

# TAKING THE MYSTERY OUT OF YOUR MORTGAGE

*Owner's Equity and Loan-to-Value Ratio • Liquid Reserves • Credit History • Delinquent Accounts • Credit Card Accounts • Public Records, Foreclosures • Investment Accounts • Owner's Equity and Loan-to-Value Ratio • Liquid Reserves • Loan Purpose, Term, and Type • Debt-to-Income Ratio • Property Type • Number of Borrowers • Self-Employed vs. W-2*

***What Desktop Underwriter<sup>®</sup> Analyzes  
in Your Loan Application***





## Introduction

How does a lender evaluate your mortgage loan application? This process may seem a bit mysterious, but it really isn't. Your lender will carefully review your credit history, your debts and income, information about the property you want to buy or refinance, and other factors explained in this booklet. The process of evaluating these factors is called *underwriting*. Underwriting helps a lender make a mortgage loan decision.

Your lender may decide to use Desktop Underwriter<sup>®</sup> to help underwrite your loan. Desktop Underwriter is an automated (computer-based) underwriting system that helps mortgage lenders collect and analyze the information needed to process mortgage loan applications.

This booklet provides an easy-to-follow overview of the factors Desktop Underwriter considers when evaluating a mortgage loan application. However, Desktop Underwriter is not the only automated underwriting system in use today. Check with your loan officer to find out specifically which method of underwriting is being used to evaluate your loan application.



## What factors does Desktop Underwriter consider?

If Desktop Underwriter is used to underwrite your loan, it will make a recommendation to your lender based upon the following risk factors:

### ***Credit Report Factors***

- Credit history
- Delinquent accounts
- Credit card accounts
- Public records, foreclosures, and collection accounts
- Inquiries

### ***Non-Credit Report Factors***

- Equity and loan-to-value ratio
- Liquid reserves
- Debt-to-income ratio
- Loan purpose
- Loan type
- Loan term
- Property type
- Number of borrowers
- Self-employed borrowers

None of these factors alone determines Desktop Underwriter's recommendation. Desktop Underwriter evaluates ***all*** of the risk factors to help the lender reach a decision about your loan application. When Desktop Underwriter determines that a loan application does not appear to meet its credit risk criteria, it refers the loan to the lender for further review and provides suggestions about where additional information could be helpful.

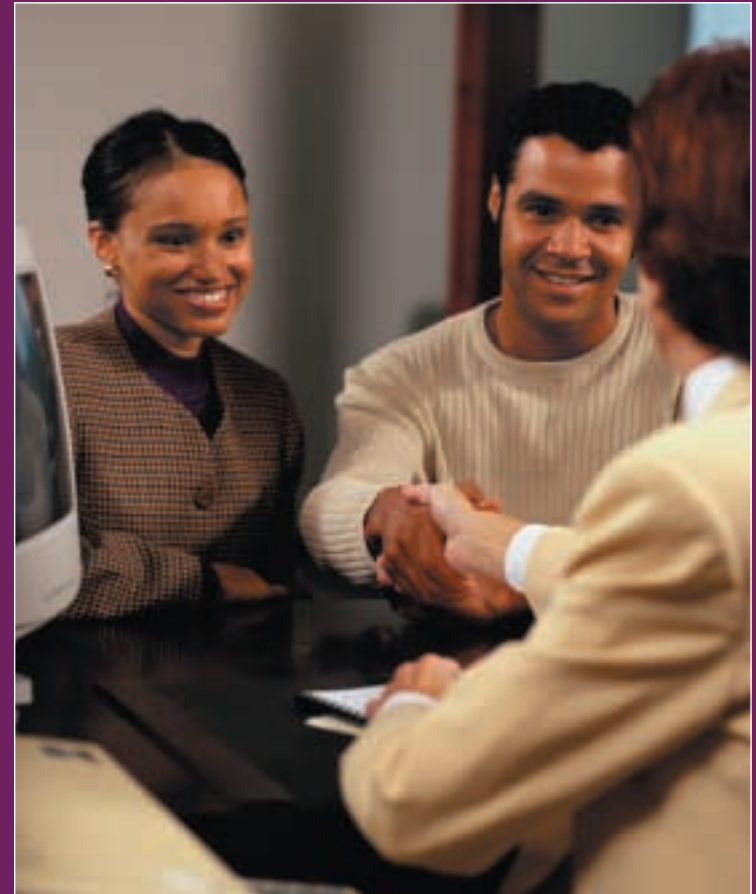
Desktop Underwriter's recommendation is taken into consideration by your lender, but it is not the definitive element in the final decision. The final decision to approve or deny your mortgage loan application is always made by your lender.

## Desktop Underwriter's evaluation is fair and objective

- Desktop Underwriter applies the same criteria to every loan application it processes. This consistency and objectivity result in a fair and unbiased underwriting recommendation. Desktop Underwriter does not consider factors such as age, race, religion, gender, national origin, or marital status in making a recommendation.



- Desktop Underwriter evaluates both credit report and non-credit report factors. No single factor is the sole basis for Desktop Underwriter's recommendation. It weighs this information based on the amount of risk and its overall significance to the underwriting recommendation. Desktop Underwriter is able to consider all of the information in a way that recognizes that a borrower's strengths in one area can offset risk factors in another area.
- Desktop Underwriter improves homeownership opportunities for more Americans by streamlining the loan application process. Because less paperwork is required, it is able to deliver evaluations that are quick, thorough, and unbiased.
- Desktop Underwriter analyzes the data directly from your credit report to determine how you manage credit. Desktop Underwriter does not use FICO® credit scores in its analysis of a borrower's creditworthiness.
- Desktop Underwriter makes evaluations and determines risk based on the past performance of more than two million mortgage loans. And because Desktop Underwriter is regularly reviewed, its capacity to analyze risk is continually fine-tuned, based on new data and loan performance.







## Your Credit Report—how to access and update it

One of the first things a lender does when you apply for a mortgage loan is to order a copy of your *credit report*.

Your credit report shows your debts and payment history with creditors who have loaned you money, such as credit card companies, banks, and department stores. It indicates whether you pay bills on time and whether you pay the proper amounts due. It also reveals how much debt you currently have and if you have not paid back some loans at all. Your credit report documents any history of tax liens, bankruptcies, and other public records, even if they happened several years ago. It specifies the names of those you have authorized to obtain a copy of your credit report and indicates how often you have applied for credit in the past two years. This data is kept on file electronically by three private credit bureaus: Equifax, Experian, and Trans Union.

You should obtain and review a copy of your credit report *before* you begin the mortgage loan application process. To get a copy of your credit report, contact one, two, or all of the following credit bureaus. It is important that your credit report be an accurate

reflection of your credit record. If you discover any mistakes or problems in your credit report, contact the appropriate credit bureau to initiate an investigation.

### Equifax

Credit Information Services  
P.O. Box 740256  
Atlanta, GA 30374-0256  
Phone: 1 (800) 685-1111  
Web Site: [www.equifax.com](http://www.equifax.com)

### Experian

National Consumer Assistance Center  
P.O. Box 2104  
Allen, TX 75013-2104  
Phone: 1 (888) 397-3742  
Web Site: [www.experian.com](http://www.experian.com)

### Trans Union

National Disclosure Center  
P.O. Box 1000  
Chester, PA 19022  
Phone: 1 (800) 888-4213  
Web Site: [www.tuc.com](http://www.tuc.com)

## Credit Report Factors

Desktop Underwriter uses the information contained in your credit report as part of the underwriting process. The credit report factors considered by Desktop Underwriter include: credit history; delinquent accounts; credit card accounts; public records, foreclosures, and collection accounts; and inquiries. It weighs each characteristic based on the amount of risk and its significance to the underwriting recommendation. Desktop Underwriter assesses your credit behavior over a period of time. Therefore, short-term attempts to improve your credit record, such as paying off an account or closing an account, may not always have a positive impact on your credit record.



***Your Credit History—an account of how you handle credit***

Your credit history is an account of how well you handle credit, both now and in the past. Generally, the longer you've had an established credit history, the better. An older, established account—even one with a zero balance—may have a more positive impact on your credit record than a newly established account.

Having a relatively new credit history (a few recently opened accounts) is not automatically considered a higher credit risk. Making payments as agreed on newly established accounts signifies less risk than not making payments as agreed on older accounts.

You may not have *any* established credit history. For instance, you may not have the type of credit that is typically reported to a credit bureau. This does not mean you will be unable to get a mortgage. Although Desktop Underwriter does not evaluate credit information that is not reported to a credit bureau, you may be able to work with your mortgage lender using your payment history on such items as rent and utilities to establish a “nontraditional” credit history. In those cases, your lender will need to separately assess your credit history and its impact on the overall risk of your loan.



**Keep in mind**

*All of your established accounts, whether active or inactive, are considered in evaluating your credit history. Think twice before closing established inactive accounts or opening a lot of new accounts. Either of these actions may have a negative impact on your credit history.*

***Delinquent Accounts—pay your bills on time***

Your credit report contains information on credit accounts for which you make or have made regular payments. This includes everything from car loans to credit card bills. A payment history that shows you've paid a bill 30 days or more late, or reveals a pattern of paying bills late, can have a negative impact on your credit record. When you are applying for a mortgage loan, even more significant is a history of being late on current or past mortgage loan payments.

Many borrowers believe that if a late payment is brought current, their credit report will not reflect their previous payment delinquency. This is not the case. Desktop Underwriter reviews your overall payment history when evaluating your loan application. That's why it's so important to pay all your bills on time.

The amount of time that has elapsed since an account was delinquent is another important factor included in the evaluation of your payment history.



The more recent a delinquency, the higher the risk. For example, a 30-day late payment that is less than three months old indicates a higher risk than a 30-day late payment that occurred several years ago.



### **Keep in mind**

*Follow these practical tips for avoiding late payments:*

- *Mark on your calendar when you must pay your bills each month, so payments will arrive before the due date.*
- *Pay bills automatically out of your checking account every month.*
- *If you plan to be out of town on a business trip or vacation, make arrangements for keeping your bills up to date, either by having someone forward your bills to you or by paying your bills ahead of time.*



### ***Credit Card Accounts—steer clear of overextended credit***

Credit cards are tools that can be used to establish good credit. You can use credit cards to show how you manage credit wisely, either by paying off the balances every month or by keeping them very low. But, it is possible to get into debt trouble by overusing or misusing your credit cards.

There are two types of credit card accounts—revolving credit card accounts and 30-day accounts. A revolving credit card account does not require immediate repayment of the credit charge. Instead, you are only responsible for a minimum monthly payment—usually a small percentage of your balance. A 30-day account is one that requires payment of the full balance within 30 days.

The amount of credit you have and how you use it are important. When you use all of your available credit, there is a good chance that you may be overextended. Therefore, when the total amount of debt owed on all of your open credit card accounts is close to the credit limits, this indicates higher risk.



### **Keep in mind**

*There are some tell-tale signs that you may be carrying too much debt. Ask these questions:*

- *Do you have balances that never seem to drop?*
- *Are your balances getting higher?*
- *Do you regularly make low or minimum payments?*
- *Do you juggle bill payments?*



***Public Records, Foreclosures, and Collection Accounts—avoid unpaid obligations***

If you don't pay your debts for a prolonged period of time, certain legal actions could be taken and these will be shown in your credit report.

Legal actions such as bankruptcies, judgments, and tax liens are public records included in your credit report.

- A **bankruptcy** is a proceeding in a federal court in which a person who owes more than he or she can afford to pay seeks relief from paying their debts. The result of the proceeding may be the establishment of a court-approved repayment plan or the liquidation of the person's assets.
- A **judgment** is the decision made by a court of law that says you owe another person or creditor money.
- A **lien** is a legal claim against a property that must be paid off when the property is sold. One example is if your taxes are not paid, the taxing authority can file a claim against your assets, including your home. This is a tax lien.

A **foreclosure** also will be indicated in the credit report. This is a legal procedure by which a borrower who is unable to pay his or her mortgage loses their home. This usually involves a forced sale of the property at public auction with the proceeds of the sale applied to the mortgage debt. Sometimes, a borrower will voluntarily give a deed to the creditor to satisfy the debt and avoid foreclosure. This is referred to as a deed-in-lieu of foreclosure.

**Collection accounts** also will be contained in the credit report. These are any unpaid bills or obligations that

have been reported to a collection agency.

A credit record that contains bankruptcies, judgments, liens, foreclosures, or collection accounts indicates higher risk. The more recent these incidents, the more negative the impact on your credit profile.



**Keep in mind**

*Reestablishing credit and maintaining a good payment history are very important after a bankruptcy or foreclosure. Although most public record and foreclosure information is retained in your credit report for seven years (ten years for bankruptcies), as time passes, it becomes less significant.*



***Inquiries—cut down on the number of recent applications for additional credit***

When you apply for any type of credit, the creditor will request your credit report from a credit bureau or agency. This is called an inquiry. An inquiry becomes a record in your credit file that indicates you have authorized a creditor to review your credit history.

Inquiries into your credit record, as stated in the credit report, will be shown if you asked for new credit or requested more credit, such as if you request an increase in your credit line. Lenders most often will request your credit report when you apply for a credit card, an auto loan, or a mortgage. Historically, a high number of inquiries can indicate a higher degree of risk. That's why it's important to manage the frequency with which these inquiries are made.

Other factors that can have a more significant negative impact include inquiries made during the most recent six months of your credit report date. These are more important in the evaluation of your credit than older inquiries. In addition, numerous attempts to apply for new or additional credit over an extended period of time are more problematic than occasional applications for credit.

However, some of your inquiries may have been made by several creditors within a short time frame because you were attempting to obtain the most favorable loan rate or terms. These types of multiple inquiries generally do not indicate higher risk.



**Keep in mind**

*Remember the value of using good credit sense. Although there is no magic number, think twice before applying for every credit card for which you receive an application in the mail and carefully evaluate applying for a new loan or credit card to pay off existing accounts.*





## Non-Credit Report Factors

There are other important factors not related to your credit that Desktop Underwriter considers in its evaluation of your mortgage loan application. These non-credit report factors include information concerning the amount of money you plan to invest or have invested in your home, your financial situation, your debt and income, the reason for your loan, the desired type and length of the loan, the property type, and the number of individuals applying for the loan.

### ***Equity and Loan-to-Value Ratio—your financial interest in your home***

Your equity is your financial interest in your home. It is the amount of your down payment, or if you refinance your mortgage, it is the difference between the fair

market value of your home and the amount you still owe on your mortgage.

The loan-to-value ratio is the amount of your mortgage as a percent of the value of your home. For example, if you purchase a \$100,000 home and get a mortgage loan for \$90,000, your equity is \$10,000 and your loan-to-value ratio is 90 percent.

A borrower who makes a large down payment or who has a lot of equity in his or her home is less likely to default on a loan than a borrower who makes a small down payment and has a small amount of equity in a home. In other words, the more equity you have in your home, the lower the risk associated with your mortgage loan.

A low loan-to-value ratio may offset other risks that are identified in your loan application.



### **Keep in mind**

*As you continue to live in your home and make mortgage payments, your loan balance decreases and the amount of equity—your financial interest in your home—often increases. By keeping up with repairs and maintaining and improving the condition and appearance of your home, you may increase the value and equity in your home.*



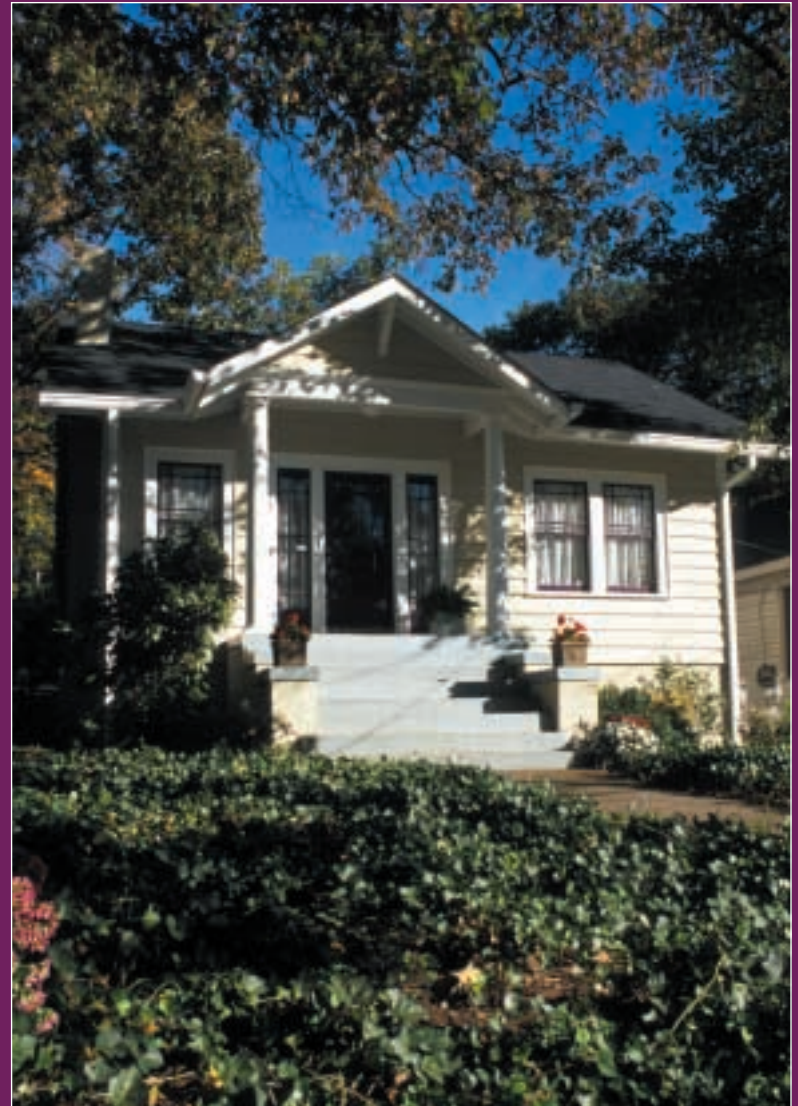
***Liquid Reserves—the money left over after your home purchase***

Liquid reserves are the funds you have left after you've bought your home. Some examples of liquid reserves include the funds in your checking or savings account; the net value of stocks, bonds, and mutual funds; the vested portion of 401(k) accounts; and funds in IRA or Keogh retirement accounts. Desktop Underwriter considers higher amounts of liquid reserves more favorably than lower amounts or no reserves. Research has shown that mortgages to borrowers with higher amounts of liquid reserves are a lower risk.



**Keep in mind**

*The best and most obvious way to increase liquid reserves is to save, save, save! One way to exercise control over your spending is to put together a budget. (A budget is also a good dress rehearsal for the mortgage loan application process, as your lender will want an account of your income and expenses.) In putting together a budget, compare your monthly income to your monthly expenses, then look for ways to prioritize and cut expenditures. Simple things such as using grocery store coupons, carpooling, and purchasing items on sale can really add up over time.*





**Debt-to-Income Ratio—what you earn against what you owe**

One way Desktop Underwriter determines how much debt you can handle is to compute your debt-to-income ratio. This involves measuring how much you owe (debt) against how much you earn (income). The debt-to-income ratio is calculated by dividing your total monthly debt (including mortgage loan payment, monthly installment payments, and minimum payment on all revolving debt) by your gross monthly income. For example:

$$\begin{array}{ll} \$1,140 & \text{monthly debt (including new mortgage loan payment)} \\ \div \$3,000 & \text{gross monthly income} \\ \hline =.38 \text{ (38\%)} & \text{debt-to-income ratio} \end{array}$$

When determining your mortgage loan payment, you should include principal, interest, real estate taxes, hazard insurance, and mortgage insurance (if you are required by your lender to have it). Generally, the lower your debt-to-income ratio, the better your financial condition. As the ratio increases, the level of risk also tends to increase.

Knowing your debt-to-income ratio is important because it helps indicate whether you are able to afford a mortgage payment in addition to your other financial obligations. It helps a lender determine the future financial implications of approving your loan.



**Keep in mind**

*Your monthly income may be more than just your paycheck. It could include alimony and child support, bonuses, commissions, tips, dividends and interest earnings, government benefits or assistance, and more. Your debt responsibility includes obligations such as mortgage payments, car payments, installment loan payments, bank/credit union loans, student loan payments, alimony and child support, 401(k) loans, co-signed loans, and minimum credit card payments. Remember, a lender will verify your income by reviewing documentation such as pay stubs, income tax returns, pension statements, interest earning statements, and W2 forms, and also may contact your employer to verify your current employment.*



***Loan Purpose—purchase or refinance***

The loan purpose is the reason you are applying for a mortgage loan. It may be to purchase a home. Or you may want to refinance an existing mortgage, either to obtain a lower interest rate or to get cash (if you have sufficient equity in your home).

There is a certain level of risk associated with each reason for a loan, whether a purchase or refinance. In general, buying a home represents less of a risk than refinancing an existing mortgage. Refinance transactions in which the borrower takes out little or no equity (cash) represent less risk than those transactions in which the borrower takes out a lot of cash.

***Loan Type—fixed-rate, adjustable-rate, balloon***

Borrowers may choose a fixed-rate mortgage, an adjustable-rate mortgage, or a balloon mortgage.

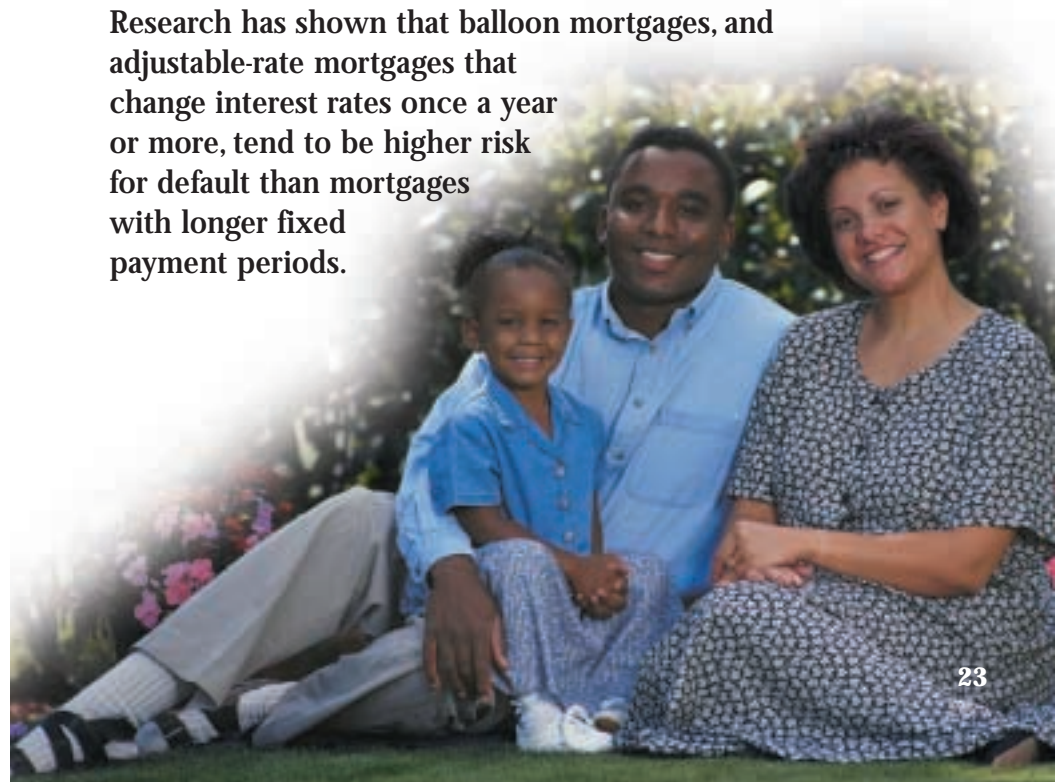
A *fixed-rate mortgage* is one in which the interest rate remains the same for as long as you have your loan. If you expect to live in your home for many years, having the same interest rate may be a primary concern.

An *adjustable-rate mortgage* (ARM) has an interest rate that can move up or down as market conditions change. An ARM often starts out with a lower interest rate for a certain period of time, after which your mortgage payments may change periodically (for example, once or twice a year). Interest rate changes typically are subject to two caps (limits), one for each adjustment period and one for the life of your loan. For example, a typical ARM that adjusts annually may have a per adjustment cap of 2 percentage points

and a lifetime cap of 6 percentage points. If you're confident that your income will increase steadily over the years, or if you plan to move in a few years and aren't concerned about potential rate increases, you may want to consider an adjustable-rate mortgage.

*Balloon mortgages* typically offer lower interest rates for shorter-term financing, usually seven years. At the end of this term, you have the option to refinance the mortgage for the remaining term or pay off the outstanding balance with a lump-sum payment. If you anticipate selling or refinancing your home in a few years, a balloon mortgage may be right for you. If you are considering a balloon mortgage, you may want to ask about and understand all the conditions you will need to meet to refinance your loan at the end of the balloon term.

Research has shown that balloon mortgages, and adjustable-rate mortgages that change interest rates once a year or more, tend to be higher risk for default than mortgages with longer fixed payment periods.



***Loan Term—the length of the payment period***

The loan term (sometimes called the amortization period) refers to the length of time it will take to pay off your mortgage. The loan term is expressed as a number of months. For example, for a 30-year fixed-rate mortgage, the term is 360 months. The standard loan term is 30 years. However, shorter terms are available that enable you to build equity in your home faster. Research has shown that mortgages to borrowers who choose to finance their mortgages over shorter terms and build up equity in their homes faster tend to perform better than mortgages with longer terms.



**Keep in mind**

*Mortgages to borrowers who choose a traditional 30-year mortgage are not deemed a higher risk. However, mortgages to borrowers who choose shorter terms—such as 15-year mortgages—are considered to be a lower risk. Shorter terms may result in paying thousands of dollars less in interest over the life of the loan and may be worth exploring if you can afford the higher monthly mortgage payment.*

***Property Type—one-to-four-units, condos, and co-ops***

Property type refers to the type of home for which you have requested a mortgage loan. These might include:

- ***One-unit*** residential properties
- ***Two-unit*** properties
- ***Three-unit*** properties
- ***Four-unit*** properties
- ***Condominiums or Cooperatives***

Research has shown that the type of property securing a mortgage can have an impact on the overall risk and performance of a mortgage. One-unit residential properties are the lowest risk, while three- and four-unit residential properties are higher-risk.





***Number of Borrowers—those legally responsible for repayment of the mortgage loan***

For each mortgage loan, there must be at least one borrower. The presence of more than one borrower on a mortgage application generally helps to reduce risk. This is because research has shown that mortgages with more than one borrower tend to have a lower default rate than mortgages with only one borrower.



**Keep in mind**

*Additional borrowers tend to reduce the level of risk only when they have good credit records. Remember, each co-borrower's credit record will be considered in the evaluation of the loan application.*



***Self-Employed Borrowers—owners or part owners of a business***

A self-employed borrower is either the owner or part owner of a business who generally has some control over the income that is earned from the business. The business may be a sole proprietorship, a partnership (general or limited), or a corporation.

Because of the increased chance of uneven cash flows, self-employment introduces an additional layer of risk to a mortgage loan application that is not present with salaried borrowers. This additional risk is generally considered adverse only when a self-employed borrower has other high-risk factors associated with his or her loan, such as a history of delinquent accounts or a low level of savings.



**Keep in mind**

*Research has shown that self-employed borrowers tend to default on their mortgages more often than salaried borrowers, all other things being equal. If self-employed, one of the ways you can offset this risk is to have a high amount of liquid reserves and a good credit profile.*



## Conclusion

We hope this brochure has taken the mystery out of Desktop Underwriter and the credit report and non-credit report factors it considers when evaluating your mortgage loan application. Understanding how the loan process works and the factors involved in arriving at a loan decision can help prepare you for homeownership.

If you have additional questions about your loan application, contact your lender directly. Your lender should be able to answer specific questions not covered in this brochure.



## Our Business is the American Dream

*At Fannie Mae, we are in the American Dream business.*

*Our Mission is to tear down barriers, lower costs, and increase the opportunities for homeownership and affordable rental housing for all Americans. We don't lend money to home buyers directly. Instead, we work with lenders who provide home buyers with mortgages. We developed Desktop Underwriter® to help lenders deliver mortgage loans more quickly and more cost effectively...helping more Americans own homes of their own.*



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