

AARMR Ability to Repay Standard

Presented by
AARMR Regulatory Exam Committee
Heidi White, Chairperson

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DDetermining the **BORROWER'S ABILITY TO REPAY** **AARMR ABILITY TO REPAY STANDARD**

Purpose

The purpose of this AARMR ABILITY TO REPAY STANDARD (hereafter referred to as ARS) is to provide state regulators with a standardized examination procedure for examining a lender's determination that ~~its~~~~their~~ borrowers have a reasonable ability to repay a loan. The ARS was developed to:

- Protect consumers by providing comprehensive examination procedures to ensure that lenders are adequately evaluating whether borrowers have the ability to repay the mortgage loans offered to them.
- Protect communities from the problems that are associated with lenders not adequately assessing the ability of borrowers to repay their mortgage loans, including foreclosures.
- Establish uniform standards applicable to multi-state examinations and enforcement actions or for review by one state of another state's reports of examination.
- Provide consistent and uniform guidance for use by lender in-house compliance and audit departments.

Comment [DB1]: Broker?

Background

A borrower's ability to repay is, in most cases, evaluated by a lender during the underwriting process. This process can be the most important step in loan origination because it controls the risk of foreclosure and other financial losses taken by both a borrower and a lender. Given the risks to consumers, communities and lenders alike, ~~lenders~~ lenders must develop and implement cautious underwriting standards. However, implementing underwriting guidelines that are too restrictive would result in the lessening of available credit for riskier borrowers. A lender must weigh its appetite for risk against the potential harm to ~~both itself~~~~itself~~, as well as the consumers and communities it deals with, when setting its own policies for the ability to repay.

~~Generally speaking, a~~ lender should not extend a residential mortgage loan unless ~~they~~ ~~have it~~ ~~has~~ come to the conclusion, given the facts and ~~their~~~~their~~ analysis, that the borrower will be able to make the ~~re~~ payments on a timely basis and in full. However, AARMR understands that a lender must have flexibility built into ~~their~~~~its~~ underwriting process and be allowed to make adjustments on a loan by loan basis based on all the factors used in the underwriting process.

Each lender evaluates, during the underwriting process, many facets of information about, and provided by, the borrower. It is usual and customary to examine the

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borrower's credit history; employment status, including future employment probabilities; income; occupancy; ratios and more.

Additionally, each lender may assign different weights to the different categories. These weights are where the biggest differences among lenders exist and these same weights comprise the lender's acceptable level of risk. This is why the examination work program must be flexible enough to adjust itself to each lender's risk level and therefore ~~its~~ underwriting processes. The examination work program is not intended to dictate these levels of risk since the result could be a lessening of available credit for certain types of borrowers.

Examination Process

Summary of the ARS

The ARS is comprised of two parts. The first, the *Policy Review Questionnaire*, provides guidance and explanation to the examiner in reviewing a lender's underwriting procedures regarding assessing a borrower's ability to repay. It also explains the main procedures used to determine the borrower's ability to repay.

The second part, the *Examiner's Loan Review Procedures*, focuses on individual loan review and assessing how well the lender has followed its own underwriting guidelines. This section also includes an Excel spreadsheet that will assist an examiner when reviewing individual loan files.

Examiner's Goals

It is very important at the beginning of the examination for an examiner to understand how the mortgage lender chooses to manage the ability-to-repay portion of its underwriting analysis. There is no one right way for a mortgage lender to conduct an ability-to-repay analysis. Each mortgage lender has a different business model that has built into it a certain amount of risk that ~~theirs~~ customers may default on their mortgage loans. The goal of mortgage regulation is to ensure that lenders manage this risk prudently. Although completely eliminating the risk of consumers defaulting on their mortgage loans is not our goal, keeping defaults low through prudent underwriting is. Once the examiner understands how the mortgage lender conducts its ability-to-repay analysis, judgments can be made about the assumptions underlying it as well as the procedures used by the company to comply with its own policy.

First Day Letter

Included in the examiner's first day letter to the mortgage lender should be a request for a detailed explanation about how the business conducts its ability-to-repay analysis and the underlying assumptions. Importantly, the examiner should specifically ask the mortgage lender in the first day letter:

Comment [DB2]: At some point, shouldn't we be saying people are taking on too much risk? Perhaps with too many defaults? I think that part of the current crisis is related to taking on too much risk, no?

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- a) to discuss its “appetite for risk,” including their goals for default rates
- b) the specifics for how the business evaluates a customer’s ability to repay, including the key ratios and other information used

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Included in the ARS is a sample first day letter addendum that can be used with the examiner’s existing letter or in conjunction with AARMR’s Core Questionnaire. This addendum is intended to correlate directly to the ARS Policy Review Questionnaire.

Examination and Exit Meetings

The examination process in general should include on-going meetings with management to clarify and better understand how the mortgage lender conducts its business. In particular, examiners should communicate with management personnel as needed to fully understand the licensee’s ability-to-repay analysis. Questions and concerns about the business’ ability-to-repay analysis should be brought to management’s attention and management should be provided with every opportunity to explain and justify its ability-to-repay program to the examiner including economic or geographic disparities, the effect of certain government programs on underwriting and the like.

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The exit meeting with management should include a detailed discussion of any concerns the examiner has about the lender’s ability-to-repay program. Given the frequent communication between the examiner and the licensee about the ability-to-repay program, management should not be surprised by any concerns raised by the examiner.

Loan File Selection

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The risk-weighted method outlined below will be incorporated into the Compliance Ease technology solution to data mine the vast database of the lender to potentially reveal loan files where the company failed to use prudent underwriting standards. The method can also be incorporated into a manual loan sampling method by asking the lender to breakdown the loan portfolio in the various categories in a spreadsheet. The risk weighted method is shown first below and the manual loan sampling method (Statistical and Judgmental) immediately follows.

There are three goals for conducting a review of a lender’s ability-to-repay procedure for a loan program:

- Determine whether the business is following its own ability-to-repay program
- Determine whether the ability-to-repay program presents unacceptable risks to consumers and their communities
- Determine if the business model is potentially predatory or injurious to the consumer

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Risk-Weighted Sampling Method

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1. Loan Programs:

- a. 50% of programs with the following characteristics

- i. Identified by management as higher risk
- ii. Debt-to-income ratios of 50% or higher
- iii. High risk of "payment shock"
- iv. Credit Scores of 640 and below
- v. Higher default rates (what constitutes higher rates?)

Number of 1st payment defaults more than 2%:
2006 national default average was 4.14% and the national average for 1st quarter of 2008 dropped to 6.35%. Any portfolio with a default average of more than 4.25% should be considered high; however, in this current market, the threshold may be as high as 6.5%.

- vi. Highest percentage collection activities
- vii. Early payment defaults
- viii. Short-term teaser rates
- ix. Loan-to-value ratios higher than 90%
- x. Stated income/low-doc/no-doc programs

b. 30% of programs with moderate risk (below) highest level risk above

- i. Identified by management as medium risk
- ii. Debt-to-income ratios from 40% to 50%
- iii. X% of Slow pays

-A portfolio exhibiting 20% slow pays is at higher risk for default and should be examined for potential underwriting errors.

-Credit scores between 640 and 686? Credit scores between 640 and 686 exhibit a moderate risk. Per Fitch Ratings, the Fico average for 2007 for loans in early default was 686; thus, the threshold should be increased to reflect that average in the moderate risk category.

- iv.
- v. Next level of default rates
- vi. Next level of early payment defaults
- vii. With loan-to-value ratios between 80% and 90%

c. 20% of programs with lowest level of risk

- i. Identified by management as lowest level of risk
- ii. Debt-to-income ratios below 40%
- iii. Loan to value ratios under 80%
- iv. Credit scores above 686

-Debt to income ratios below 40%

-Loan to value ratios below 80%

-Credit scores above 686? Credit scores above 686 are not currently showing higher rates of default; thus, these consumers should be placed in lowest level of risk category.

2. Highest compensation programs:

Loan programs yielding the most money to

- i. Loan officers
- ii. Company

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iii. Brokers

Sample Structure

Type of Loan Product – Level of Risk

Base Income – Borrower

Other Income – Borrower (Residual) – Weight & Benchmark

Income should be considered but should not be included in the DTI calculation unless the income is documentable for at least 24 months prior to origination and proven to be continuous and ongoing with or without compensating factors.

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Base Income – Co-Borrower

Other Income – Co-Borrower (Residual) – Weight & Benchmark

Income should be considered but should not be included in the DTI calculation unless the income is documentable for at least 24 months prior to origination and proven to be continuous and ongoing with or without compensating factors.

First Mortgage P & I – Using Fully Indexed Rate for ARM

Second Mortgage P & I

Hazard Insurance

Taxes

Mortgage Insurance

HOA Fees

Lease/Ground Rent

Other

Other Property

All Other Monthly Pmts

Appraisal Value

First Mortgage Loan Amount

Second Mortgage Loan Amount

LENDER QUALIFYING RATIOS/CRITERIA – MANUAL OR BATH INPUT BASED ON LENDER INFORMATION

Primary Housing Expense to Income – Weight & Benchmark

Not more than 29%

Total Debt To Income – Weight & Benchmark Not over 50%

Loan to Value - Weight & Benchmark Not over 95%

Due to current drop in appraised values loans to 100% should be limited to refinancing and not purchases.

Cumulative Total Loan to Value – Weight & Benchmark See above

Credit Scores – Weight & Benchmark

Manual Loan Sampling Method

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Statistical Loan Sampling

Definition: A method of selecting a portion of a population, by means of mathematical calculations and probabilities, for the purpose of making scientifically and mathematically sound inferences regarding the characteristics of the entire population.

The examiner first ascertains the licensee’s total loan population from which to select samples. Next, the examiner sorts the total population by various types of loan products offered, such as (1) First Lien Real Estate Mortgages; (2) Junior Lien (Second, third lien, etc) Real Estate Mortgages. If a licensee predominantly offers First and Second Lien mortgages secured by the same property and funded simultaneously; (often called “Combo” loans) then, the examiner sorts by this category to select samples of both first and second lien loan types.

To maintain statistical validity, each item in the population should have an equal chance of being selected for the sample. The following chart must be used to determine the total number of sample loans to select from any given population.

TOTAL UNIVERSE TABLE			
<u>Number in Universe</u>	<u>Minimum</u>	<u>Plus:</u>	<u>Maximum</u>
<u>Under 99</u>	<u>20</u>	<u>Total universe if smaller</u>	<u>20</u>
<u>100-299</u>	<u>20</u>	<u>10% of number above</u>	<u>40</u>
		<u>100</u>	
<u>300-499</u>	<u>40</u>	<u>7% of number above</u>	<u>54</u>
		<u>300</u>	
<u>500-749</u>	<u>54</u>	<u>6% of number above</u>	<u>69</u>
		<u>500</u>	
<u>750-999</u>	<u>69</u>	<u>5% of number above</u>	<u>82</u>
		<u>750</u>	
<u>1000-1999</u>	<u>82</u>	<u>4% of number above</u>	<u>122</u>
		<u>1000</u>	
<u>2000-2999</u>	<u>122</u>	<u>3% of number above</u>	<u>152</u>
		<u>2000</u>	
<u>3000-4999</u>	<u>152</u>	<u>2% of number above</u>	<u>192</u>
		<u>3000</u>	
<u>5000-9999</u>	<u>192</u>	<u>1.5% of number above</u>	<u>267</u>
		<u>5000</u>	
<u>10000 or more</u>	<u>267</u>	<u>1% of number above</u>	
		<u>10000</u>	

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Once the population is known, the examiner sorts them into various product groups. Because different companies offer different ranges of loan products, the examiner needs to determine how many loans to select from each product category offered. The table below represents the percentage of each product group applied to the sample size.

Products Offered Table*					
	<u>Stand Alone Firsts</u>	<u>Stand Alone Seconds</u>	<u>First Second Combos</u>	<u>Unsecured Personal</u>	<u>Secured Personal</u>
<u>Company 1</u>	-	30%	70%	-	-
<u>Company 2</u>	50%	50%	-	-	-
<u>Company 3</u>	0%	30%	70%	-	-
<u>Company 4</u>	25%	25%	-	25%	25%
<u>Company 5</u>	0%	-	100%	-	-
<u>Company 6</u>	-	-	100%	-	-
<u>Company 7</u>	10%	10%	40%	20%	20%
<u>Company 8</u>	-	-	-	50%	50%

*Note, this table is for illustration purposes only. Not all possible product combinations are shown.

For Example:

Using Company 4 from the Products Offered Table, if the total population of all four categories is 3000, then according to the Total Universe Table the total number of loans to be selected for the examination is 152. The 152 loans are then divided by four, which represents the number of loans (25%) to select from each category. Thus, 38 loans are selected from each category.

Now the examiner selects the particular loans within each category. Using the Company 4 example above, if there are 1600 First Lien RE Mortgages, 900 Second Lien RE Mortgages, 300 Secured Personal Loans and 200 Unsecured Personal Loans, you would start with the 1600 First Lien RE Mortgages and divide by 38 to get the interval that each loan is selected. Approximately every 42nd loan is selected. Then the examiner does the following:

- Pick any starting point between zero and twenty, say row 10.
- Starting with row 10, count the items until the interval number (42) is reached. The loan that corresponds with that row (51) will be the first item selected for the sample.
- Starting with the next consecutive row (52) as number 1, count until the number corresponding with the interval (row 93) is reached and select that loan for the sample.
- Repeat above steps throughout the entire universe.

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- If for some reason the item pulled does not fit the characteristics of the sample (different state property, wrong date, or business loan) pull the item then begin counting with the next row. This ensures that items are sampled uniformly.
- To ensure that the results of the sample are statistically valid, the EIC must strictly adhere to the procedures for the sampling method selected.
- The EIC should verify that the sample sizes are able to be accomplished within the time allowed for an examination. The initial sample size may need to be reevaluated to get a new sample size.

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Judgmental Loan Sampling

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Judgmental sampling, like statistical sampling, involves an in-depth analysis of only a portion of a group. The basic purpose of the sampling is to draw conclusions about a “population” by testing a portion of that population. The feature that distinguishes judgmental from statistical sampling is that each item in the population does not have an equal chance of being selected. Items are not selected randomly because a predetermined hypothesis has been made after reviewing the Loan Section Spreadsheet. For example, after taking a statistical sample of real estate loans and reviewing each of them, the examiner discovers that the number selected does not meet the desired goal of the number of loans to review for the examination. The examiner may then increase the sample size and select more real estate loans in the predetermined type of loans the examiner believes may have higher risks from experience with the licensee.

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Examination Conclusions

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By the end of the examination, the examiner should be able to make conclusions about the following:

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1. The mortgage lender’s appetite for default risk
2. The quality of the mortgage lender’s ability-to-repay analysis, including:
 - a. Whether the lender uses preferred ratios and other metrics in their ability to-repay analysis
 - b. Whether the lender weight²s the factors it considers appropriately
 - c. Whether the lender follows its own policies through appropriate procedures and internal controls
 - d. Whether the lender appropriately monitors its default ratios and adjusts its ability-to-repay analysis accordingly
 - e. Whether the lender’s ability-to-repay analysis presents unreasonable risk of default to consumers in the future or at present
 - f. Whether the lender appropriately connects employee compensation and evaluation to loan performance

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3. Recommended changes to a lender's ability-to-repay analysis
4. Recommended rating assigned to a lender's ability-to-repay analysis
A sample rating system follows that allow for a rating of 1 to 5 based on the
examiners findings
5. Recommended levels of administrative action

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Rating Definitions

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Rating of "1":

The company adheres to strong extensive written policies and procedures and extensive internal training that focus on the consumer's ability to repay across all product lines. Management properly weighs loan product features which prevent accepting unacceptable risks. Management actively monitors and conducts a delinquency analysis on respective loan programs and makes modifications as deemed necessary. As a result delinquency and foreclosure rates across all products lines exceed are lower than industry averages.

Rating of "2":

The company has satisfactory written policies and procedures and training programs that focus on the consumer's ability to repay across all product lines; and the company generally follows these polices, procedures and programs. The company has developed various lending programs which include loan features which enables the company to accept more risk when evaluating the consumer's ability to repay. The aggressive lending programs and adherence to satisfactory (or should we say "strong") risk management policies, procedures and programs have resulted in delinquency and foreclosure results which would be considered to meet industry averages.

Rating of "3":

The company has less than satisfactory policies and procedures or does not consistently follow its policies and procedures when determining if the consumer has the ability to repay their respective loans across all product lines. The company has developed various lending programs with loan features that are considereds more "risky" and doesn't consistently and actively consider the consumer's ability to repay their respective loan. The aggressive loan programs have led to higher than average delinquency and foreclosures. Management fails to actively monitor and adjust loan programs. Insufficient policies and procedures coupled with lack of effective training plans needs immediate attention by management

Rating of "4":

The company hasn't developed policies and procedures or the policies and procedures have no bearing on the products offered. Therefore the company cannot properly determine if the consumer has the ability to repay the loans across all product lines. Controls and monitoring of all loan programs are considered inadequate. Management hasn't monitored delinquency and consumer complaints. There is evidence of predatory lending and financial loss to consumers and the company warrants immediate policy

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reviews and revisions. The company needs immediate supervisory guidance to prevent further deterioration.

Rating of "5":

The company has failed to develop any loan programs that address the consumer's ability to repay their loan. There is evidence of extensive predatory lending and financial losses to the consumer and the company. The company warrants immediate regulatory enforcement to force the company to cease offering the risky products or cease operations.

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Remedies

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Examining a licensee's ability-to-repay analysis should be done in a thoughtful, iterative way with abundant opportunity for management to explain what they do. Unless circumstances warrant otherwise, AARMR recommends that the primary method used to enforce compliance with a state's standards for a licensee's ability-to-repay analysis be the candid comment and criticism between licensee and regulatory more commonly used in the regulation of depository institutions. Unless consumers are significantly at risk through a mortgage lender's weak ability-to-repay analysis, AARMR recommends that progressive discipline be used to address exceptions to an ability-to-repay analysis and related items such as board resolutions, memoranda of understanding, orders, and fines with license revocations and suspensions used as last resorts.

Similarly, less frequently used tools in the world of non-depository mortgage regulation may yield beneficial results such as:

1. Having non-portfolio lenders study their default rates by tracing loans or contacting consumers (as discussed above)
2. Off-site monitoring programs to report default rates quarterly to a regulator when an ability-to-repay analysis is determined to be weak
3. Requiring mortgage lenders to increase capital or net worth or to fund Allowance for Loan and Lease Loss Accounts when ability-to-repay analyses are insufficient

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Summary of the ARS

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The ARS is comprised of two parts. The first provides guidance and explanation to the examiner in reviewing a lender's underwriting procedures regarding assessing a borrower's ability to repay. It also explains the main procedures used to determine the borrower's ability to repay.

The second part focuses on individual loan review and assessing how well the lender has followed its own underwriting guidelines. This section also includes an Excel spreadsheet that will assist an examiner when reviewing individual loan files.

Definitions

Combined Loan to Value (CLTV):

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The total of 1st and any subordinate lien loan amounts divided by the lesser of the selling price or the appraised value.

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Credit Score:

A single numerical score, based on information in an individual's credit report, which measures that individual's creditworthiness.

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Combined Loan to Value (CLTV):

The total of 1st and any subordinate lien loan amounts divided by the lesser of the selling price or the appraised value.

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Fully Amortizing Payment:

The monthly mortgage payment which, if unchanged through the remaining life of the loan at the then-existing interest rate, will pay off the loan at term.

Fully Indexed Rate:

On an **ARM** (Adjustable Rate Mortgage **ARM**), the current value of the interest rate index, plus the margin. For example, assume a mortgage carries an initial rate of 6% for one year, the fully indexed rate is 10% and the rate adjusts yearly by a 1% rate increase cap. If the index remains the same, the 10% fully indexed rate will be reached ~~in~~ at the end of the fourth year.

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Loan to Value (LTV):

The loan amount divided by the lesser of the selling price or the appraised value.

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Negative Amortization:

If the loan payment made is less than the interest incurred, the remaining balance of the loan increases.

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Predatory Lending:

Unsavory lender practices calculated to take advantage of unsuspecting borrowers. This would include, but not be limited to, a borrower paying more for a mortgage than they should, related to their risk profile.

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Total Debt to Income (Total DTI):

Total DTI should include Household Debt such as property tax; homeowner's insurance; condo or homeowner assoc fees; PMI; secondary or subordinate mortgages; as well as, Other Debt such as credit card; motor vehicle or other contractual obligations.)

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Underwriting:

The process of collecting and verifying the information and qualifications about a borrower that will lead a lender to approve or deny ~~the~~ a mortgage loan application.

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**Determining the
BORROWER'S ABILITY TO REPAY**

POLICY REVIEW QUESTIONNAIRE

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A. Step One (Documentation Request)

		Y	N	EXAMINER'S COMMENTS
A.1	Do written policies and procedures adequately cover how the borrower's ability to repay is determined?			
A.2	Have the written policies and procedures recently been modified? <i>(Examiner should be aware that their loan sampling may include certain loan products that may have been subject to an older policy)</i>			
A.3	Have any complaints been filed against the institution related to a borrower's ability to repay a loan that was originated by, or through a third party on behalf of, the institution? <i>(Review complaints received by your agency as well as the institution's complaint logs)</i>			

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B. Step 2 (Review of Policy)

		Y	N	EXAMINER'S COMMENTS
B.1	Does the policy demonstrate that management has a clear understanding of its responsibilities related to the borrower's ability to repay? <i>(Policy should identify all areas necessary to evaluate the ability to repay)</i>			
B.2	Is there evidence in the policy that management clearly understands the risks related to the customer's ability to repay? <i>(Does the policy address the potential problems to both the institution and to the borrower should the borrower be unable to</i>			

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	<i>make their monthly payment?)</i>			
B.3	Is the policy developed by the institution? If not, by whom?			
B.4	Does the policy address qualifying standards that evaluate the borrower's ability to repay the debt by final maturity at the fully indexed rate?			
B.5	Does the policy assume a fully amortizing repayment schedule in determining the borrower's ability to repay?			
B.6	Does the policy address reasonable limitations on potential payment shock at expected payment change dates? (Is the index used a standard index or a more volatile one? Are there "teaser" rates that are significantly below market? Is there a reasonable cap on changes over the life of the loan?)			
B.7	Does the policy address negative amortization features related to the borrower's ability to repay?			
B.8	Does the policy address how the company will verify and document the borrower's income, including the borrower's current employment and reasonably expected future income? (Examiners should consider the use of IRS W-2's, tax returns, payroll receipts, financial institutions records and any document supporting receipt of other income.)			
B.9	Does the institution's policy allow for the borrower's assets, net worth or equity in their primary residence to be used when determining the borrower's ability to repay? (If so,			

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	explain)			
B.10	Does the institution's policy allow for borrower's assets, credit scores, equity in the home or net worth, to SUBSTITUTE for ability to repay based on income?			
B.11	Does the policy allow the institution to determine the borrower's ability to repay, based solely on guidelines provided by a federal agency, such as Fannie or Freddie?			
	Debt to Income (DTI)	Y	N	EXAMINER'S COMMENTS
B.12	Does the policy outline an acceptable range for the borrower's DTI based on the loan type? <i>(Examiner should consider industry standard percentages based on loan type and risk. Examples: Reduced doc. loan — 30-35% Subprime ARM — 40-45%)</i>			Do we still want to discuss front end vs back end ratios?
B.13	Does the policy's total DTI ratio include all of the borrowers' contractual obligations?			We discussed the possibility of defining these terms? These terms have been defined so the definition part of this section was removed.
B.14	Does the institution's policy address counseling borrowers on the impact of their decision to accept a mortgage with an adjustable rate, balloon payment, or other alternative mortgage product? <i>(Counseling should include how their standard of living might change, and the potential loss of their home)</i>			
	Indirect Originations (use of brokers or other lenders)	Y	N	EXAMINER'S COMMENTS
B.15	Does the policy include standards for using third party originators? <i>(Are the originators provided with a copy of the institution's policy? Are the originators informed of the</i>			

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	consequences of their failure to abide by the policy?			
B.16	<p>Do written policies and procedures outline the standards required for determining the ability to repay when allowing third party originations?</p> <p>Does the policy address appropriate due diligence of third party originations including a regular quality control review to determine compliance with the policy?</p> <p>When deficiencies are noted in the above QC review, does the policy outline the remedial action recommended for third party originators for various violations of the policy?</p> <p>Does the policy address the appropriate due diligence of third party originators including pre-relationship review, verifications of borrower information?</p>			<p>Original language left unhighlighted at the bottom of the box. The new language highlighted in turquoise.</p> <p>Also still need to add in direct origination QC review/monitoring.</p>
B.17	<p>Does the institution's policy require a regular review of a reasonable sample of its loan transactions to determine compliance with underwriting standards regarding repayment ability? (How often? How many? Is it sufficient? Is there a record of the review?)</p>			
	Multiple Concurrent Transactions	Y	N	EXAMINER'S COMMENTS
B.18	<p>Does the policy address a borrower who may be applying for multiple transactions, simultaneously or within a 60 day period?</p>			
	Prepayment Penalty Clauses	Y	N	EXAMINER'S COMMENTS
B.19	<p>Does the policy require both verbal and written notification to borrowers regarding any potential prepayment penalty?</p>			<p>We agreed to discuss this section later.</p>

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B.20	<p>Does the policy address the effect of a prepayment penalty on borrower's ability to repay the transaction? (How would this affect their ability to repay other than payoff? If it doesn't, it's covered below) Does the policy explain how the prepayment penalty works and the cost associated with paying the loan off early?</p> <p><i>(Does the policy allow for exceptions to charging the prepayment penalty such as: a refinance by the same institution or subsidiary; or a refinance due to a bona fide emergency of the borrower?)</i></p>			
	Examination (Sampling Loan Transactions)	Y	N	EXAMINER'S COMMENTS
B.22	Examiner must request a sampling of loans originated to determine the licensee's level of adherence to their policies regarding repayment ability			
B.23	<p>Does the policy require that the institution review its delinquency report, to determine if the policy on the ability to repay adequately supports the risk associated with each product type, category or geographic region? (Examiners should review available delinquency reports and consider whether the institution's delinquency rates are significantly higher than the industry average for the product type or category. Also try to determine if there may be concentrations that point to a particular source, such as an originator or one particular broker. <i>**The National Delinquency Survey, released quarterly, by the Mortgage Bankers Association is a useful guide.</i>)</p>			

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**Determining the
BORROWER'S ABILITY TO REPAY**

EXAMINER'S LOAN REVIEW PROCEDURES

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	LOAN REVIEW PROCESS	Y	N	EXAMINER'S COMMENTS
	Before beginning to evaluate each borrower's ability to repay the examiner should:			
LR.1	Review and evaluate lender underwriting standards, including loan policies through the Policy Review Questionnaire.			
LR.2	Determine the validity of the income documentation and verify that the amounts used are correct.			
LR.3	Ensure that all debts are documented and disclosed in full as per the borrower's application. Overlooked debt may greatly affect the ratios calculated during the initial underwriting process possibly to the extent of a change in the loan approval status.			

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	Using the Ability to Repay Spreadsheet, Examiner should enter information requested in each category. Calculations are done electronically	Y	N	EXAMINER'S COMMENTS
S.1	Enter Lender's Name			
S.2	Enter Lender's Address			
	Locate the "Enter the Lender's Underwriting Standards Below (after the blank column, at the bottom of the spreadsheet)	Y	N	EXAMINER'S COMMENTS
S.3	Enter the qualifying ratios the lender uses in their underwriting standards. These ratios should be found within their underwriting policy: QUALIFYING RATIOS The Lender's Underwriting Standards			

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	<ul style="list-style-type: none"> ◆Primary Housing Expense to Income ◆Total Debt to Income ◆Loan to Value ◆Cumulative Total Loan to Value 			
	Monthly Income	Y	N	EXAMINER'S COMMENTS
S.4	<p>Enter the income amounts listed on the borrower's application and which have been verified through additional documentation. Enter:</p> <ul style="list-style-type: none"> ◆Base Income Borrower ◆Other Income Borrower ◆Base Income Co-Borrower ◆Other Income Co-Borrower 			
	Total Monthly Housing Payments	Y	N	EXAMINER'S COMMENTS
S.5	<p>Housing projections based on Fully Indexed Rate or on Highest ARM Rate (ceiling) as permitted by the Promissory note and attachments to the note.</p> <p>Enter each of the following as found within the closed loan documents:</p> <ul style="list-style-type: none"> ◆First Mortgage P & I ◆Second Mortgage P & I ◆Hazard Insurance ◆PMI (Mortgage Insurance) ◆Real Estate Taxes ◆HOA Fees ◆Lease/Ground Rent ◆Other housing expense 			
	Total Debts	Y	N	EXAMINER'S COMMENTS
S.6	<p>The following will describe and help to classify all debt that must be considered in qualifying borrowers.</p> <p>In computing the total debts for the <i>debt to income ratios</i>, include the new total monthly housing payment and all other additional recurring charges extending 10 months or more, including payments on installment accounts, child support</p>			

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	<p>or separate maintenance payments, revolving accounts and alimony, etc.</p> <p>For revolving account payments, calculate using the greatest of 5 percent of the balance or \$10, unless the account shows a specific minimum monthly payment.</p> <p>In the file, observe additional possible contingent liabilities (example: co-signed on accounts for others or a company obligation); projected obligations (example: student loan) scheduled to begin with twelve (12) months of the loan closing.</p> <p><u>Obligations not to be considered debt</u> (or subtracted from gross income) include federal, state and local taxes; FICA or other retirement contributions such as 401(k) accounts (including repayment of debt secured by these funds); commuting costs; union dues; open accounts with zero balances; automatic deductions to savings accounts; child care; and voluntary deductions.</p> <p>Enter:</p> <ul style="list-style-type: none"> •The total of All Other Monthly Payments 			
	Final Spreadsheet Entries	Y	N	EXAMINER'S COMMENTS
S.7	<p>Enter the following items which will complete the spreadsheet and calculate the final ratios:</p> <ul style="list-style-type: none"> •Appraised Value •First Mortgage Loan Amount •Second Mortgage Loan Amount 			

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FIRST DAY LETTER / QUESTIONNAIRE ADDENDUM **INFORMATION REQUEST**

BORROWER'S ABILITY TO REPAY

1. Does management have a written policy concerning evaluation of the borrower's ability to repay? Yes No

If so, provide a copy of the policy.

2. Have any complaints been filed against the institution related to the borrower's ability to repay? Yes No

If so, provide copies of those complaints.

3. What appetite for risk does management assume, specifically what is the default rate management is willing to assume?

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The following questions will ask for details concerning management's policies, written or otherwise, concerning evaluation of the borrower's ability to repay.

4. What are the qualifying standards that evaluate the borrower's ability to repay the debt by final maturity at the fully-indexed rate?

5. Does the policy assume a fully-amortizing repayment schedule in determining the borrower's ability to repay? Yes No

6. Does the policy address potential payment shock at payment change dates? Yes No

If so, how?

7. Does the policy address negative amortization related to the borrower's ability to repay? Yes No

If so, how?

8. How does the company verify the borrower's income, including borrower's current employment and reasonably expected future income along for repayment ability?

9. Does the policy allow for the borrower's assets, net worth or equity in their primary residence to be used when determining the borrower's ability to repay? Yes No

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If so, explain?

10. Does the policy allow the institution to determine the borrower's ability to repay, based solely on guidelines provided by a federal agency, such as Fannie or Freddie? Yes No

11. Does the policy outline an acceptable range for the borrowers Debt to Income based on the loan type? Yes No

If so, what are the DTI ranges based on loan type?

12. Does the policy's DTI ratio include all of the borrowers' contractual obligations? Yes No

13. Does the institution's policy address counseling borrowers on the impact of their decision to accept a mortgage with an adjustable rate, balloon payment, or other alternative mortgage product? Yes No

If so, explain counseling procedures and content.

14. Does the policy allow for assets, credit scores, equity in the home or net worth, as a SUBSTITUTE for the borrower's ability to repay based on income? Yes No

15. Does the policy include standards for third party originators Yes No

15a. Are the originators provided with a copy of the policy? Yes No

Yes No

15b. Are the originators informed of the consequences of their failure to abide by the policies? Yes No

16. Does the policy address the appropriate due diligence of third-party originators including pre-relationship review, verifications of borrower information, responsibility for post-closing reviews? Yes No

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17. What is the criteria for entering into and maintaining relationships with third-party originators to originate including whether or not the originator is licensed and in good standing with the agency?

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18. What is the policy for third party compensation?

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18a. Does the compensation policy to loan originators correlate to the default pattern of loans that they have originated? Yes No

If yes, explain.

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19. Does the policy require a regular review of third party loan transactions to determine compliance with underwriting standards? Yes No

If so, how many? How often? Is there a record of these reviews?

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20. Is consideration given to a borrower who may be applying for multiple transactions, simultaneously or within a 60 day period? Yes No

If so, how?

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21. What notification is required to be given to borrowers in regard to prepayment penalties?

22. Are exceptions to prepayment policies allowed? Yes No

If so, explain.

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23. Does the policy address promotional materials and other product descriptions including oral statements or scripts? Yes No

If so, explain.

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24. Does management feel that it adheres to their policies in determining the borrower's ability to repay? Yes No

25. Does the policy require management to review their delinquency report to determine if the policy in use adequately supports the management's acceptable level of risk associated with each product type? Yes No

25a. How is the delinquency reports tracked? By loan originator, product type, EPD?

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26. Discuss the company's "appetite for risk," including their goals for default rates.

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27. Discuss the specifics for how the business evaluates a customer's ability to repay, including the key ratios and other information used

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**Determining the
BORROWER'S ABILITY TO REPAY**

POLICY REVIEW QUESTIONNAIRE

A. Step One (Documentation Request)

		<u>Y</u>	<u>N</u>	<u>Comments regarding repayment policies</u>
<u>A.1</u>	<u>Does management have a written policy concerning evaluation of the borrower's ability to repay?</u>			
<u>A.2</u>	<u>Have complaints been filed against the institution related to the borrower's ability to repay? (Review complaints received by your agency as well as the institution's complaint logs)</u>			

B. Step 2 (Review of Policy)

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		Y	N	Comments regarding repayment policies
<u>B.1</u>	<u>Does the policy demonstrate that management has a clear understanding of its responsibilities related to the borrower's ability to repay? (Policy should identify all areas necessary to evaluate the ability to repay)</u>			
<u>B.2</u>	<u>Is there evidence in the policy that management clearly understands the risks related to the customer's ability to repay? (Does the policy address the potential problems to both the institution and to the borrower should the borrower be unable to make their monthly payment?)</u>			
<u>B.3</u>	<u>Is the policy developed by the institution? If not, by whom?</u>			
<u>B.4</u>	<u>Does the policy address qualifying standards that evaluate the borrower's ability to repay the debt by final maturity at the fully-indexed rate?</u>			
<u>B.5</u>	<u>Does the policy assume a fully-amortizing repayment schedule in determining the borrower's ability to repay?</u>			
<u>B.6</u>	<u>Does the policy address reasonable limitations on potential payment shock at expected payment change dates? (Is the index used a standard index or a more volatile one? Are there "teaser" rates that are significantly below market? Is there a reasonable cap on changes over the life of the loan?)</u>			
<u>B.7</u>	<u>Does the policy address negative amortization features related to the borrower's ability to repay?</u>			
<u>B.8</u>	<u>Does the policy address how the company will verify the borrower's income, including borrower's current employment and reasonably expected future income along for repayment ability? (Examiners should consider the use of IRS W-2's, tax returns, payroll receipts, financial institutions records, credit report or payment history on existing mortgage)</u>			
<u>B.9</u>	<u>Does the institution's policy allow for the</u>			

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	<u>borrower's assets, net worth or equity in their primary residence to be used when determining the borrower's ability to repay? If so, explain.</u>			
B.10	<u>Does the policy allow the institution to determine the borrower's ability to repay, based solely on guidelines provided by a federal agency, such as Fannie or Freddie?</u>			
	<u>Debt to Income (DTI)</u>	<u>Y</u>	<u>N</u>	<u>Comments regarding repayment policies</u>
B.11	<u>Does the policy outline an acceptable range for the borrowers Debt to Income based on the loan type? (Examiner should consider industry standard percentages based on loan type and risk. Examples: Reduced doc. loan 30-35% Subprime ARM 40-45%)</u>			
B.12	<u>Does the policy's DTI ratio include all of the borrowers' contractual obligations? (DTI should include items such as: taxes, insurance, homeowner assoc fees, PMI, concurrent loan payments, etc.)</u>			
B.13	<u>Does the institution's policy address counseling borrowers on the impact of their decision to accept a mortgage with an adjustable rate, balloon payment, or other alternative mortgage product? (Counseling should include how their standard of living might change, and the potential loss of their home)</u>			
B.14	<u>Does the institution's policy allow for assets, credit scores, equity in the home or net worth, as a SUBSTITUTE for the borrower's ability to repay based on income?</u>			
	<u>Indirect Originations (use of brokers or other lenders)</u>	<u>Y</u>	<u>N</u>	<u>Comments regarding repayment policies</u>
B.15	<u>Does the policy include standards for using third party originators? (Are the originators provided with a copy of the institution's policy? Are the originators informed of the consequences of their failure to abide by the policy?)</u>			
B.16	<u>Does the policy address the appropriate due diligence of third-party originators including pre-relationship review, verifications of borrower information, responsibility for initial RESPA/Reg Z.</u>			

Comment [DB3]: Where is this from?

Comment [DB4]: This is not recommended, right?

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	<u>compliance, responsibility for Adverse Action notice compliance, and post-closing reviews?</u>			
<u>B.17</u>	<u>Does the institution's policy adequately address criteria for entering into and maintaining relationships with third-party originators to originate including whether or not the originator is licensed and in good standing with the agency?</u>			
<u>B.18</u>	<u>Does the institution's policy establish criteria for third-party compensation designed to avoid providing incentives for originations?</u> <i>(Does the policy dictate the type of fees allowed or is the maximum amount of the fees allowed commensurate with the work performed including use of YSPs according to HUD guidelines?)</i>			
<u>B.18a</u>	<u>Does the institutions policy address compensation to loan originators that correlates the to the default pattern of loans that they have originated:</u> <i>Examiner, is there any type of breakdown in the payment of commissions, for example 50% at closing and the remaining after 30-60 days if the loan has not defaulted?</i>			
<u>B.19</u>	<u>Does the institution's policy require a regular review of a reasonable sample of its loan transactions to determine compliance with underwriting standards? If so, how often? How many? Is it sufficient? Is there a record of the review?</u>			
	Multiple Concurrent Transactions	<u>Y</u>	<u>N</u>	Comments regarding repayment policies
<u>B.20</u>	<u>Does the policy address a borrower who may be applying for multiple transactions, simultaneously or within a 60 day period?</u>			
	Prepayment Penalty Clauses	<u>Y</u>	<u>N</u>	Comments regarding repayment policies
<u>B.21</u>	<u>Does the policy require both verbal and written notification to borrowers regarding any potential prepayment penalty?</u>			
<u>B.22</u>	<u>Does the policy allow for exceptions to charging the prepayment penalty such as: a refinance by their institution or subsidiary; or a refinance due to a bona fide emergency of the borrower?</u>			

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	Promotional Materials	Y	N	Comments regarding repayment policies
B.23	<u>Does the institution's policy address promotional materials and other product descriptions, including oral statements or scripts so that borrowers are clearly disclosed the particulars of the mortgage products being sold?</u>			
	Examination (Sampling Loan Transactions)	Y	N	Comments regarding repayment policies
B.24	<u>Examiner must request a sampling of loans originated to determine the licensee's level of adherence to their policies regarding repayment ability</u>			
B.25	<u>Does the policy require that the institution review their delinquency report to determine if the policy adequately supports the risk associated with each product type? Does the institutions delinquency report track by loan originator, product type, EPD? Based on the information provided in the delinquency report, does the institution's policy address the ability to make changes to their policy? <i>Examiners review delinquencies. Are they significantly higher than industry average for the product and risk? Are there particular originators whose loans are responsible for the increase?</i></u>			

Comment [DB5]: Does this relate specifically to ability to repay? For instance, if they advertise a payment, is the implication that the payment will be for the entire term, and is it? This might be more specifically suited to ability to repay.

Comment [DB6]: Guidance on #?

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Comment [DB7]: Where do you get the industry average from?

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**Determining the
BORROWER'S ABILITY TO REPAY**

EXAMINER'S LOAN REVIEW PROCEDURES

	<u>LOAN REVIEW PROCESS</u>	<u>Y</u>	<u>N</u>	<u>EXAMINER'S COMMENTS</u>
	Before beginning to evaluate each borrower's ability to repay the examiner should:			
<u>LR.1</u>	<u>Review and evaluate lender underwriting standards, including loan policies through the Policy Review Questionnaire.</u>			
<u>LR.2</u>	<u>Determine the validity of the income documentation and verify that the amounts used are correct.</u>			
<u>LR.3</u>	<u>Ensure that all debts are documented and disclosed in full as per the borrower's application. Overlooked debt may greatly affect the ratios calculated during the initial underwriting process possibly to the extent of a change in the loan approval status.</u>			

	<u>Using the Ability to Repay Spreadsheet, Examiner should enter information requested in each category. Calculations are done electronically</u>	<u>Y</u>	<u>N</u>	<u>EXAMINER'S COMMENTS</u>
<u>S.1</u>	<u>Enter Lender's Name</u>			
<u>S.2</u>	<u>Enter Lender's Address</u>			

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	<u>Locate the “Enter the Lender’s Underwriting Standards Below (after the blank column, at the bottom of the spreadsheet)”</u>	<u>Y</u>	<u>N</u>	<u>EXAMINER’S COMMENTS</u>
<u>S.3</u>	<p><u>Enter the qualifying ratios the lender uses in their underwriting standards. These ratios should be found within their underwriting policy:</u> <u>QUALIFYING RATIOS – The Lender’s Underwriting Standards</u></p> <ul style="list-style-type: none"> • <u>Primary Housing Expense-to-Income</u> • <u>Total Debt-to-Income</u> • <u>Loan-to-Value</u> • <u>Cumulative Total Loan-to-Value</u> 			
	<u>Monthly Income</u>	<u>Y</u>	<u>N</u>	<u>EXAMINER’S COMMENTS</u>
<u>S.4</u>	<p><u>Enter the income amounts listed on the borrower’s application and which have been verified through additional documentation. Enter:</u></p> <ul style="list-style-type: none"> • <u>Base Income - Borrower</u> • <u>Other Income – Borrower</u> • <u>Base Income – Co-Borrower</u> • <u>Other Income – Co-Borrower</u> 			
	<u>Total Monthly Housing Payments</u>	<u>Y</u>	<u>N</u>	<u>EXAMINER’S COMMENTS</u>
<u>S.5</u>	<p><u>Housing projections based on Fully Indexed Rate or on Highest ARM Rate (ceiling) as permitted by the Promissory note and attachments to the note.</u> <u>Enter each of the following as found within the closed loan documents:</u></p> <ul style="list-style-type: none"> • <u>First Mortgage P & I</u> • <u>Second Mortgage P & I</u> • <u>Hazard Insurance</u> • <u>PMI (Mortgage Insurance)</u> • <u>Real Estate Taxes</u> • <u>HOA Fees</u> • <u>Lease/Ground Rent</u> • <u>Other housing expense</u> 			

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	Total Debts	Y	N	EXAMINER'S COMMENTS
S.6	<p>The following will describe and help to classify all debt that must be considered in qualifying borrowers.</p> <p>In computing the total debts for the <i>debt-to-income ratios</i>, include the <i>new total monthly housing payment and all other additional recurring charges extending 10 months or more</i>, including payments on installment accounts, child support or separate maintenance payments, revolving accounts and alimony, etc.</p> <p>For <i>revolving account payments</i>, calculate using the greatest of 5 percent of the balance or \$10, unless the account shows a specific minimum monthly payment.</p> <p>In the file, observe additional possible contingent liabilities (example: co-signed on accounts for others or a company obligation), projected obligations (example: student loan) scheduled to begin with twelve (12) months of the loan closing.</p> <p><i>Obligations not to be considered</i> debt (or subtracted from gross income) include federal, state and local taxes; FICA or other retirement contributions such as 401(k) accounts (including repayment of debt secured by these funds); commuting costs; union dues; open accounts with zero balances; automatic deductions to savings accounts; child care; and voluntary deductions.</p> <p>Enter: The total of All Other Monthly Payments</p>			

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	Final Spreadsheet Entries	Y	N	EXAMINER'S COMMENTS
S.7	<p>Enter the following items which will complete the spreadsheet and calculate the final ratios:</p> <ul style="list-style-type: none"> • Appraised Value • First Mortgage Loan Amount • Second Mortgage Loan Amount 			

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When the spreadsheet is complete and combined with other random sampling evaluations, the EIC will gather information to evaluate and determine if the underwriting ratios or mitigation circumstances applied to the sampled loans correlate with the lenders underwriting standards.

EIC may review the historical performance of the lender's loan portfolio (default rates on each loan product) to determine if mitigating circumstances exist for certain products or are otherwise justified.

Excessive variations, mitigating or otherwise, may show an avoidance of mandated policies and may indicate a lack of internal control of the Lender and should be brought to the attention of the appropriate management. Management may be able to show why such extreme variance exists. If not, they may be driven to perform their own evaluations to see where their policies are being ignored.

Underwriting policies are the key to determining that borrowers have the ability to repay their mortgage loan. Lenders need to ensure that their underwriting policies are sufficient and most importantly, followed completely and properly.

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