents

Employment

Current Employer:	Joint Stock Service Co. 26 Bolshoi Suharevski Pereulok 103051 Moscow
Dates Employed:	January 1991 to date
Position:	Investment Banker
Current Salary:	$30,000

Previous Employer:	Russian Federation Mortgage Association (RFMA)
Dates Employed:	June I983 to Dec I990
Position:	Senior Financial Analyst
Ending Salary:	$24,000

Monthly Income

Salary:	$2,500.00
Child Support:	$ 200.00
Interest/Dividends:	Qtrly Dividend RFMA stock - $300. 00 ('94) Qtrly Dividend RFMA stock - $200. 00 ('93) Qtrly Dividend RFMA stock - $100. 00 ('92)

Assets

Moscow First Federal
Tverskaya 39
46782 Moscow

Account #:	11258-61-51
Type of Account:	Savings
Balance:	$20,000
Stocks and Bonds:	900 shares of RFMA stock valued at $40. per share

Liabilities

Car Loan

Moscow First Federal
(same as above)
Account # 871-23-456
Balance Due: $3,600
Monthly Payments: $300/month
Cost of Car: $20,000 (l990 Fiat)
Remaining Loan Balance $10,000
Value of Car Today: $16,000

GUM Department Store

Revolving Credit
Account # 6830495
Balance Due: 0 (Pay off balance monthly)

Monthly Housing Expense

Current: Utilities at your parents' apartment totaling averaging $60 per month.

Proposed: $490.00 per month
40.00 taxes
25.00 hazard insurance
15.00 mortgage insurance
Total $570.00 per month

Session 6
Underwriting Residential Mortgages

Time:	**2.5 hours**	**Format:**	**Lecture and discussion**
	3.5 hours		**Case studies**
	1.0 hours		**Lecture and discussion**

Introduction

The success of a bank's residential mortgage lending business depends on its ability to originate mortgage loans that meet the housing finance needs of its customers and result in a sound and prudent investment of the bank's funds.

Underwriting is the process by which the bank achieves both these goals.

Introduce the session by reviewing the topics to be covered. Say something like:

> **"In the first part of this session, we will begin with a brief discussion of the importance to the bank of written underwriting policies and procedures and a quality control system to ensure a successful underwriting operation.**

"We will then focus on the steps that Underwriters need to take to underwrite the borrower—that is, to determine the ability and willingness of the borrower to repay the loan.

"We will next examine the steps that Underwriters need to take to underwrite the property—that is, to determine the adequacy of the property as security for the loan in the event the borrower is unable to repay the loan.

"Finally, we will discuss how the Underwriter decides whether to recommmend that the Credit Committee approve, decline, or suspend the loan application.

Review the day's agenda with the group.

- underwriting standards and process (lecture)
- case study exercise
- the credit decision and closing the loan (lecture)

Remind students that each person should expect to participate, through discussion and a case study exercise, and to make this a joint learning experience. Explain that the case study method used in this session is frequently selected in the U.S. as a means of training managers and executives. For this training method to be successful, each person must contribute to the activity.

qu

Do not feel that you as an instructor must carry this entire session. In fact, be careful to limit your lectures and to leave plenty of time for the case study activity. Most of the lecture information in this session should be a review for students.

Encourage everyone to participate. Do not allow one or two individuals to dominate discussion or attempt to dominate the case study activity. Remind students that everyone's opinion counts. Be sure students listen to one another and that they acknowledge the other person's point of view, even when disagreeing.

Finally, as the instructor, resist the urge to favor one position over another. It is better to let students work through issues and differences of opinion as a group. You should not appear arbitrary or to favor one individual over another.

Establishing underwriting guidelines

The bank should establish a written policy so that its Underwriters have guidelines to follow when making decisions on specific loan applications.

The guidelines should clearly state the following:

- various types of documentation the bank requires;

65

- suggested underwriting ratios Underwriters should apply to help them determine a borrower's ability to repay the mortgage debt; and

- suggested loan-to-value ratios to help Underwriters evaluate the adequacy of the property as security for the mortgage.

Ask the students why they think it would be important for the bank to have an Underwriting Policy. The responses you are looking for include: to make sure that each Underwriter uses the same criteria for loan application evaluation; to make sure that Underwriters use guidelines that are designed to only approve loans which should be profitable; to make sure that Underwriters know the information that they are looking for and do not miss any when evaluating the loan; any response that discusses the need for uniform underwriting procedures and the importance of policy in establishing profitable loans.

Setting up a quality control system

It is also important to have a quality control system that evaluates and monitors the overall quality of the bank's mortgage loan originations.

The system should review a random sampling of loans that reflect the scope of the bank's business on a regular basis.

It should verify the existence of legal, credit, and property documents.

And, it should scrutinize underwriting decisions and property appraisals to make sure they meet established guidelines.

Ask students why quality control is important. Responses could include: to make sure that the Underwriting policy is being followed; to protect the bank from poor practices which could result in unprofitable loans; to make sure that the Underwriting policy is still valid and does not need to be updated; any response that points out the need to maintain consistent adherence to policy in the interest of only approving profitable loans.

Assessing the borrower's ability to repay

[Show OH 6 - 1 Indicators of the Borrower's Ability to Repay]

There are five key indicators of a borrower's ability to repay the mortgage:

- if the borrower has been able to maintain stable employment—preferably in the same line of work—and income continuity for a substantial period of time (two full years) before applying for the mortgage;

- if the borrower's monthly mortgage payment will not exceed about 25 percent of this monthly income (or whatever benchmark the bank has established)

- if the borrower's total monthly debts—including his proposed monthly mortgage payment—will not exceed about 32 percent of his monthly income (or whatever benchmark your bank has established);

- if the borrower has sufficient liquid assets to make the downpayment and cover the closing costs and, if possible, still have the equivalent of two monthly mortgage payments in reserve; and

- if the borrower has a positive net worth.

Employment stability

To determine if the borrower has been able to maintain stable employment and income continuity for the two full years before applying for the mortgage, the Underwriter should analyze the "Employment" section of the borrower's *Loan Application and the Verification of Employment* form(s) provided by the Customer Service Representative as part of the loan file.

If the borrower's employer(s) has been able to verify that the borrower has been employed steadily for the previous two years the Underwriter might reasonably conclude that the borrower's employment will remain stable and provide the borrower's employment will remain stable and provide him with a reliable source of income in the years to come.

Ask the students What obstacles there might be in verifying employment. How would they propose handling these difficulties?

Debt-to-income ratios

Once the Underwriter has analyzed the "Employment" section of the borrower's *Loan Application* and the *Verification of Employment* and has drawn some conclusions about the probability of the borrower's ability to maintain stable employment and income continuity, the Underwriter should then look at the "Monthly Income" section of the *Loan Application, the Verification of Employment*, pay stubs, tax returns, and other documentation provided by the borrower to determine whether or not the borrower has sufficient income to make the mortgage payments and meet his other financial obligations.

In order to calculate the amount of the borrower's total monthly income, the Underwriter should once again analyze the *Verification of Employment* form(s) provided in the loan file.

To determine the borrower's monthly income, the Underwriter may consider following income sources:

- Wages and salary (current gross monthly income)
- Overtime (monthly average over one year)
- Part-time or second job income (monthly average over two years)
- Bonus income (monthly average over one year)
- Commission income (monthly average over 1 or 2 years, level or increasing earnings trend)
- Dividend and interest income (monthly average over 1 year)
- Retirement income (retirement award letter)
- Rental income received from properties other than the borrower's primary residence or second home (legally executed lease)

In order to ensure that the borrower's income has kept pace with inflation, the Underwriter should analyze the borrower's income using a tool like the *Inflation Adjustment Worksheet (see page 63 in the Residential Mortgage Loan Manual).*

To determine the amount of the borrower's monthly debts, the Underwriter should examine the "Liabilities" section of the loan application and the proposed monthly mortgage payment, including principal, interest, taxes and insurance.

When the Underwriter had determined the borrower's gross monthly income and the borrower's monthly debts, the Underwriter should look at the relationship between the borrower's income and total monthly liabilities (the total debt-to-income ratio).

The current benchmark in Russia of the housing-expense-to-income ratio is about 25 percent and the total debt-to-income is about 32 percent.

Write the following figures on the blackboard and ask the students to calculate this loan applicant's housing-expense-to-income ratio and total-debt-to-income ratio. Then ask students if the applicant appears to be a good loan candidate.

On the blackboard, write:

Applicant's income:	**$30,000/year**
Applicant's housing expense	**6,000/year**
Housing-expense-to-income ratio:	**Calculate**
Applicant's income	**$30,000/year**
Applicant's total debt	**9,000/year**
Total-debt-to-income ratio:	**Calculate**

Applicant appears to be a good candidate for loan approval. Housing-expense-to-income ratio = 20%; total-debt-to-income ratio = 30%

Assets

The fourth key indicator of a borrower's ability to repay the mortgage is the availability of savings or other liquid assets to cover the down payment and closing costs.

Liquid assets are those assets that can be converted to cash quickly and easily without undue expense.

Ask students to name some sources of liquid assets with which they are familiar.

To determine the amount of the borrower's liquid assets, the Underwriter should examine the "Assets" section of the borrower's *Loan Application* and the *Verification of Deposits* form obtained by the Loan Processor for indications that the borrower has sufficient savings or other liquid assets to cover the downpayment and closing costs.

If the borrower keeps funds in a bank—whether a Russian bank or a foreign bank—the Loan Processor should have obtained and provided the Underwriter with verification of the current balances and average balances for the previous two months by sending *Verification of Deposit* forms to those banks.

The Underwriter should pay special attention to any significant deposits within the previous two months to verify that these funds were not borrowed.

A significant deposit is defined as an amount greater than the amount of income an borrower receives for a normal pay cycle, (weekly, biweekly, monthly, etc.).

If any significant deposits during the previous two months are evident, the source of these funds should have been documented by the Customer Service Representative and included in the loan file.

If a borrower's assets are abnormally high in comparison to his income, the Underwriter should verify the source of these assets even if it extends beyond the previous two months.

Because of the current highly inflationary climate in Russia, a significant number of borrowers will most likely keep most, if not all, of their funds in cash. This may be in the form of rubles or hard currency.

Verifying that these funds are not borrowed is difficult. However, the loan file should contain the borrower's written explanation describing the source of this cash.

If the cash was obtained after January 1, 1992, the borrower should have been required to provide the tax documents disclosing the source of these funds.

If the borrower indicates that he received these funds prior to l992, then the source of these funds should be investigated very thoroughly.

Ask students why they think that these funds should be investigated. The answer is to make sure that they were obtained legally.

Finally, the Loan Processor should have made arrangements to physically verify all cash to be used for any part of the mortgage transaction.

Fixed assets can be sold and the proceeds used as part of the mortgage transaction as long as they are sold before closing, the transaction(s) can be documented, and it can be verified that the sale was an "arms length transaction" (that is, that the borrower did not sell the asset to a relative of friend with the intention of buying it back once the application has been approved).

Ask students to name some types of fixed assets with which they are familiar.

A borrower can satisfy part of the cash requirement for closing with gifts from immediate family members as long as these funds are received prior to the closing of the mortgage loan and a Gift Letter *[see page 76 in the RML Manual]* has been completed and signed by the donor.

Net worth

The fifth key indicator of a borrower's ability to repay the mortgage is the borrower's net worth.

To determine the borrower's net worth, the Underwriter should look at the "Net Worth" section of the *Loan Application*.

The borrower's net worth is calculated by adding up all of the borrower's assets—both liquid assets and fixed assets—and then subtracting the total of the borrower's existing debt.

If the borrower's assets exceed his liabilities, the borrower is said to have a positive net worth.

The accumulation of net worth—particularly in the form of liquid assets—can be a strong indicator of a borrower's ability to repay a debt.

Furthermore, a borrower who accumulates net worth solely from earnings and savings demonstrates a general competence in managing financial affairs.

Assessing the borrower's willingness to repay

It is considerably more difficult for the Underwriter to assess the willingness of the borrower to repay the mortgage.

[Show OH 6 - 2 Indicator of the Borrower's Willingness to Repay]

The major indicator of a borrower's willingness to repay the mortgage is the borrower's history of meeting his financial obligations in the past—particularly his housing payments—in full and on time.

To determine if the borrower has met his debt obligations in the past the Underwriter should analyze the *Verification of Loan and Payment History* provided as part of the loan file, the *Rent Payment Books* and *Utility Payment Books* provided by the borrower, and any other documentation of the borrower's having made regular payments on debt or for services.

If the borrower's creditors have verified that the borrower has a history of meeting regular financial obligations in full and on time, the Underwriter might reasonably conclude that the borrower will continue to faithfully meet his financial obligations.

Underwriting the Property

Underwriting the property is as important as underwriting the borrower because the property is the bank's security for the mortgage if the borrower becomes unwilling or unable to repay the mortgage.

The Underwriter must analyze the *Property Valuation Report*, a document produced by a qualified Property Valuation Expert, to determine if the property is adequate security for the mortgage.

The **Property Valuation Report** analyzes the current condition of the property and the conditions of the market surrounding the property to derive a *Fair Market Value* for the property.

The **Fair Market Value** is the most reasonable price that a property should bring in a competitive and open market—a price that would seem fair to both the buyer and the seller of the property.

For the next portion of this session on Underwriting Residential Mortgages, we will discuss what the Underwriter must consider in analyzing the Property Valuation Report and the property's Fair Market Value. We will then discuss how the Underwriter calculates and evaluates the relationship between the property's Fair Market Value and the size and type of loan the borrower is requesting.

Analyzing the Property Valuation Report

[Show OH 6 - 3 Two Key indicators of the Property's Adequacy as Security for the Mortgage]

The Underwriter should analyze the description of the property provided by the Property Valuation Expert in the Property Valuation Report. This is done to ensure that there is nothing about the residence itself, the site on which it is located, or the surrounding neighborhood that might inhibit the ability of the lender to sell the property and recoup the balance due on the mortgage, should this ever become necessary,

Residence

First the Underwriter should look at the Property Valuation Expert's description of the residence itself.

This description should be based on the Property Valuation Expert's visual inspection of both the inside and outside of the residence and should describe both in general and specific terms the quality and design of the residence and the attitudes of typical purchasers in the property's market area toward them.

The Underwriter should analyze issues such as the following:

Is the residence **compatible** with other homes in the neighborhood and does it meet the requirements of the competitive market?

What is the actual **age** of the residence? What is the effective age of the residence based on the current condition of the property? Is the residence of the quality and condition that will be acceptable to home buyers in the property's market area?

Does the house have adequate **insulation?** Are there any other energy-efficient items on the property that may contribute to the property's overall market value?

What type of **heating** system does the residence have? Is there anything about the **layout or floorplan** of the residence that could encounter market resistance?

How **large** is the residence and how large is each room in the residence?

What are the type, quality and condition of the **floors and walls** in the residence? What is their durability and popularity within the market area?

Ask students to suggest impacts these factors have on the present and future value of the property. Answers should include the fact that condition and amenities offered by the property impact its value to the buyer. The bank needs to know that they are not lending more than the property would actually sell for if the bank is forced for some reason to foreclose and sell the property to recover the loan investment. The bank must protect its investment by lending no more than the property is worth now and analyzing the condition of the home to make sure that it will be worth at least the same amount, if not more, for future re-sale.

Site

The Underwriter should also analyze the Property Valuation Expert's description of the **site** on which the residence is located. This description should be based on the Property Valuation Expert's visual inspection of the site and should describe the special features of the site that could enhance or have a negative influence on the property's marketability and value.

When analyzing this site description, the Underwriter should consider issues such as the following:

Is the site **compatible** with other sites in the neighborhood?

Is there anything about the site—**topography, shape, size, drainage capacity**—that enhance or detract from the site's marketability?

Are **utilities** accessible? Do they meet community standards and are they generally acceptable to area residents?

Is the street on which the site is located **maintained** so that it meets community standards and is generally acceptable to area residents?

Ask students why these factors are important. The answers should be the same as in the previous interaction.

Neighborhood

Finally, the Underwriter should look at the Property Valuation Expert's description of the **neighborhood** in which the property is located.

The Property Valuation Expert's description of the neighborhood should be based on his visual inspection of the neighborhood and should cover the market area as widely as necessary to reflect all significant influences affecting the value of the property.

The Underwriter should analyze such issues as the following:

Is the property readily **accessible** by roads that meet local standards and that have adequate utilities available and in service?

What percentage of the land in the neighborhood has been **developed?** Is the growth rate of the neighborhood slow—and if so, what effect might that have on the marketability of properties in that neighborhood?

What is the **average time** it takes a reasonably priced property **to sell** in the neighborhood?

What are the various **uses of the land** in the neighborhood: residential, single-family homes, apartments, commercial or industrial?

Are most of the homes in the neighborhood **owner-occupied or rental** properties?

What is the **predominant price** at which properties in the neighborhood are selling? What is the price range? Are prices increasing or decreasing?

What is the **predominant age** of the properties in the neighborhood? What is the age range.

Ask students if these factors are also good indicators of present and future value of the property. The answer should be yes.

Analyzing the estimate of market value

After analyzing the Property Valuation Expert's description of the property, the Underwriter should look on the Property Valuation Report for the estimate of the market value (Fair Market Value) of the property and a description of how he arrived at this estimate.

Property Valuation Experts can use three ways to estimate a property's market value: the cost approach, the income approach, and the sales comparison approach.

Often they use a combination of all three.

Cost approach

The cost approach is based on an assumption that the market value of a property is related to the cost a home buyer should incur if he or she were to build a new residence identical to—and intended for the same use as—the property in question.

Income approach

The income approach is based on an assumption that the market value of a property is related to the amount of income one could expect to earn from that property.

Generally, the income approach is not applicable to the valuation of single-family properties.

Sales comparison approach

Most often, Property Valuation Experts use the sales comparison approach to estimate the market value of a residential property.

The sales comparison approach is based on an assumption that a home buyer should not pay more for a property than it should cost to purchase a comparable property in the same neighborhood or in a similar neighborhood.

It requires the Property Valuation Expert to analyze recent sales of properties comparable to the property in question.

To arrive at an accurate and reliable estimate of market value according to the sales comparison approach, the proper selection of comparable properties is essential.

Property Valuation Experts should use at least three comparable properties in the same neighborhood as, and as similar as possible to, the property the Underwriter are underwriting.

These comparables should be as recent as possible—in general, sold within twelve months of the mortgage application.

However, the Property Valuation Expert may develop supporting data based on less recent sales, on contract offerings, or even on current real estate offerings that have not yet resulted in sales.

In addition, sales from comparable neighborhoods are acceptable when no sales exist in the neighborhood where the property is located.

Evaluating the loan-to-value ratio

After the Underwriter has analyzed the Property Valuation Expert's description of the property and his estimate of the property's market value, the Underwriter should look at the relationship between that estimate of market value and the size and type of loan the borrower is requesting.

This relationship is generally referred to as the LTV or loan-to-value ratio.

To calculate the loan-to-value ration, the Underwriter should divide the loan amount by the value assigned to the property by the Property Valuation Expert or by the sale price (the price the seller is asking)—whichever is lower.

Ask students why the lower price would be used. The answer should be that the bank wants to protect its investment by not lending more than the property is worth.

The loan-to-value ratio is the most important indicator of whether a property should constitute sufficient security for the mortgage in the event of a default.

The benchmark currently in use in Russia appears to a loan-to-value ratio of 50 percent.

This ratio should ensure that the value of the property should always be greater than the outstanding loan balance.

It should provide enough equity to protect the interests of the bank and should not severely limit the number of eligible borrowers.

Have students calculate the loan-to-value ratio for the following example and determine whether or not the ratio is acceptable.

On the blackboard write:

Desired loan amount	**$50,000**
Property value	**$80,000**
Loan-to-value ratio	**Calculate**

Marginally Acceptable
Loan-to-value-ratio = 62.5%

Making the Credit Decision

In making a decision to approve or decline a mortgage application, the Underwriter should keep two major goals in mind: giving the borrower every opportunity to receive favorable consideration, and protecting the bank from undue risk.

Maintaining the delicate balance between these two objectives is more of an "art" than a "science."

In this portion of the Underwriting Residential Mortgages session, we will review the risk factors the Underwriter must analyze and some of the compensating factors he may want to consider in making his recommendation to the Credit Committee.

117

We will also discuss the consequences of the Credit Committee's decision regarding the borrower's loan application, including how the loan offer is made if the application is approved.

Reviewing the risk factors

[Show OH 6 - 4 Reaching a Fair Conclusion]

Before making his final recommendation, the Underwriter should review the risk factors to which the bank might be exposed by making the loan. These include the following:

- the stability of the borrower's employment situation;
- the relationship between the borrower's debt and income;
- the risk that the borrower's income will not keep pace with inflation;
- the borrower's credit history; and
- the risks that might arise out of the relationship between the market value of the property and the loan amount for which the borrower has applied.

118

Considering the compensating factors

If these risks appear high, the Underwriter should give serious consideration to compensating factors that could offset those risks.

The following are some of the compensating factors that might offset risk factors such as high debt-to-income ratios.

Less than two years of employment

Due to the recent years of economic transition in Russia, many borrowers may have less than two years of employment in the same line of work.

The underwriter can give favorable consideration to these borrowers if:

- the reason for the shorter length of employment is because the borrower was in school or in the military and the Customer Service Representative (or Underwriter) can obtain a copy of the borrower's diploma or discharge papers as verification;

- the borrower is currently employed in a line of work where continuing demand could lead to career advancement and/or increased income;

- the borrower has only recently entered the job market but has a level of education and training that could lead to career stability including advancement and/or increased income; or

- the borrower is employed by a business that has a strong likelihood of long-term viability.

Ask students why these factors offset the risk. Correct responses should include that the applicant demonstrates future earning potential that make him a better loan approval prospect.

Frequent job changes

The Underwriter can also give favorable consideration to a borrower who has changed jobs frequently if:

- the borrower has maintained income continuity and

- the borrower has changed jobs to advance within the same line of work or because that is the nature of the employment that is available.

The Underwriter should look carefully at borrowers who move from job to job or occupation to occupation without advancement or increased income because this may indicate an inability to master a job.

Gaps in employment

The Customer Service Representative or Underwriter must obtain a written explanation from the borrower when a borrower has gaps in his past employment that extend beyond one month.

In such cases, the Underwriter should carefully assess the borrower's explanation.

The Underwriter should take into account the following:

- the frequency of the gaps,
- the type of work involved,
- the job market, and
- any extenuating circumstances.

The Underwriter should then draw some conclusions about whether these gaps are the result of circumstances beyond the borrower's control or are an indication that the borrower may have a problem maintaining stable employment in the future.

121

Ask students to name some circumstances in which employment gaps are not bad. These could include time off to go back to school or to pursue a different type of career such as self-employment. Ask the students what types of employment gaps represent problems to underwriting the applicant. These can include gaps where the applicant was fired, depending on the circumstances, or where the applicant quit and did not find another job for a lengthy period.

High debt-to-income ratios

If a borrower has a particularly high net worth—particularly in the form of liquid assets—this may offset a borrower's large liabilities, in that such assets may be used if necessary to pay the mortgage debt, to pay for unexpected obligations beyond the mortgage debt, or to protect against any short-term interruptions of income that could occur.

A high level of residual income can be used as a compensating factor that may support a total debts-to-income ratio above 32 percent.

Residual income is calculated by estimating the income required for basis subsistence according to the life style demonstrated by the borrower and subtracting it from the applicant's gross income.

The remainder is residual income.

Fixed assets that are not being used for the mortgage transaction can be considered a compensating factor.

The exact value of these assets does not have to be verified.

The Underwriter should place an approximate value on these assets using the information provided on the borrower's *Loan Application* and based on the Underwriter's own judgement.

If a borrower is making a large down payment (typically 25 percent or greater) toward the purchase of a property, it is extremely unlikely that the borrower will default on the debt.

Ask students why they think the borrower would be unlikely to default. Correct responses should be a variation on the theme that the borrower has made a large investment—the down payment—in the property and would lose his investment if he defaulted on the loan.

When a borrower has a potential for increased earnings and advancement because of his education or job training, this could be a compensating factor, even if he or she has just entered the job market.

Making a recommendation to the Credit Committee

Having reviewed both the risk factors and the compensating factors, the Underwriter should complete the *Mortgage Loan Underwriting Summary* [page 69 in the Workbook] and make a thoroughly documented recommendation to the Credit Committee.

The Underwriter's rationale should be based on documentation sufficient to lead the Credit Committee to the same conclusion he reached.

The Underwriter might recommend that the Credit Committee

- Approve the borrower's loan application
- Decline the borrower's loan application; or
- Suspend the borrower's loan application pending further research.

Transition to the case study exercise by telling students they will now practice thinking like an underwriter.

Decide how you want to handle the lunch break: let students break when they want, or all break at the same time.

Practice Exercise: Underwriting Loan Applicants (3.5 hours)

Introduction:

This exercise is based on a case study approach. Case studies are commonly used in training managers and executives in the U.S. The approach was pioneered at Harvard University. The value of the case study approach is that it uses realistic information and simulates the actual performance that is expected of the student on the job. There is not always an absolutely correct answer when working with case studies. This is important to emphasize with students.

Purpose:

This exercise gives students an opportunity to practice applying what they have learned in this session about making underwriting decisions. They will work with one or more cases and make a decision to approve or deny the loan application based on the case information.

Materials:

Prepare copies in advance for all students:

- Package of 10 Underwriting Case Studies
- Mortgage Loan Underwriting Worksheet (blank)
- Transparencies (or flip chart pages) and markers for group reports (optional]

Time Required:

3.5 hours (15 minutes for directions, 1.5 hours to complete the cases and prepare the report, 1.5 hours for group reports, 15 minutes for final discussion)

Directions:

(Note: You will want to complete steps 1 - 5 at the end of the previous day so that students can read all the cases the night before.)

1. Divide the class into 10 groups. Assign a number to each group (# 1, # 2, # 3, and so on).

2. Explain the purpose of the case study exercise to the class. Then assign two case studies to each group as follows:

   Group # 1: Cases 1 and 2
   Group # 2: Cases 2 and 3
   Group # 3: Cases 3 and 4
   Group # 4: Cases 4 and 5
   Group # 5: Cases 5 and 6
   Group # 6: Cases 6 and 7
   Group # 7: Cases 7 and 8
   Group # 8: Cases 8 and 9
   Group # 9: Cases 9 and 10
   Group # 10: Cases 10 and 1

3. Give students time to read the directions on the first page of the case study package.

4. Explain the purpose of using case studies and that there are no absolutely correct answers to the cases. The most important thing is to use the correct process and ask the right questions. They are free to use their workbook and other class materials as necessary.

5. Tell students that they will have time to work in class as a group on the case. This includes completing the Mortgage Loan Underwriting Worksheet and preparing their report to the class. Answer any questions.

127

6. Explain that working in a group also simulates the "real world" environment of mortgage lending. Different perspectives are helpful in making underwriting decisions. They should be sure everyone in the group has a chance to contribute and participate.

7. Make sure each group has space to work. Distribute blank transparencies or flip chart pages and markers as appropriate for groups who want to use them for their report. Announce that groups will have 1.5 hours total to complete their cases and prepare their report. Remind each group to select a spokesperson for the group report.

8. Announce how you want to handle lunch. Give students an exact time to return, allowing 1.5 hours for preparation and 1 hour for lunch.

9. As the groups are working on the cases, circulate from group to group to clarify the task. Be careful not to provide additional information or lead the groups. The information provided is very typical of what an underwriter often must work with.

10. After approximately one hour, announce that groups should begin finalizing their decisions and preparing their reports.

11. At the end of the allowed time, if some groups are still working, announce a short break and then ask everyone to return, ready to make their reports.

12. Start with group # 1 and ask for a report on only their first case. Make sure the report includes reasons for the decision. Ask group # 2 if their decision and rationale were the same or different. Encourage questions from the class.

13. Congratulate group # 1 on their efforts and proceed to group # 2, who will report on case # 2. Again, ask group # 3 if their decision was the same or different. Continue with the reports until all have been given. Take time to thank each group and comment positively on some aspect of their presentation.

14. After all reports have been given, you may want to share the solutions provided in your instructor kit. Remind students that these are only an opinion. If their decisions differed but they had good reasons, that is what is important.

15. Ask the groups how comfortable they felt making decisions with the information available. How did having underwriting standards and guidelines help them? Where were the areas of greatest disagreements among group members?

Thank the groups for their hard work.

129

Transition: After the underwriter makes a decision regarding the loan application, the entire package then goes to the Credit Committee.

Making the Credit Decision

When the Credit Committee receives the loan application package from the Underwriter, it reviews the loan file and the Underwriter's recommendation and makes the decision to approve, decline, or suspend the mortgage application in light of the bank's overall underwriting policy guidelines.

[Show OH 6-5 How to Make the Credit Decision]

If the Credit Committee decides to approve the loan application, the Credit Committee sends a *Commitment Letter* [see pages 73-77 in the RML Manual signed by a member of the Credit Committe.

The *Commitment Letter* is the bank's formal loan offer. It states all terms and conditions of the loan including:

- the mortgage terms and conditions;
- the amount of the commitment fee;
- any conditions the borrower must fulfill prior to closing; and
- the date by which the borrower must return the

signed *Commitment Letter* and fee to the Customer Service Representative.

The borrower may request an extension, in which case the Customer Service Representative should send a *Commitment Extension Letter [see page 77 in the RML Manual]* to the borrower.

If the Underwriter or the Credit Committee decides to approve the application contingent on the borrower's meeting certain conditions, the Underwriter must review the documentation submitted by the borrower and initial each condition on the *Mortgage Loan Underwriting Summary* signifying that those conditions have been satisfied before the loan can be sent on to closing.

Ask students what they think some of these conditions might be.

Decline

If the Credit Committee makes the decision to decline the loan, the Credit Committee should send a *Statement of Credit Denial [see page 68 in the RML Manual* to the mortgage applicant signed by a member of the Credit Committee.

131

Suspend

There may be circumstances under which the Underwriter decides to recommend that the Credit Committee temporarily suspend the application.

In that case the Credit Committee should inform the borrower of the reason for the suspension, what steps need to be taken next, and the anticipated time frames.

One reason for suspension could be that the Underwriter or Credit Committee decides that the information they have received from the borrower is insufficient to make a decision. A Field Credit Investigator may be used to perform more in-depth research into the applicant's financial situation.

Another reason for which an application might be suspended would be if the Underwriter or Credit Committee feels that a Guarantor or co-signer should be a condition of granting the loan.

A Guarantor is a person (usually a member of the immediate family) or a business (usually the borrower's employer) that agrees to insure the timely receipt of payments by the bank, according to the amortized schedule, if the borrower becomes unable or unwilling to abide by the terms of the loan.

An *individual* (as opposed to a corporate) Guarantor must have comparable or higher income than the applicant and must not be a Guarantor for any other financial obligations.

If the Guarantor is salaried, the Customer Service Representative must verify the Guarantor's employment stability and income through pay receipts and a *Verification of Employment.*

When a company, such as the borrower's employer, serves as Guarantor, the Customer Service Representative will have to research the financial viability of the company to serve as a Guarantor for the loan and any future loans and must obtain a signed *Letter of Guarantee.*

If the borrower fails to make his mortgage payments, the lender will contact the Guarantor at a time determined by loan servicing policy and require that the loan be paid down according to the current payment schedule or demand the immediate repayment of the outstanding loan balance.

In the latter instance, upon receipt of the total monies due to the bank, the lender will sign over the mortgage to the Guarantor, which transfers the lien on the property to the Guarantor.

The Guarantor then has the option of pursuing repayment of the mortgage from the borrower or initiating legal proceedings with the intent of foreclosing on the mortgage and taking possession of the property.

In most instances, lenders will contact a Guarantor with the intent of requiring the Guarantor to pay down the loan according to the current payment schedule and continue to make monthly principal and interest payments.

This will continue until the bank can pursue other methods for collecting the outstanding loan balance from the borrower according to the servicing policy.

The bank recognizes that the borrower represents the primary source of repayment.

Therefore, the lender should attempt to exhaust all reasonable possibilities with respect to repayment of the loan by the borrower before commencing any action against the Guarantor.

Handing off the loan file to the Closing Department

Once the borrower has returned the signed *Commitment Letter*, the commitment fee, and documentation that any conditions listed in his *Commitment Letter* have been satisfied, the Customer Service Representative should take the following steps:

- deliver a receipt for the commitment fee to the borrower and enter a copy of the receipt into the mortgage loan file;
- forward the commitment fee to the Servicing Department;
- forward the documentation that the conditions listed on the *Mortgage Loan Underwriting Summary* have

been met to the Underwriter for review and approval.

- contact the Closing Department to order the documentation required for closing; and

- forward the mortgage loan file to the Closing Department along with the *Mortgage Loan Underwriting Summary*.

Closing the Loan

The term "loan closing" refers to the proceedings at which the mortgage lender disburses the loan funds to the seller of the property on behalf of the borrower, which enables the borrower to purchase the property and obtain the title to the property.

In this portion of the Underwriting Residential Mortgages session, we will look at how the bank's Closing Department prepares for this important event.

We will also examine the role of the Customer Service Representative and the role of the Servicing Department in preparing for the closing.

Finally, we will describe what takes place on closing day itself.

Review of the loan's progress to this point

Closing is the culmination of the mortgage loan origination process, so before proceeding, let's briefly review the steps in the lending process that have led up to this point.

Originating and processing

The Customer Service Representative has done a good job of originating and processing the loan. The Customer Service Representative has done the following:

As review, ask the students to list what the Customer Service Representative has done. List their responses on the blackboard. Make sure that all responses listed in the following bullets are presented.

- determined the type of loan best suited to the borrower's needs, the amount of funds the borrower has available for the down payment and closing costs, and the amount of funds the borrower will need to borrow to purchase the property;

- pre-qualified the borrower to determine that there is at least a reasonable chance that the loan might be approved and that the borrower should proceed with the loan application;

136

- provided the Underwriter with all of the information and documents that the Underwriter needs to analyze the bank's risk in approving the loan;

- responded quickly to the Underwriter's request for any additional information or documentation, and taken the responsibility for getting this information from the borrower and forwarding it to the Underwriter;

- acted as the bank's primary contact with the borrower all through this process,keeping the borrower informed about the progress of the application.

Underwriting

The Underwriter has also contributed his particular skills in moving the loan application towards closing.

The Underwriter has done the following:

As review, ask the students to list what the Underwriter has done. List their responses on the board or flipchart. Make sure that all responses listed in the following bullets are presented by including some responses yourself if necessary.

137

- reviewed all of the pertinent documentation and evaluated it against the bank's written policies on underwriting;

- considered any compensating factors that might work in the borrower's favor without exposing the bank to undue risk; and

- arrived at a decision that he feels comfortable with and that he feels he can defend before the Credit Committee.

Having made the decision to recommend approval of the loan application, the Underwriter forwards the loan file to the Credit Committee, accompanied by the *Mortgage Loan Underwriting Summary* that gives the Credit Committee all of the information they need to make the credit decision.

Making the credit decision

The Credit Committee has carefully considered the Underwriter's recommendation and has decided to fund the loan.

Making the formal loan offer

The Customer Service Representative's has prepared the *Commitment Letter* —which is the formal loan offer—and delivered it to the borrower.

From the time the *Commitment Letter* is sent until the day of closing, the Closing Department and its legal counsel perform their major duties.

The Closing Department's responsibilities

[Show OH 6 - 6 The Closing Department's Responsibilities]

The three major activites of the Closing Department prior to closing are:

- checking the loan file;
- preparing the loan documents; and
- registering the mortgage.

139

Checking the loan file

The Closing Department thoroughly examines the loan file to ensure that the bank is fully protected against any legal claim. Among other things, the Closing Department makes sure of the following:

- that the borrower has complied with any conditions attached to the Commitment Letter;
- that the loan will close within the time frame stated in the Commitment Letter;
- that the borrower has been provided with all of the necessary disclosures;
- that the contract of sale corresponds to the information on the sale provided by the borrower;
- that the borrower has acquired the necessary hazard insurance and mortgage insurance required by the bank and has assigned these policies to the bank; and
- that the seller's Certificate of Ownership and the Deed of Transfer of Ownership are in order.

141

Preparing the loan documents

The Closing Department is also responsible for preparing the loan documents for closing. These documents include:

- the promissory note;
- the mortgage;
- instructions to the borrower regarding disbursement of funds; and
- an accounting of sources and disbursements of funds.

Registering the mortgage

A representative of the Closing Department and the borrower must present a joint application to the Registry at least seven days before the anticipated closing.

The application is accompanied by the following documents:

- the mortgage contract;
- documents mentioned in the mortgage contract as appendices; and
- evidence of payment of the State Duty charged for registration.

The Registry may require submission of additional documentation regarding propery rights if needed to confirm the legality of the transaction.

The Registry reviews the application and either approves or disapproves it within a maximum of seven days.

When the Registry approves the application for mortgage registration, a registration number is issued.

- 142

The Customer Service Representative's responsibilities

[Show OH 6 - 7 The Customer Service Representative's Responsibilities]

Prior to closing a loan, the Customer Service Representative continues to be the point of contact with the borrower. This means that the Customer Service Representataive acts as the liaison between the borrower and the Closing Department and the borrower and the Servicing Department.

The Customer Service Representative does the following:

- keeps the borrower informed of the progress of the loan;
- sets the dates for registering the loan and closing the loan;
- advises the borrower to engage an attorney to advise him concerning the signing and generally to represent his interests in this final important meeting
- provides the borrower with a Statement of Receipts and Disbursement of Funds describing the exact closing costs three days prior to closing;

140

- explains the different methods of payment to the borrower and helps him decide which he prefers; and
- informs the Servicing Department of the borrower's choice so they can make the necessary preparations to begin servicing the mortgage on the day it closes.

The Servicing Department's responsibilities

[Show OH 6 - 8 The Servicing Department's Responsibilities]

The Servicing Department's responsibilities prior to closing include:

If the borrower elects to make his mortgage payment by payroll deduction, the Servicing Department should obtain written authorization from the borrower to do so.

The Servicing Department should then make arrangements with the borrower's employer to deduct the mortgage payment from the borrower's salary and remit it to the bank through a correspondent bank or through a pay order.

If the borrower elects to have his mortgage payment automatically debited from his personal bank account, the Servicing Department must establish an account for the borrower for that purpose.

145

If the borrower elects to make his mortgage payment in cash, the Servicing Department must prepare coupons that can be given to the borrower on closing day.

These coupons should be imprinted with the borrower's name, account number, the amount of the borrower's monthly mortgage payment, and the date on which the payment is due. The appropriate coupon should accompany the borrower's monthly mortgage payment.

Some banks may give borrower who are making their mortgage payments in cash the option of making their payment at another bank—perhaps one that is more convenient for the borrower.

If the bank decides to give borrowers that option, the Servicing Department must open collection accounts in commercial banks in different areas of the city, and make arrangements with those banks to collect the borrower's mortgage payment, send a copy of the coupon accompanying the mortgage payment acknowledging receipt of payment to the bank, and transfer the appropriate amount of funds to the clearing account in a timely fashion.

The Servicing Department should establish two ledgers for the borrower:

- one to record each loan payment and the effect of that payment on the principal balance of the loan; and

- one to record the portion of each mortgage payment that is deposited into an escrow account for payment of taxes and insurance premiums and the effect of those payments on the borrower's escrow balance.

The loan closing

On the day the loan closes, a representative of the Closing Department (or in some cases, the Customer Service Representative) meets with the borrower (and his attorney) and the seller of the property.

The Closing Department representative supervises the review and signing of all documents by the appropriate parties.

The borrower delivers the down payment to the seller and the bank delivers the loan proceeds to the seller on the borrower's behalf. This amount should equal the sale price.

The seller delivers the property title to the borrower, who now becomes the home owner.

And the bank takes a lien for the mortgage.

After closing, the Customer Service Representative forward the completed loan file to the bank's Servicing Department, and the Servicing Department places the mortgage documents in a secure, fireproof place for safekeeping.

The bank now has a sound and profitable new loan on its books that should provide a steady stream of interest income over the life of the loan.

Five key indicators of the borrower's ability to repay

There are five key indicators of a borrower's ability to repay the mortgage:

- If the borrower has been able to maintain stable employment — preferably in the same line of work — and income continuity for a substantial period of time (two full years) before applying for the mortgage

- If the borrower's monthly mortgage payment will not exceed about 25 percent of his monthly income (or whatever benchmark the bank has established)

- If the borrower's total monthly debts — including his proposed monthly mortgage payment — will not exceed about 32 percent of his monthly income (or whatever benchmark the bank has established)

- If the borrower has sufficient liquid assets to make the down payment, pay the closing costs, and have the equivalent of two monthly mortgage payments in reserve

- If the borrower has a positive net worth

[OH 6-2]

The key indicator of the borrower's willingness to repay

- The major indicator of a borrower's willingness to repay the mortgage is the borrower's history of meeting his financial obligations in the past — particularly his housing payments — in full and on time.

[OH 6-3]

Two key Indicators of the Property's Adequacy as Security for the Mortgage

- There is nothing about the residence itself, the site on which it is located, or the surrounding neighborhood that might inhibit the ability of the lender to sell the property and recoup the balance due on the mortgage should this ever become necessary.

- The loan-to-value ratio indicates that the value of the property would always be greater than the outstanding loan balance.

How to give the borrower every consideration and protect the bank from undue risk

Step 1: Review the risk factors -

- employment
- debt-to-income ratio
- inflation
- assets
- net worth
- credit history

Step 2: Review the compensating factors -

- high net worth
- residual income
- fixed assets
- large down payment

Step 3: Complete the *Mortgage Loan Underwriting Summary* and make a thoroughly documented recommendation to the Credit Committee to accept, decline, or suspend the mortgage application

How to Make the credit decision

Step 1: Review the loan file and the Underwriter's recommendation.

Step 2: Make the decision to accept, decline or suspend the mortgage application in light of the bank's overall asset-liability management strategy.

- If accepted, send a *Commitment Letter* to the applicant, signed by a memeber of the Credit Committee, outlining the mortgage terms and conditions, the amount of the commitment fee, the conditions the borrower must fulfill prior to closing (if any), and the date by which the borrower must return the signed *Commitment Letter* and fee to the Customer Service Representative.

- If declined, send a *Statement of Credit Denial* to the mortgage applicant signed by a member of the Credit Committee.

- If suspended, inform the borrower of the reason for suspension.

[OH 6-6]

The Closing Department's Responsibilities

- Checking the loan file
- Preparing the loan documents
- Registering the mortgage

153

[OH 6-7]

The Customer Service Representative's responsibilities

- Keeping the borrower informed of the progress of the loan

- Setting the dates for registering the loan and closing the loan

- Advising the borrower to engage an attorney to advise him concerning the signing of papers, and generally to represent his interests at this final important meeting

- Providing the borrower with an estimate of the funds required for Closing

- Providing the borrower with a *Statement of Receipts and Disbursement of Funds* describing the exact closing costs three days prior to closing

- Explaining the different methods of payment to the borrower and helping him decide which he prefers

- Informing the Servicing Department of the borrower's choice so they can make the necessary preparations to begin servicing the mortgage on the day it closes

The Servicing Department's responsibilities

If the borrower elects to make his mortgage payment by payroll deduction —

- obtain written authorization from the borrower to do so
- make arrangements with the borrower's employer

If the borrower elects to have his mortgage payment automatically debited from his personal bank account —

- establish an account for the borrower for that purpose

If the borrower elects to make his mortgage payment in cash —

- prepare coupons that can be given to the borrower on closing day

If the borrower elects to make his mortgage payment through a collection account —

- open collection account(s) in commercial bank(s) and make arrangements with the bank(s) to collect the borrower's mortgage payment

Establish two ledgers for the borrower —

- one to record each loan payment and the effect of that payment on the principal balance of the loan
- one to record the portion of each mortgage payment that is deposited into an escrow account for payment of taxes and insurance premiums and the effect of those payments on the borrower's escrow balance

Practice Exercise: Underwriting Loan Applicants

Contents

- Package of 10 Underwriting Case Studies
- *Mortgage Loan Underwriting Worksheet*

General Directions

- Work as a group to underwrite the loan application you have been assigned
- Complete the *Mortgage Loan Underwriting Worksheet* to arrive at your decision.
- Try to give the mortgage loan applicant the benefit of any compensating factors without exposing your bank to undue risk.
- Be prepared to report on your underwriting decision.

156

Mortgage Loan Underwriting Worksheet

Borrower Name ______________________________

Property Address ______________________________

____

Loan Characteristics (Check all applicable categories)

Loan Type:

_____ DAIR
_____ Other

Loan Amount __________ Initial Note Rate _______% Term __________

Loan Purpose:

_____ Purchase
_____ Refinance
_____ Construction

Occupancy:

_____ Single-Family Owner-Occupied
_____ Multi-Family Owner-Occupied
_____ Second Home

Underwriting Information

Sales Price _______________ Appraised Value _______________

Loan-to-Value _____________%

Appraiser's Name and Company Name

____

____

Underwriter's Name ______________________________

Property Type: _____ Apartment Block _____ Detached

_____ Townhouse _____ Other

159

Mortgage Loan Underwriting Worksheet continued

Verified Monthly Income

	Borrower	Co-Borrower	Total
Base Income	________	________	________
Other Income	________	________	________
Total Income	________	________	________

Proposed Monthly Payments

Borrower's Primary Residence:

Mortgage Payment (P & I) ________________

Property Taxes ________________

Hazard Insurance ________________

Mortgage Life Insurance ________________

Other (________________) ________________

Total Housing Expense ________________

Other Obligations:

(________________) ________________

(________________) ________________

(________________) ________________

Total Other Monthly Payments ________________

Total All Monthly Obligations ________________

Housing expense-to-income ratio ____% Total debt-to-income ratio ____%

158

Mortgage Loan Underwriting Worksheet continued

Verified Funds

Checking/Savings Account __________

Equity from sale of real estate __________

Gifts/Contributions __________

Other Assets __________

Total Verified Funds __________

Verified Employment History

Present Employer ____

Current Position ____

Number of Years in Current Position ________________________________

Previous Position ____

Number of Years in Previous Position ________________________________

Previous Employer ____

Position ____

Number of Years with Previous Employer______________________________

Verified Loan and Payment History

Number of Rental/Utilities Payment Delinquencies for last 12 Months

_____ None _____ 30 days _____ 60 days _____ 90 days

Other Loan Repayment History ________________________________

____

159

Mortgage Loan Underwriting Worksheet continued

Compensating Factors

____

____

____

____

____

Underwriter's Comments

____

____

____

____

____

____

Underwriter's Recommendation:

_____ Accept _____ Reject _____ Suspend

Conditions to be included on Commitment Letter

____

____

____

____

Case Study # 1
John Smith

Situation

Do you have enough information below to make a sound underwriting decision? If so, would you recommend approving or denying John Smith's mortgage application? Justify your recommendation for the Credit Committee.

Application date:	September 15, 1993
Estimated closing date:	December 1, 1993
Borrower:	John Smith
Age:	26 years
Occupation:	Electrical engineer with Coca Cola (a strong Western company) which began operations in Russia during January 1992. John has been working there since November 1, 1992.
Education:	Graduated from a top tier school in Moscow in June 1992 with a degree in engineering.
Current address:	Borrower has lived with his parents his entire life and does not pay any rent.
Marital status:	Single

161

Salary:	$20,000 per year, received in bi-weekly paychecks.
Monthly debt:	$25. 00 per pay period is automatically deducted from each pay check by his employer, which is sent to AAA Appliance Store. These payments are for a refrigerator John bought for his parents when he got the job with Coca Cola. The refrigerator will stay in his parents house after he moves into the subject property. As of the application date, there are still 40 payments owed to AAA Appliance store.
Purchase price:	$80,000
Loan-to-value ratio:	50%
Loan amount:	$40,000
Monthly principal and interest payments at 8 1/4%:	$300.00 per month
Hazard insurance:	$11.00 per month
Real estate taxes:	$10.00 per month
Property insurance: (mortgage life insurance)	$8.00 per month

Assets:	John has $50,000 which he holds in a hard currency account at Mosbusiness Bank. The money has been in the bank for approximately 18 months.
Credit History:	Determined by the Customer Service Representative to be satisfactory.

Case Study # 1
John Smith

Solution

Enough information was provided to make a sound underwriting decision. Assuming the subject property was appraised for at least $ 80,000, an underwriter would recommend approving for a mortgage of $ 40,000 based on the following reasons:

Debt-to-income ratio

John Smith's total obligations-to-income ratio is 22.7% which is below the cutoff of 32% set by the bank.

Principal and Interest	$ 300.00
Taxes	$ 10.00
Hazard Insurance	$ 11.00
Property Insurance	$ 8.00
Total Housing Expense	$ 329.00
Monthly debt	$ 50.00 ($ 25.00 per pay check which is received twice a month)
Total monthly obligations	$ 379.00

Total Monthly Obligations-to-Income Ratio = $\frac{\$\ 379.00}{\$\ 1{,}666.67}$ = 22.7 %

Even though the refrigerator will stay in his parents house, John Smith is still responsible for making the payments whether he uses the appliance or not. Therefore, the $50.00 per month should be included as part of his monthly debt.

164

Liquid Assets

The borrower has sufficient assets to cover the downpayment and closing costs that have been verified by the bank. Although the money has been in the bank for 18 months, an underwriter should require a written explanation regarding the source of the borrower's assets. Since the amount of funds to be used by John Smith is substantial, a reasonable explanation should be given. However, unless the underwriter can positively determine that these funds were obtained illegally, the funds should be accepted.

Duration of Employment

Although the borrower has only been employed by Coca Cola for 9 months, there are several compensating factors that help this case. The first is that the borrower is well educated and received a degree that is in the same line of profession as is his employment. In addition, the borrower is young and works for a strong firm which, in all likelihood, will mean that his salary will increase over the next few years.

Case Study # 2
Darryl and Maya Johnson

Situation

Do you have enough information below to make a sound underwriting decision? If so, would you recommend approving or denying Darryl and Maya Johnson's mortgage application? Justify your recommendation for the Credit Committee.

Application date:	September 15, 1993
Estimated closing date:	December 1, 1993
Borrower:	Darryl and Maya Johnson
Age:	Darryl - 42 years Maya - 41 years
Occupation:	Darryl Johnson President - Johnson Trading Company Johnson Trading Company is an import/export company that started operations on September 1, 1992. The company, which is 100% owned by Darryl Johnson, exports semi-precious metals to Pacific Rim countries. Prior to starting the trading company, Darryl worked in a zinc mine outside of St. Petersburg for six years. Maya Johnson Housewife

166

Education:	Neither borrower completed high school.
Current address:	The borrowers currently live in an apartment in Moscow which they have occupied for the past 12 months with monthly rent of $ 500. Their previous residence was a state-owned flat with rent of $12 per month where they lived for 10 years.
Salary:	According to financial paper developed by Johnson Trading's certified accountant, Darryl Johnson received a salary from his company of $50,000 over the previous 12 months. The company's sales have increased every month since its inception and has $350,000 in liquid assets. These liquid assets consist of cash (rubles) and hard currency that have been verified by Mosbusiness Bank. The company reported a net profit for its first full year of operations of $35,000 which was kept in the company as retained earnings. While working in the zinc mines, Darryl's salary was approximately $600 per year.
Monthly debt:	The Johnsons do not have any monthly debt.
Purchase price:	$400,000
Loan-to-value ratio:	43.7 %
Loan amount:	$175,000
Monthly principal and interest payments at 8 1/4%:	$1,352.00 per month

Hazard insurance:	$47.00 per month
Real estate taxes:	$20.00 per month
Property insurance: (mortgage life insurance)	$15.00 per month
Assets:	The borrowers have indicated that they intend to use liquid assets held by Johnson Trading for the downpayment and closing costs.
Credit History:	A Field Credit Investigator (FCI) was used to investigate and research the borrowers and Johnson Trading and determined that the borrowers had a satisfactory credit history. However, the FCI discovered that there had been a dispute over a $2,000 bill sent to Johnson Trading from one of its suppliers in Greece during January of I993. The matter was finally resolved during June of I993.

Case Study # 2
Darryl and Maya Johnson

Solution

This is an interesting scenario due to the lack of history regarding the borrower's occupation which should be noted by the underwriter as a negative factor. However, the borrower does have some experience in this field from the years working in the zinc mines.

The borrower's debt-to-income ratio is 33.7% which is slightly above the cutoff set by Mosbusiness Bank.

Principal and Interest	$ 1,352.00
Taxes	$ 20.00
Hazard Insurance	$ 47.00
Property Insurance	$ 15.00
Total Housing Expense	$ 1,434.00
Monthly debt	$ 0
Total monthly obligations	$ 1,434.00

Total Monthly Obligations-to-Income Ratio = $\frac{\$1,434.00}{\$4,167.00}$ = 34.4%

However, the real strength in this case is the borrower's assets which total over $350,000. Since Darryl Johnson owns 100 percent of the Johnson Trading Company, he is entitled to use the company's assets for his own personal needs. After the downpayment and closing costs, the borrower will still have over $100,000 in reserves which can be used to repay the loan. This compensating factor outweighs the negative aspects of this loan which include a high ratio and a lack of history regarding the borrower's occupation. The one dispute regarding the bill to Johnson Trading should not be given too much emphasis. It is common for a company to have a dispute every now and then in the course of business. As long as it is not a reoccurring problem, it should not be treated that heavily against the borrower.

In underwriting this loan, it is important to determine the viability of Johnson Trading which would include researching the semi-precious metals industry. If any licenses or approvals are required to export these commodities, the underwriter should require a copy of these as a condition to the commitment. As long as the underwriter feels confident that the Field Credit Investigator's report on Johnson Trading is accurate, the loan should be recommended for approval.

Case Study # 3
Michael Mattia

Situation

Do you have enough information below to make a sound underwriting decision? If so, would you recommend approving or denying Michael Mattia's mortgage application? Justify your recommendation for the Credit Committee.

Application date:	September 15, 1993
Estimated closing date:	February 1, 1994
Borrower:	Michael Mattia
Age:	28
Occupation:	Michael Mattia is a bookkeeper for the Hotel Metropol, Moscow. Michael started working for the Hotel Metropol in December, 1992. Prior to working for the Hotel Metropol, he was employed by Peat Marwick, Inc. as a staff accountant. He worked there for approximately 5 months from February 1992 to June 1992. Between June 1992 and December 1992, Michael was unemployed. Prior to Peat Marwick, the borrower was employed by Arthur Andersen, Inc. as a manager in their audit department for approximately 1 1/2 years.

171

Education:	College graduate with a degree in accounting. The borrower is a Certified Public Accountant (CPA).
Current address:	The borrower lives in a privatized apartment since February I992.
Salary:	Michael currently earns $14,000 per year. His salary at Peat Marwick and Arthur Andersen at the time of his departure was $15,500 per year and $16,000 per year, respectively.
Monthly debt:	The borrower reported that he owes $5,000 to a friend payable at $50 per month. He also has a loan from a Mr. Freeman totaling $2,000, on which he makes payments of $20 per month. Michael Mattia stated that both loans were for personal reasons and would not provide any further information regarding these loans.
Purchase price:	$66,000
Loan-to-value ratio:	50.0 %
Loan amount:	$33,000
Monthly principal and interest payments at 8 1/4%:	$ 248.00 per month

Hazard insurance:	$ 9.00 per month
Real estate taxes:	$ 6.00 per month
Property insurance: (mortgage life insurance)	$ 8.00 per month
Assets:	The Customer Service Representative verified liquid assets held in a hard currency bank account totaling $40,000. However, researching the account over the past three months reveals a highly volatile account balance ranging from a low of $10,000 to a high of $55,000. The borrower was not able to provide a reasonable explanation regarding the account balance fluctuations.
Credit History:	The only piece of credit history the Customer Service Representative was able to retrieve was the borrower's rent history which showed only two payments over thirty days late during the past year. The rest of his rent payments were within 30 days of the due date.

Case Study # 3
Michael Mattia

Solution

The borrower's ratio is acceptable at 29.2% and he has sufficient assets for the down payment and closing costs.

Principal and Interest	$ 248.00
Taxes	$ 6.00
Hazard Insurance	$ 9.00
Property Insurance	$ 8.00
Total Housing Expense	$ 271.00
Monthly debt	$ 70.00
Total monthly obligations	$ 341.00

Total Monthly Obligations-to-Income Ratio = $\frac{\$\ 341.00}{\$1,167.00}$ = 29.2 %

However, there is something about this case that just doesn't make sense. First, why did he have three jobs all in the last two years? Second, why did he take a decrease in salary for each of the past two jobs and a demotion in title? These should be the first two things the underwriter should have questioned. The next problem with this loan is the borrower's assets and credit history. The loans seem pretty suspicious since the borrower could not provide an acceptable explanation for the loans. It also seems strange that his account balances would fluctuate so widely. Lastly, the borrower had two late rent payments which is the most important piece of credit history to the bank since the borrower will be paying his housing expense to the bank in the future. Although the borrower has sufficient assets and enough income to quality, a recommendation for rejection would be the prudent decision. There are just too many unanswered questions regarding this applicant. The whole situation surrounding the borrower doesn't make sense which is more than enough of a reason for a recommendation of rejection. It's very possible that the borrower can't hold down a job which will affect his ability to repay the loan. The fluctuating account balances and personal loans for no apparent reason may also indicate that he has some sort of gambling problem. Nothing, of course, is conclusive but it provides enough of a doubt that it warrants a rejection.

Case # 4
Jack Smith and Mary Jones

Situation

Do you have enough information below to make a sound underwriting decision? If so, would you recommend approving or denying the Jone's mortgage application? Justify your recommendation for the Credit Committee.

Application date:	October 1, 1993
Estimated closing date:	March 15, 1994
Borrowers:	Jack Smith and Mary Jones
Age:	Both are 58 years old.
Occupation:	Jack Smith is a factory worker in a Fiat automobile manufacturing plant. He has been with his current employer for approximately 21 years. Mary Jones is a former factory worker in the same plant but is now disabled and does not work.
Education:	High school graduates.
Current address:	Both borrowers have lived together in a state owned flat for 10 years.

176

Salary:	Jack earns $10.00 per hour for a 40 hour work week and time and a half for overtime (anything over 40 hours). He has averaged 10 hours of overtime per week during the previous year. Mary receives disability payments in the amount of $800.00 per month and will continue to receive this until she turns 65 years which is the mandatory retirement age for Fiat, after which, she will receive a pension of $400 per month. Jack will receive a pension of $700 per month starting at age 65. Jack also works part-time as an auto mechanic averaging 5 hours per week at $5 per hour.
Monthly debt:	Both borrowers have no monthly debt.
Purchase price:	$80,000
Loan-to-value ratio:	50.0 %
Loan amount:	$40,000
Monthly principal and interest payments at 8 1/4%:	$ 300.00 per month

Hazard insurance:	$ 8.00 per month
Real estate taxes:	$ 5.00 per month
Property insurance: (mortgage life insurance)	$ 7.00 per month
Assets:	The borrowers have a combined $3,500 in liquid assets that have been verified by the Customer Service Representative. As part of the employee benefits, Fiat will pay the down payment and all closing costs of a home purchased by any employee with over 15 years of employment with the company up to a maximum of $35,000. Mary has a l988 Fiat that she plans to sell to cover the remaining down payment requirement. She estimates the value to be approximately $4,500.
Credit History:	Both borrowers have an excellent credit history as verified by the Customer Service Representative.

Case Study # 4
Jack Smith and Mary Jones

Solution

Probably the most important aspect of this loan is the ages of the borrowers. An underwriter must determine the borrower's capacity to repay the loan over its 15 year term. The property insurance will insure the repayment of the loan in case a borrower dies. However, due to the borrowers' ages, an underwriter must determine if the borrowers will have sufficient income at retirement to make their monthly payments. Using their current income in calculating their ratio would not lead to a prudent underwriting decision. A more conservative approach would be to use their pension income totaling $1,100 which results in a total monthly obligations to income ratio of 29% which is acceptable according to the bank's guidelines. Although there was no stated mandatory retirement age for his part-time job, this income should not be counted since there is the possibility that, due to the borrower's age, this income may not continue for a significant length of time. However, this would be considered a positive compensating factor.

Regarding the borrowers' assets, an underwriter should accept the $35,000 plus all closing costs as part of the liquid assets requirement as long as it's been verified by a Customer Service Representative that this money does not have to be repaid. Since the borrowers only have $3,500 in liquid assets, the underwriter should include a condition to the commitment requiring that the borrowers net at least $1,500 from the sale of Mary's Fiat which will be used as part of the downpayment. This condition does not require Mary to sell her car for $1,500, but that she needs to net at least $1,500 from the transaction to be used as part of the downpayment. In the case of a borrower selling a fixed or non liquid asset in order to meet the downpayment or closing costs requirement, the underwriter should always make this a condition to the commitment rather than requiring that the transaction be completed prior to approval. That way, in case the borrowers are rejected for a different reason or the deal just falls through, the borrower hasn't unnecessarily sold any of their assets.

Assuming all other factors included in this case are satisfactory, this loan should be approved.

Case #5
The McMillans

Situation

Do you have enough information below to make a sound underwriting decision? If so, would you recommend approving or denying the McMillan's mortgage application? Justify your recommendation for the Credit Committee.

Application date: August 1, 1993

Estimated closing date: January 1, 1994

Borrowers: Tim and Judy McMillan and their children Kevin and Sue

Age:
Tim - 50 years
Judy - 55 years
Kevin - 28 years
Sue - 20 years

Occupation: Tim and Judy McMillan own a printing shop which has been in operation for approximately 10 years. They each own 50 percent of the business.

Kevin works at a nuclear power plant as a technician and has been at the same plant since he graduated from high school which was 10 years ago.

Sue McMillan is currently unemployed. She used to work for a clothing manufacturer where she was a seamstress from January, 1990 until June , 1993. She is currently looking for a job as a seamstress with another company.

Current address:	The McMillan family has all lived together in the same state-owned flat for the past 20 years. After pooling all their savings, they were able to come up with enough money for the downpayment and closing costs on a home that is in the process of being constructed.
Salary:	Although the profits from the printing shop have not been stable, over the previous three years, the McMillan's have given themselves a combined average of $20,000 in salary. Kevin makes $5.00 per hour for a 40 hour work week. He typically works 2 hours a week in overtime for which he earns time and a half. Sue does not receive any unemployment compensation but earns $4.00 per hour for babysitting which she does whenever she can find the work. However, her babysitting hours have been very sporadic and she does this only because she has not yet found full time employment.
Monthly debt:	A few years ago, Tim and Judy had to borrow $10,000 for a new press for their printing shop. The bank required that the McMillan's personally guarantee the debt. The loan has three years remaining with monthly payments of $200. The McMillans also have a car loan with 5 months remaining with monthly payments of $75 per month. Kevin McMillan does not have any monthly debt. Two years ago, while Sue was working, she bought a car with the help of a loan from her local bank. The payments are $60 a month with two years remaining to pay off the loan.

Purchase price:	$120,000
Loan-to-value ratio:	50.0 %
Loan amount:	$60,000
Monthly principal and interest payments at 8 1/4%:	$ 451.00 per month
Hazard insurance:	$ 20.00 per month
Real estate taxes:	$ 15.00 per month
Property insurance: (mortgage life insurance)	$ 18.00 per month
Assets:	The following is a breakdown of the liquid assets of the McMillan family which have been verified by the Customer Service Representative: Tim and Judy McMillan - $47,500 Kevin McMillan - $22,000 Sue McMillan - $15,000
Credit History:	A verification of the McMillan's (including Sue's car loan) monthly debt revealed a satisfactory payment history.

Case Study # 5
The McMillans

Conclusion

The first thing the underwriter must be concerned with is the length of time between the application and the estimated closing date. Prior to closing, the Customer Service Representative should reverify all of the borrower's pertinent information including their income, assets, and credit history. The underwriter should also utilize a Field Credit Investigator to research the McMillan's printing shop in order to determine if the financial information provided by their tax returns and financial statements is accurate. The Field Credit Investigator should also try to form an opinion regarding the long term economic viability of the business.

When you have a loan application with multiple borrowers, each borrower's income and expenses are used to calculate a combined total monthly debt-to-income ratio.

Principal and Interest	$	451.00
Taxes	$	15.00
Hazard Insurance	$	20.00
Property Insurance	$	18.00
Total Housing Expense	$	504.00
Monthly debt	$	335.00
Total monthly obligations	$	839.00

Income:		
McMillans	$ 1,667.00	
Kevin	867.00	(regular pay)
	65.00	(overtime)
Total income	$ 2,599.00	

Total Monthly Obligations-to-Income Ratio = $\frac{\$\ 839.00}{\$2,599.00}$ = 32.2 %

Based on the above analysis, a recommendation for approval would be the correct decision. The borrower's ratio is a little high. However, mitigating this risk is the fact that one of the borrowers, Sue, is a qualified seamstress who is temporarily unemployed. It is most probable that she will eventually gain employment and will be able to help contribute toward the mortgage payment.

Due to the subject property being new construction, the underwriter should carefully check the appraisal to insure that the proper methodology was used. The appraisal should be performed after the construction is completed in order to make a more accurate determination of value.

Case Study # 6
Joanne M. Grillo

Situation

Do you have enough information below to make a sound underwriting decision? If so, would you recommend approving or denying Joanne Grillo's mortgage application? Justify your recommendation for the Credit Committee.

Application date:	August 1, 1993
Estimated closing date:	November 30, 1993
Borrower:	Joanne M. Grillo
Age:	36 years
Occupation:	Joanne has been a registered nurse with the same hospital for 15 years. She has an excellent reputation within the hospital and has been offered a management position numerous times over the past few years. However, Joanne enjoys working with the patients and has turned down all offers to move into hospital administration.
Current address:	Joanne has lived with her parents her entire life. During 1988, Joanne's parents divorced and her father moved to the U.S. and gained U.S. citizenship in 1990.

Salary:	$11,400 per year with an expected cost of living increase each year of 3% over the published annual inflation rate.
Monthly debt:	The borrower currently has no monthly debt. However, Joanne disclosed that she recently paid off over $5,000 in credit card liabilities with the help of a gift from her father, in anticipation of buying a home and qualifying for a mortgage. She originally obtained the credit cards in 1990 with assistance from her father when he moved to America. From 1990 until she paid off all her debts, Joanne consistently had credit card balances of approximately $5,000. Because she lived with her mother and did not pay any rent, she was able to make the monthly payments of approximately $250. During 1988, Joanne bought a relatively expensive foreign car with the help of a $3,500 car loan and a $500 down payment. Because Joanne has never been able to build up any significant savings, the down payment depleted her savings account. During the summer of 1990, Joanne's father, feeling guilty over the divorce and leaving his only child, sent Joanne $3,000 to be used to pay off her car loan.
Purchase price:	$80,000
Loan-to-value ratio:	50%
Loan amount:	$40,000

Monthly principal and interest payments at 8 1/4%:	$300.00 per month
Hazard insurance:	$8.00 per month
Real estate taxes:	$5.00 per month
Property insurance: (mortgage life insurance)	$7.00 per month

Assets:	To date, Joanne is still unable to save any substantial amount of money even though she doesn't pay any rent and earns a good salary. The Customer Service Representative notices that Joanne wears expensive clothing and enjoys the nicer things in life such as going on several vacations each year and eating at the nicest restaurants in town. Her father, who has since become fairly wealthy, has provided 100% of the down payment and closing costs requirement and also has given the borrower an extra $750. All of these assets have been verified and are currently in Joanne's bank account. However, Joanne spent $250 of the extra $750 that her father gave her on a weekend ski trip.
Credit History:	The Customer Service Representative verified that all of the borrower's previous debts were paid on time.

Case Study # 6
Joanne Grillo

Solution

The borrower's total monthly debt to income ratio is a little high at 33.6%. However, the strength and stability of her employment history and the fact that she automatically receives a raise every year would normally be a strong enough compensating factor to offset the higher ratio. The borrower has sufficient assets to close the loan and has two months of reserves in the bank. The two months of reserves are calculated by taking the borrower's projected house payment and multiplying it by two. Finally, the borrower's credit history is perfect. This seems to be an ideal borrower. However, after carefully analyzing the above situation, an astute and conservative underwriter should recommend rejecting Joanne Grillo for this mortgage.

Joanne Grillo is a perfect example of a classic credit abuser. This is someone who has demonstrated an inability to conservatively manage their finances. The borrower's past history of paying her obligations is not a guarantee of paying her future obligations. Joanne's total debt has been between $3,000 and $5,000 for the past five years. She has grown accustomed to a very expense life style which an underwriter cannot assume will be given up in the future. Her lack of ability to save any substantial amount of money, while earning over $900 a month, should have provided the first warning to the underwriter. The only reason the borrower currently doesn't have $5,000 in monthly debt, which would make her ratio too high to qualify, is that her father provided the funds to pay this debt down. There is no reason to believe that the borrower will not continue to build substantial debt through the use of her credit cards. She already spent $250 of the $750 given to her on the ski trip. An underwriter should not assume that a borrower will change their life style due to the purchase of a house. It can be assumed that some borrowers will make certain sacrifices in order to purchase a home and pay their mortgage. This borrower, however, has always been given the money she needed in order to pay down her excessive debts. Joanne Grillo has not demonstrated the ability and willingness to manage her finances in a way that would enable her to take on a mortgage of $40,000 and the corresponding monthly obligations. For this reason, a rejection would be the prudent decision.

Case Study # 7
Joseph and Sue Carter

Situation

Do you have enough information below to make a sound underwriting decision? If so, would you recommend approving or denying the Carter's mortgage application? Justify your recommendation for the Credit Committee.

Application date:	January 1, 1994	
Estimated closing date:	March 15, 1994	
Borrower:	Joseph and Sue Carter (husband and wife)	
Age:	Joseph Carter	28 years
	Sue Carter	26 years
Occupation:	Mr. and Mrs. Carter opened a trendy retail store selling the latest in women's fashions including clothes, shoes, jewelry and other accessories. The store has been in operation for approximately 4 years. Prior to this, neither Joe or Sue had any retail or women's fashions experience.	
Current address:	The borrowers have lived in a privatized flat in Moscow for the past two years. Prior to that, they were living with Sue's parents in order to reduce their expenses while the business was in its early stages.	

Salary:	Neither borrower gets a fixed salary from the business. It is the Carter's policy to take 50% of each month's net profit as salary for both of them. The remaining 50% is left in the business for working capital requirements. At the end of the year, the Carters pay themselves a bonus of 75% of the remaining net profit with the remainder being reinvested into the business. During the previous four years, the Carters had total income for the year as follows :

1990	$2,000
I991	$4,000
1992	$8,000
1993	$14,000

Monthly debt:	The Carter's have no monthly personal debt. However, the business has total debt amounting to approximately $25,000 with payments of $2,100 per month.
Purchase price:	$66,000
Loan-to-value ratio:	50%
Loan amount:	$33,000
Monthly principal and interest payments at 8 1/4%:	$248.00 per month
Hazard insurance:	$15.00 per month

Real estate taxes:	$ 5.00 per month
Property insurance: (mortgage life insurance)	$8.00 per month
Assets:	The Carters currently have a combined total of $3,000 in hard currency bank accounts in their name. They plan to withdraw approximately $35,000 from funds held in their company's name to satisfy the downpayment and closing cost requirements of their mortgage.
Credit History:	The Customer Service Representative verified that all of the borrower's previous debts were paid on time.

Case Study # 7
Joseph and Sue Carter

Solution

This is a relatively simple loan to underwrite. The Carter's ratio falls within the bank's standards for acceptable borrowers at 30%.

Monthly debt	$ 276.
Monthly income	$ 917.00 (To be conservative, a two year average of their income was used due to the fluctuating nature of self-employed borrowers' income.)

$$\text{Total Monthly Obligations-to-Income Ratio} = \frac{\$\ 276.00}{\$\ 917.00} = 30.0\ \%$$

It should have been noted that their income has steadily increased since the business first opened. A field credit investigator would be used for this application to check the accuracy of the business's financial statements and the general condition and economic viability of the business. The only other major concern would be to verify that the Carter's business has enough liquidity to operate after the withdrawal of the $35,000. If not, the Carter's business may have trouble generating the profits from which the bank's mortgage is being repaid. All other factors being favorable, this loan should be recommended for approval.

This case illustrates the fact that self-employed borrowers can use funds from their business for their personal use as long as they have 100% ownership of the company. If not, an underwriter should verify the availability of any funds to be withdrawn by an applicant. In addition, any business debt should not be included in the applicant's ratio since you are already accounting for this by taking a net income figure for their income.

Case Study # 8
Greg McManus

Situation

Do you have enough information below to make a sound underwriting decision? If so, would you recommend approving or denying Greg McManus' mortgage application? Justify your recommendation for the Credit Committee.

Application date:	December 15, 1994
Estimated closing date:	April 5, 1995
Borrower:	Greg McManus
Occupation:	Greg is a banker with a new Western bank that has just opened operations in Moscow on December 1, 1993. Greg has been with his bank for approximately five years in its Germany office.
Current address:	The applicant has lived in a hotel in Moscow since he arrived here on December 1, 1993. Greg has been with his bank for approximately five years in its Germany office.

Salary:	Greg is well paid by Russian standards, due to his employment with a Western company, at $35,000 per year.
Monthly debt:	Greg has a car that he bought with a $10,000 loan. The payments which are $350 per month are paid by his employer as stipulated in his employment contract. The terms of this agreement state that while Greg is employed by the Bank, the Bank will pay for all expenses related to his car up to $400 per month.
Purchase price:	$100,000
Loan-to-value ratio:	50%
Loan amount:	$50,000
Monthly principal and interest payments at 8 1/4%:	$492.00 per month
Hazard insurance:	$30.00 per month
Real estate taxes:	$28.00 per month
Property insurance: (mortgage life insurance)	$28.00 per month

Assets:	Greg's employer has agreed to pay all expenses related to moving to Russia for Greg including the payment of a downpayment and closing costs up to $65,000. The Customer Service Representative has verified that this is a part of the benefits offered by Greg's company and that it is not a loan, and therefore does not have to be repaid.
Credit History:	The Customer Service Representative verified that all of the borrower's previous debts were paid on time.

Case Study # 8
Greg McManus

Solution

The major concern with this application are the verification of the borrower's benefits since this is where the borrower will be getting the funds to pay for the house. Even though Greg's company pays his car loan, this monthly debt should be included in his ratio. This is because if he leaves his company or is terminated, the company is no longer responsible for the payment of this debt. An underwriter must verify that the applicant can meet his monthly obligations in a case like this.

Another concern is Greg's length of employment. This should not be a problem with Greg since he was employed with his bank in Germany prior to moving to Moscow. Even if he was not employed by his current bank, but had experience in banking in general, this would have satisfied Mosbusiness Bank's requirement of sufficient experience in a related field of profession.

The fact that Greg is getting the downpayment and closing costs from his employer should not be a negative factor in underwriting this loan. However, it should be verified that he has some funds to serve as reserves. His reserves only have to be equal to two months of his proposed mortgage payment. In a case like this, Mosbusiness Bank may want to inquire about Greg's employer guaranteeing the loan which would reduce the risk of default.

Case Study # 9
Dave Mironov

Situation

Do you have enough information below to make a sound underwriting decision? If so, would you recommend approving or denying Dave Mironov's mortgage application? Justify your recommendation for the Credit Committee.

Application date:	August 20, 1993
Estimated closing date:	October 15, 1993
Borrower:	Dave Mironov
Occupation:	Accountant with the accounting firm of Blake, Windsor and Mironov. The applicant has been a CPA for approximately 6 years. Although the firm's senior partner is his dad, George Mironov, the applicant does not have any ownership in the busines. Therefore, he is not considered a self-employed borrower.
Current address:	Dave has lived in a state-owned flat paying rent of $5 permonth for the last five years.

10

Salary:	According to computer generated pay stubs and the Verification of Employment form, the applicant earns $36,500 per year in salary. In addition, he has received bonuses at year-end in the amount of $3,000 and $2,500 for l992 and l991 respectively.
Monthly debt:	Dave has student loans with scheduled monthly payments of $400 per month. The applicant intends to use his deferment option for these loans for the next two years due to the substantial increase in his monthly housing expense. According to his loan terms, a borrower can defer principal and interest payments on a student loan, for any reason, for up to two years. The unpaid interest each month is added to the outstanding loan balance. Prior to the purchase of the applicant's house, Dave paid the full amount due on his student loans.
Purchase price:	$120,000.
Loan-to-value ratio:	50%
Loan amount:	$60,000
Monthly principal and interest payments at 8 1/4%:	$461.00 per month
Hazard insurance:	$25.00 per month

Real estate taxes:	$15.00 per month
Property insurance: (mortgage life insurance)	$18.00 per month
Assets:	The Customer Service Representative has verified that Dave has $30,000 in liquid assets. The remaining balance of what is due for the down payment and closing costs will come from a gift from his father. It has been verified that his father has the financial capacity to give such a gift.
Credit History:	Dave's credit history is satisfactory.

Case Study # 9
Dave Mironov

Solution

Of major concern with this application is the accuracy of Dave's stated earnings. This is because of Dave's employment with his father's firm. The integrity of a Verification of Employment form can be suspect due to the borrower's relationship with the company's management. Of more importance is the fact that the borrower supplied the bank with a computer generated pay stub which is a better source to verify income than a Verification of Employment or a hand generated pay stub. However, due to the applicant's father owning the company, the underwriter should have utilized a Field Credit Investigator with this application. The Field Credit Investigator should research average earnings figures within his father's firm and other accounting firms, comparing salaries for employees with similar traits such as education, age, length of employment, and title. Obviously if the Field Credit Investigator finds any fraud or misrepresentation by the borrower or his employer, the application should immediately be rejected.

When calculating the borrower's ratio, his full monthly student loan payment should be included. This is a more conservative approach in underwriting this loan. As an underwriter, you want to make sure that an applicant can make their loan payments over the life of the loan. Due to the student loan payment being substantial, this should be included in his ratio. It allows the underwriter to make a more accurate assessment of the borrower's long term economic viability with regard to the proposed mortgage payments.

When calculating Dave's income, an average of his previous two years bonuses should be added to his current salary which results in a monthly income of $3,279. His total monthly housing expense to income ratio is 28%.

Provided that the Field Credit Investigator verified the validity of the applicant's income, this applicant should be recommended for approval.

Case Study # 10
Sam Turner

Situation

Do you have enough information below to make a sound underwriting decision? If so, would you recommend approving or denying Sam Turner's mortgage application? Justify your recommendation for the Credit Committee.

Application date:	October 1, 1993
Estimated closing date:	February 1, 1994
Borrower:	Sam Turner
Occupation:	Owns a restaurant in Moscow. The restaurant which is called "Sam's" has been in business for 4 years.
Current address:	Sam lives in an apartment over his restaurant. He owns the building that his restaurant and apartment are in. The building is debt free.

Salary:	Sam's restaurant has done well since it opened averaging $24,750 per year in net profits, of which, 100% is taken out by the applicant. Sam has begun construction of two new restaurants in Moscow that are scheduled to be completed by the end of 1994 or the beginning of 1995. The costs related to building these restaurants are paid directly by the borrower. When asked for a detailed construction budget, Sam replied that he has known the general contractor in charge of construction for over 20 years. The general contractor submits expense reports each month which are paid by Sam. Sam has never developed or asked from his general contractor a detailed budget for construction. The general contractor estimates that the cost over the next year will be approximately $15,000.
Monthly debt:	Outside of his construction expenses, the borrower has no monthly debt.
Purchase price:	$90,000
Loan-to-value ratio:	50%
Loan amount:	$45,000
Monthly principal and interest payments at 8 1/4%:	$362.00 per month
Hazard insurance:	$19.00 per month
Real estate taxes:	$21.00 per month

Property insurance: (mortgage life insurance)	$13.00 per month
Assets:	Sam keeps large amounts of cash on hand due to the nature of his business. A Customer Service Representative verified that as of November 1, 1993, Sam had $55,000 on hand. Sam indicated that the amount of cash he has at any one time fluctuates according to the sales of his restaurant and his purchases of supplies for the restaurant.
Credit History:	An inquiry into Sam's business references reveals that Sam pays all of his bills in a timely manner.

Case Study # 10
Sam Turner

Solution

This is an application that requires an underwriter to look at it from a qualitative viewpoint rather than a quantitative approach. The first thing that should have caught the attention of an underwriter is the possibility that Sam is expanding too rapidly. Not only is he purchasing a house, but he's also building not one, but two, new restaurants. Next, the lack of a detailed construction budget should alert the underwriter to the possibility of cost overruns not anticipated by the borrower. His long time relationship with the general contractor does not eliminate the possibility of substantial increases to the cost of his two new restaurants.

It goes back to the general rule of thumb for underwriters: Does this loan make sense? The underwriter should be concerned with the many different things that can go wrong with the new restaurants that would affect the borrower's ability to repay the loan. Even if the borrower presented a more formal budget for construction, there is just too much risk involved with the construction of two restaurants in addition to adding the proposed mortgage payments. Because of this, the underwriter should recommend a rejection of this application. The bank should also inform Sam that he would have a better chance of obtaining a mortgage after the two new restaurants are built and have established an operating history. At that time, an underwriter will be able to make a more informed decision regarding the borrower's financial capacity and ability to repay a mortgage loan.

20

Session 7
Servicing Residential Mortgages

Time: 1.25 hours **Format: Lecture and discussion**

(Plus 45 minutes with Collections)

Introduction

This session covers the following functions as part of loan servicing:

- the cashiering function;
- the accounting function;
- the taxes and insurance function; and
- the collections function.

Depending on the time available, you may or may not want to include the collections function in this session. If you cover collections, add at least 45 minutes to the time you allow for the session.

Introduce the session by reviewing the topics to be covered. Remind students that each person should expect to participate and contribute, through discussion, and to make this a joint learning experience. Say something like:

205

"In this session we will look at the basic functions that make up the loan servicing process. Loan servicing is an opportunity to solidify our relationship with our customers and to generate profits for our institutions. But to make sure that we all understand how the servicing principles can be applied in Russia, your participation is critical. Now and then, I will stop and ask you to link the information to our market and our environment. Through discussion and sharing, we can all benefit."

Do not feel that you as the instructor must carry the entire session. While there is information you will need to communicate, the most important objective is to make sure that students think about and discuss how this information can be applied to their own institutions and to their environment. So, keep your lectures brief and allow time for interaction.

Encourage everyone to participate—do not allow one or two individuals to dominate the entire discussion. Remind students that everyone's opinion counts. Be sure students listen to each other and that they acknowledge the other person's point of view, even when disagreeing.

20

As the instructor, resist the urge to favor one position over another. It is better to let students work through issues and differences of opinion as a group. You should not appear arbitrary or to favor one individual over another. Finally, thank individual students for their contributions. This will encourage others to join in.

The term "loan servicing" refers to the variety of duties associated with managing the bank's relationship with the borrower from the time the loan closes until it is paid off.

The importance of the Servicing Department to the success of the overall mortgage lending operation cannot be overstated, since this is the department that ultimately ensures that the mortgage loan is repaid.

In addition, Servicing has the potential to increase business and earnings for the bank as a whole.

Servicing solidifies relationships with customers over the life of the loan which gives the bank the opportunity to provide borrowers with additional financial products and services.

We will begin by discussing what a bank needs to have in place to begin servicing mortgage loans.

207

We will then look at what is involved in the four major servicing functions:

- the cashiering function—responsible for collecting borrower's mortgage payments;
- the accounting function—responsible for maintaining mortgage records; and
- the taxes and insurance function—responsible for paying property taxes and insurance premiums on behalf of the borrower.
- the collections function—responsible for preventing and resolving delinquencies.

Stop here and ask students what steps they think a bank should take to set up the Servicing Department. The requirements are that the department should run smoothly and profitably. Record students' responses on a flip chart or board. Then say something like:

> **"That's a good list. Let's talk about what goes into preparing to service residential mortgages."**

Preparing to Service Residential Mortgages

[Show OH 7-1 Preparing to Service Residential Mortgages]

There are a number of steps a bank can take in setting up its Servicing Department that will increase the likelihood that it will operate efficiently and contribute to the success and profitability of the entire mortgage lending operation.

Developing policies and procedures

Just as the bank should have written underwriting policies and procedures, the bank should also establish a comprehensive, written set of servicing policies and procedures.

Hiring skilled staff

The bank should hire staff who are equally skilled in dealing with numbers and people.

209

Organizing for efficiency

The best organizational structure for a Servicing Department depends on the volume of mortgage loans they are servicing.

If the volume of loans is large, the department should be organized into at least four distinct areas—each having a staff responsible for one of the four major servicing functions.

If the volume of loans is small, one or two people may perform all of the servicing functions.

Providing training and technology

The bank should provide Servicing staff with the training and technological support they need to perform their tasks accurately and efficiently in order to provide customers with the kind of service that makes them want to entrust all of their financial business to the bank.

Stop here and check to see if students think these are reasonable requirements for establishing the Servicing Department. Say something like:

> **"We've talked about the need to have policies and procedures, hire skilled staff, organize our department efficiently, and provide the training and support Servicing staff will need. Do these sound like reasonable requirements for Russian banks? Where do you think we will encounter the greatest difficulties? What can we do to overcome those challenges?"**

Establishing relationships with insurers

The bank should establish relationships with hazard and mortgage insurance companies to help the bank reduce the risks associated with mortgage lending.

Hazard (or property) insurance ensures that the property owner is compensated for damage to the property due to all sorts of calamities, such as fire.

Mortgage insurance ensures that the lender is compensated against loss caused by a borrower's inability or unwillingness to repay the mortgage. Mortgage insurance may cover a percentage or virtually all of the mortgage loan amount, depending on the type of mortgage insurance.

Mortgage life insurance ensures the borrower that the unpaid principal balance of their mortgage loan will be paid off in the event they die while the policy is in force.

Establishing relationships with employers and other banks

The bank should establish relationships with employers in their area so the bank can offer borrowers the option of making their monthly mortgage payment through payroll deduction.

Collecting mortgage payments through payroll deduction is probably one of the most efficient and risk-free methods of collecting mortgage payments.

The bank should also establish relationships with commercial banks in the area that may be willing to collect borrowers' mortgage payments on the bank's behalf.

The bank will then be able to offer borrowers the option of making their mortgage payment at other convenient locations.

212

Stop here and discuss how relationships can be formed with insurers, employers, and other banks. Say something like:

> **"What are some ways we can form relationships with insurers, employers, and other banks? What kinds of difficulties do you expect to encounter? How can you overcome those difficulties?"**

Setting up accounts to facilitate processing of payments

To facilitate the efficient flow of funds, the bank should set up three bank accounts: a clearing account, a principal and interest account, and an escrow account.

A **clearing account** is an account into which each borrower's entire payment is deposited—principal, interest, taxes, and insurance;

A **principal and interest account** is an account into which the principal and interest portion of the borrower's payment is deposited from the clearing account.

An **escrow account** is one into which the taxes and insurance portion of the borrower's payment is deposited from the clearing account and held in trust for the payment of insurance premiums on the borrower's behalf.

213

Preparing supply of coupons and receipts

The bank should prepare a supply of preprinted **coupons** to provide to borrowers who will be making their mortgage payments in cash.

These coupons should have space for the bank to fill in the borrower's name, account number, the amount of the borrower's monthly mortgage payment, and the date on which it is due.

They should also prepare a supply of preprinted **receipts** in duplicate to provide to borrowers who will be making their mortgage payments in cash.

Preparing supply of ledger cards

They should prepare a supply of **ledger cards**. The accounting function will use these to record each loan payment and the effect of that payment on the principal balance of the loan. The taxes and insurance function will also use them to record the portion of each borrower's mortgage payment deposited into the escrow account for payment of taxes and insurance premiums and the effect of those payments on the borrower's escrow balance.

214

Setting up a cashbook

They should set up a **cashbook** in which to record the total amount of cash deposited each day into the clearing account.

Preparing a secure place to store mortgage documents

Finally, the bank should establish a secure, fireproof location where mortgage documents can be placed for safekeeping after closing.

Stop here and ask students if they can think of other preparation that should take place. You might also refer back to the list they generated at the beginning of the session. Ask students to comment on how reasonable they think this advance preparation is. Where do they anticipate problems?

215

The cashiering function

[Show OH 7-2 The Cashiering Function]

The cashiering function has two primary responsibilities:

- collecting the borrower's mortgage payments
- delivering the receipts and records of payment to the accounting function.

Stop here and ask students to list the different ways that borrowers can make their payments. Probe for these methods: cash, payment at a commercial bank, payroll deduction, automatic deduction from their personal bank account. Explain that the cashiering function has slightly different responsibilities depending on the payment method.

Collecting borrower's mortgage payments

If borrowers make their mortgage payments in cash, the cashiering function does the following:

- accepts cash payment and coupon from borrower;
- verifies the amount of cash received and the date received against the amount and date on the coupon;

- completes a receipt in duplicate with the borrower's name, account number, actual amount of payment received, and the date on which it was received; and

- provides one copy of the receipt to the borrower as proof of payment and retains one copy for the bank's records.

Stop here and ask students what interpersonal skills they think the cashiering staff must possess to interact well with customers who are making payments.

If borrowers make their mortgage payment at a commercial bank at which your bank has opened a collection account, the cashiering function receives a copy of the coupon that accompanied the borrower's payment stamped by the collecting bank acknowledging receipt of payment and checks to be sure that the collecting bank has transferred the appropriate amount of funds to the clearing account.

If borrowers make their mortgage payments through payroll deduction, the cashiering function receives a record of payment from the borrower's employer and checks to be sure that the employer has transferred the appropriate amount of funds to the clearing account.

217

If borrowers make their mortgage payments through an automatic deduction from their personal bank account, the cashiering function debits the borrower's bank account for the amount due and transfers those funds to the clearing account, and generates a record of payment.

At the end of each business day, the cashiering staff total the cash receipts they have received and reconcile those receipts with the actual cash collected.

They then prepare a deposit slip for the cash, deposit the cash into the clearing account, and record the cash deposit in the Cashbook.

Delivering receipts and records of payment to accounting

At the end of each day, the cashiering function delivers all cash receipts and records of payment from employers and collection accounts to the accounting function.

Stop here and ask students what aspect of the cashiering function they consider to be most important. Then ask if they can see any obstacles that might make it difficult for the cashiering staff to perform effectively. Ask for suggestions to overcome those obstacles.

228

The accounting function

[Show OH 7-3 The Accounting Function]

The accounting function is responsible for:

- maintaining mortgage records
- calculating new ARM payments
- providing quarterly statements
- processing loan payoffs

Maintaining record of payments

The accounting function receives receipts and records of payment from cashiering on a daily basis and records each borrower's payment on his individual ledger card.

Specifically, accounting staff record the following:

- the payment due date;
- the date the payment was actually made;
- the total amount collected;

219

- the portion of the payment applied to interest;
- the portion of the payment applied to principal;
- the resulting principal balance;
- the portion of the payment to be deposited into an escrow account for payment of taxes and insurance on the borrower's behalf; and
- the resulting escrow balance.

Calculating new ARM payments

If the borrower has an adjustable rate mortgage, the accounting staff must calculate the borrower's new payment amount at least one month before the mortgage is scheduled to adjust.

If the borrower makes his mortgage payment in cash, the accounting staff are responsible for notifying the borrower of the change in his monthly mortgage payment and supplying the borrower with a new set of coupons for the months for which payment is due at that amount.

If the borrower makes his mortgage payment by having it debited automatically from his bank account, the accounting department is responsible for notifying the borrower of the new monthly payment with a reminder to make sure that adequate funds are available in the account to cover the debit.

If the borrower makes his mortgage payment through payroll deduction, they are responsible for notifying the borrower of the new monthly payment and notifying the borrower's employer—preferably by courier—at least one month in advance of the new monthly payment amount.

Providing quarterly statements

Accounting Department staff are responsible for providing borrowers with a quarterly statement of the status of their mortgage loans, including the outstanding principal balance.

Processing loan payoffs

The accounting function is responsible for processing the borrower's payoff of the mortgage loan. When they receive a request from a borrower to pay off the mortgage loan, they must calculate the payoff amount (principal balance, plus interest due, less escrow balance) and notify the borrower of the payoff amount.

When they receive the payoff amount from the borrower, they write "paid-in-full" on the borrower's ledger card.

Finally, they retrieve the mortgage note from the vault and return it to the borrower.

Stop here and ask students if these accounting responsibilities seem reasonable. Ask if they can think of other responsibilities that accounting should assume. Where do they anticipate the biggest problems for accounting? What can be done about those problems?

The taxes and insurance function

[Show OH 7-4 The Taxes and Insurance Function]

The taxes and insurance function is responsible for paying property taxes and insurance premiums on the borrower's behalf.

Estimating payments due from borrower

They estimate the monthly deposit needed to pay each expense as it comes due.

They analyze the borrower's escrow account as appropriate to determine that the balance is adequate, and, if necessary, make any adjustment needed to meet the estimated future charges.

Paying taxes and insurance premiums

They receive tax and insurance premium bills and pay them on the borrower's behalf from the escrow account when they are due.

223

Maintaining records

They record the payment of taxes and insurance premiums on the borrower's individual ledger card set up for that purpose, the effect of those payments on the borrower's tax liability and insurance premium, and the balance in the borrower's escrow account.

They inform the accounting staff of the status of the borrower's escrow account so that this can be included in the quarterly statement that accounting provides the borrower.

Stop here and ask students what obstacles they anticipate for the taxes and insurance function. What methods can they suggest for overcoming the obstacles? Be sure to encourage ALL students to participate in the discussion.

The collections function

The collections function is responsible for preventing delinquencies and resolving them quickly when they do occur.

To be effective, the collections function should have established guidelines for resolving delinquencies but should be flexible enough so that the bank can vary its approach based on the individual circumstances of the borrower.

Stop here and ask students if their institutions have experience with collections and handling delinquent accounts. Ask students to describe what their bank does and how successful those methods have been.

The collections function should have the following:

- staff that are familiar with the economic conditions of the areas the bank services and understand how these may affect their collection efforts.

- an accounting function that immediately alerts the collections function when a mortgage is delinquent;

- counseling procedures to advise borrowers on how to avoid or resolve delinquencies;

- guidelines for the individual analysis of each delinquency;

- procedures and adequate controls for sending delinquent notices, assessing late charges, maintaining collection histories, and reporting delinquencies to credit bureaus (when this becomes a possibility); and

- management review procedures to evaluate both the borrower's actions and the Collection Function's efforts before a final decision is made to accelerate the loan or start enforcement proceedings.

[Show OH 7-5 Collections]

226

Preventing delinquencies

The adage "an ounce of prevention is worth a pound of cure" holds true when it comes to the collection of mortgage payments.

By taking steps early—before a mortgage is a problem—the bank can increase the chances that a borrower will demonstrate good payment habits.

Educating borrowers

The most effective way to prevent delinquencies is through homebuyer education. The education process begins at the time of the loan interview.

As you may recall, one of the Customer Service Representative's responsibilities at the time of the loan interview is to explain in non-technical language what a mortgage contract includes, particularly the responsibility of the borrower to make their mortgage payments in full and on time.

Again, during the loan application process, the Customer Service Representative is required to provide the borrower with full, written disclosures, including the borrower's obligations once he obtains a mortgage and the consequences of defaulting on the mortgage payments.

227

Offering payment options

In addition to homebuyer education, we have also mentioned some other ways that banks can prevent delinquencies, such as obtaining authorization from the borrower to debit the borrower's bank account on the day the mortgage payment is due, or to have the mortgage payment deducted automatically from the borrower's paycheck and remitted to the bank by the borrower's employer.

Imposing late charges

A bank may want to impose a late charge on any payment that is more than a certain number of days late.

For most borrowers, just knowing that a late charge will be assessed provides an incentive to pay on time.

Resolving delinquencies

Given adequate delinquency prevention measures, most borrowers can be counted on to make their mortgage payments on time.

However, the few that are delinquent can consume a great deal of time and resources.

Collections staff, therefore, should make early contact with delinquent borrowers and carefully evaluate their individual circumstances in order to resolve the delinquencies before they become serious.

Sending payment reminder notices

Payment reminder notices alert borrowers that the bank has not yet received their monthly payment and that a late charge will be assessed if payment is not received within a stated number of day of the due date.

Sending late payment notices

Late payment notices advise the borrower that a late charge is due in addition to the scheduled payment.

Making telephone contact

Telephone contact enables you to determine the reason for the delinquency and, if necessary, to discuss the alternatives that are available to help the borrower resolve a delinquency.

Sending letters

Letters—preferably not a form letter—are the preferred way of making contact with borrowers who are habitually late.

They give the bank the opportunity to emphasize that a delinquency is a serious matter that can jeopardize their credit rating.

Conducting face-to-face interviews

Face-to-face interviews are the best alternative for a borrower who is seriously delinquent and for whom enforcement seems imminent.

Interviews enable you to determine the reason for the delinquency, assess the borrower's attitude toward the debt, and discuss alternatives to prevent enforcement action.

230

Stop here and ask students what methods they think will work best for situations involving chronically delinquent accounts. Be sure you encourage students who may not have contributed to join in the discussion.

Providing temporary assistance

If the bank determines that a delinquency is the result of a temporary condition, such as illness or unexpected expenses, and that there is a reasonable the borrower can bring the mortgage current, you may want to consider one of the following alternatives:

- a 30-day grace period;
- a temporary reduction or suspension of mortgage payments; or
- a plan to repay the overdue mortgage payment incrementally as part of the regular monthly mortgage payment.

Providing a 30-day grace period

The bank can give the borrower a 30-day grace period to bring the mortgage current.

A 30-day grace period may be appropriate in any of the following situations:

- a sale or rental of the property is pending;
- an insurance settlement is being negotiated;
- assistance has been arranged, but the borrower has not yet received funds;
- additional time is needed to formalize a repayment plan under another alternative
- one or more mortgage payments were lost in transit and have to be traced; or

Temporarily reducing or suspending mortgage payments

The bank and borrower can agree in writing to a reduction or suspension of the borrower's monthly payments for a specific period of time (usually no longer than three months from the date of the first reduced or suspended payment).

After that, the borrower must resume regular monthly payments as well as pay additional funds toward the delinquency at scheduled intervals.

This arrangement may be appropriate in situations in which a borrower is experiencing a temporary reduction in income or financial hardship, but expects at a later date to be able to resume regular payments and to pay additional amounts at scheduled intervals to resolve the delinquency.

Examples of such situations include:

- a co-borrower's death or the death of a contributor to the monthly mortgage payment;
- illness or natural disaster for which the borrower is not insured; or
- a substantial reduction in income that the borrower could not prevent.

Stop here and ask students what benefits and risks are associated with reducing or suspending payments.

Scheduling repayment plan

Under a scheduled repayment plan, the borrower agrees to make payments in addition to his or her regular monthly payment to resolve the delinquency.

A scheduled repayment plan may be appropriate when the borrower has experienced a temporary hardship that no longer appears to be a problem.

Close this session by emphasizing that preventing delinquencies in the first place is the preferred plan. But prevention is not always possible. Staff assigned to the collections function must have excellent interpersonal skills and must be adept in working with people to formulate a plan that benefits both the bank and the borrower.

Preparing to service residential mortgages

- Develop policies and procedures
- Hire skilled staff
- Organize for efficiency
- Provide training and technology
- Establish relationships with insurers
- Establish relationships with employers and other banks
- Set up accounts to facilitate processing of payments
- Prepare supply of coupons and receipts
- Prepare supply of ledger cards
- Set up a cashbook
- Prepare secure place for safekeeping of documents

The Cashiering Function

The cashiering function is responsible for —

- collecting borrower's mortgage payments
- reconciling cash-on-hand with cash receipts
- making deposits to clearing account
- maintaining cashbook
- delivering receipts and records of payment to accounting

The Accounting Function

The accounting function is responsible for —

- maintaining record of payments
- calculating new ARM payments
- providing borrower with quarterly statements
- processing loan payoffs

The Taxes and Insurance Function

The taxes and insurance function is responsible for —

- paying taxes and insurance premiums on the borrower's behalf
- estimating payments due from borrower
- maintaining records

The Collections Function

The collections function is responsible for --

- preventing delinquencies
- resolving them quickly

Advanced Underwriting and Servicing Examination

Time: 2 Hours
Format: Open Book

1. **Define the following terms:**

Mortgage:
A legal agreement in which a bank agrees to lend money to a borrower to purchase a home and the borrower pledges the property as security for the repayment of the loan.

Note:
The borrower's written promise to pay back a specified sum of money borrowed from the lender plus a stated interest rate over a specified period of time.

Collateral:
Property pledged as a backup security for the full payment of the loan.

Lien:
The bank's legal claim against the borrower's rights to the property as security for the mortgage debt.

Property Valuation Report:
A report by a qualified third party that estimates the market value of a property based on the current condition of the property and the conditions which exist in the neighborhood surrounding the property.

Loan application fee:
A fee paid to a lender for processing a loan application.

Title search:
A check of the title records to ensure that the seller is the legal owner of the property and that there are no liens or other claims outstanding.

240

2. **Fill in the blanks:**

The __________ market operates at the local level of the economy when a home buyer borrows funds from a lender to purchase a home.

The __________ market operates at the national level of the economy when a lender sells mortgages to an investor.

primary

secondary

3. **What is the purpose of the *Verification of Deposits* form?**

To verify that the applicant can pay for the down payment and closing costs out of his own funds.

. . . the *Verification of Employment* form?

To verify that the applicant has a history of stable employment and to determine the probability and stability of the applicant's future employment.

. . . the *Verification of Payment of Debt* form?

To verify that the applicant has a good record of repaying previous debts, and to verify the amount of the applicant's total liabilities and monthly debts.

4. **What three concerns does the underwriter have in examining the applicant's loan file?**

Is the applicant able to repay the debt?

Is the applicant willing to repay the debt?

Is the property adequate secured for the loan if the borrower is unable to repay the loan? (Is there adequate collateral?)

5. **A borrower should have enough cash on hand to be able to pay for the down payment and closing costs and still have the equivalent of how many mortgage payments in reserve?**

Two

6. Explain what an underwriter means by "compensating factors."

These are positive conditions that offset negative elements in the applicant's loan file. For example, the applicant may have large debts, but this negative element could be offset by the applicant's high net worth, residual income, significant fixed assets, or a large down payment.

7. Why would gaps in an applicant's employment history be a cause for concern to an underwriter?

Such gaps might indicate that the applicant could have trouble maintaining stable employment in the future and might therefore not be able to repay the mortgage loan.

8. Define the "sales comparison approach" as used by an appraiser to estimate a property's market value.

This approach to estimating market value assumes that a property is worth no more than it would cost a home buyer to purchase a similar property in the same neighborhood.

9. How soon before closing day should the Customer Service Representative provide the applicant with a statement of the exact closing costs?

Three days before closing

10. What are the four main functions of a loan servicing department?

Cashiering (or collecting mortgage payments)

Accounting (or maintaining records of all loan activity)

Taxes and insurance (or paying tax and insurance premiums on behalf of the borrower)

Collections (or preventing or resolving delinquencies)

11. What are the three types of accounts that the loan servicing department must set up?

Clearing account

Principal and interest account

Escrow account (or taxes and insurance account

[Questions 12 - 14 are not covered in Sessions 2, 5, 6, or 7. If the concepts appear elsewhere in the course, retain these questions. Otherwise, delete them.]

12. What is a mortgage assumption?

A method of transferring property in which the buyer agrees to take responsibility for (or assume) the existing mortgage.

13. A loan modification involves changing one or more features of a mortgage in order to help the borrower bring a defaulted loan current and prevent foreclosure. What are three possible ways a loan might be modified?

Reducing the interest rate on the mortgage

Extending the term of the mortgage

Changing the mortgage product (for example, from an adjustable rate to a fixed rate)

14. A deed in lieu of foreclosure takes place when a borrower voluntarily gives the deed to the mortgaged property to the lender to satisfy the debt and avoid foreclosure. Why do lenders use a deed in lieu of foreclosure only as a last resort?

Because the lender ends up with an acquired property that must be managed until it is disposed of, and this takes time and money.

15. Calculate the total-obligations-to-income ratio for the following examples:

Monthly mortgage payment is 750,000
Other monthly debt totals 250,000 rubles
Monthly income is 3,750,000 rubles
Loan amount is 93,000,000 rubles

Monthly mortgage payment is 500,000 rubles
Other monthly debt is 187,500 rubles
Monthly income is 1,500,000 rubles
Savings is 50,000,000 rubles