Section F. Borrower Qualifying Ratios

Overview

In This Section

This section contains the topics listed in the table below.

1. General Information on Borrower Qualifying

Introduction

This topic contains general information on qualifying a borrower, including

- lender responsibility when qualifying a borrower, and
- the importance of careful underwriting analysis.

Change Date

March 1, 2011

4155.1 4.F.1.a Lender Responsibility When Qualifying a Borrower

The lender is responsible for adequately analyzing the probability that a borrower will be able to repay the mortgage obligation according to the terms of the loan.

This responsibility includes using qualifying ratios and compensating factors when qualifying a borrower. Qualifying ratios can be exceeded when significant compensating factors exist.

4155.1 4.F.1.b Importance of Careful Underwriting Analysis

Underwriting requires a careful analysis of many aspects of the mortgage.

Each loan is a separate and unique transaction, and there may be multiple factors that demonstrate a borrower’s ability and willingness to make timely mortgage payments.

Simply establishing that a loan transaction meets minimal standards does not necessarily constitute prudent underwriting. When qualifying a borrower, it is important to avoid the danger of “layering flexibilities” when assessing the mortgage insurance risk.

2. Qualifying Ratios

Introduction

This topic contains information on determining ratios to qualify a borrower, including

- general information about qualifying ratios
- mortgage payment expense to effective income ratio
- total fixed payments to effective income ratio, and
- estimating real estate taxes when determining qualifying ratios.

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March 1, 2011

4155.1 4.F.2.a General Information About Qualifying Ratios

Qualifying ratios are used to determine if the borrower can reasonably be expected to meet the expenses involved in home ownership, and provide for his/her family. In order to make this determination, the lender must calculate

- the Mortgage Payment Expense to Effective Income ratio, as described in HUD 4155.1 4.F.2.b, and
- the Total Fixed Payment to Effective Income ratio, as described in HUD 4155.1 4.F.2.c.

Note: The underwriter must calculate the qualifying ratios for entry into the Automated Underwriting System (AUS) in order to be evaluated by the Technology Open To Approved Lenders (TOTAL) Scorecard.

Continued on next page

2. Qualifying Ratios, Continued

4155.1 4.F.2.b Mortgage Payment Expense to Effective Income Ratio

The relationship of the mortgage payment to income is considered acceptable if the total mortgage payment does not exceed 31% of the gross effective income.

A ratio exceeding 31% may be acceptable only if significant compensating factors, as discussed in HUD 4155.1 4.F.3, are documented and recorded on Form HUD-92900-LT, *FHA Loan Underwriting and Transmittal Summary*.

For those borrowers who qualify under FHA's Energy Efficient Homes (EEH), the ratio is set at 33%.

Note: The total mortgage payment includes

- principal and interest
- escrow deposits for real estate taxes
- hazard insurance
- mortgage insurance premium
- homeowners' association dues
- ground rent
- special assessments, and
- payments for any acceptable secondary financing.

4155.1 4.F.2.c Total Fixed Payments to Effective Income Ratio

The relationship of total obligations to income is considered acceptable if the total mortgage payment and all recurring monthly obligations do not exceed 43% of the gross effective income.

A ratio exceeding 43% may be acceptable only if significant compensating factors, as discussed in HUD 4155.1 4.F.3, are documented and recorded on Form HUD-92900-LT, *FHA Loan Underwriting and Transmittal Summary*. For those borrowers who qualify under FHA's EEH, the ratio is set at 45%.

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2. Qualifying Ratios, Continued

4155.1 4.F.2.d Estimating Real Estate Taxes When Determining Qualifying Ratios

For real estate taxes, lenders must use accurate estimates of monthly property tax escrows when qualifying borrowers. In new construction cases, property tax estimates must be based on the land and completed improvements, not just on the land value.

Reference: For information on projecting and collecting real estate tax payments, see HUD 4155.2 6.A.1.i.

3. Compensating Factors

Introduction

This topic contains information on using compensating factors to qualify a borrower, including

- documenting compensating factors, and
- compensating factors benchmark guidelines.

Change Date

March 1, 2011

4155.1 4.F.3.a Documenting Compensating Factors

Compensating factors used to justify approval of mortgage loans with ratios that exceed benchmark guidelines must be recorded on the Underwriter Comments section of Form HUD-92900-LT, FHA Loan Underwriting, and Transmittal Summary. Any compensating factor used to justify mortgage approval must also be supported by documentation.

TOTAL Scorecard Accept Recommendation
The Technology Open To Approved Lenders (TOTAL) Scorecard Accept recommendation does not require documented compensating factors, even if qualifying ratios have exceeded FHA benchmark guidelines.

Reference: For more information on the TOTAL Scorecard recommendations, see the *TOTAL Mortgage Scorecard User Guide*.

4155.1 4.F.3.b Compensating Factors Benchmark Guidelines

The table below describes the compensating factors that may be used to justify approval of mortgage loans with ratios that exceed FHA benchmark guidelines.

Compensating Factor	Guideline Description
Housing Expense Payments	The borrower has successfully demonstrated the ability to pay housing expenses greater than or equal to the proposed monthly housing expenses for the new mortgage over the past 12-24 months.

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3. Compensating Factors, Continued

4155.1 4.F.3.b Compensating Factors Benchmark Guidelines (continued)

Compensating Factor	Guideline Description
Down Payment	The borrower makes a large down payment of 10% or higher toward the purchase of the property.
Accumulated Savings	The borrower has demonstrated • an ability to accumulate savings, and • a conservative attitude toward using credit.
Previous Credit History	A borrower's previous credit history shows that he/she has the ability to devote a greater portion of income to housing expenses.
Compensation or Income Not Reflected in Effective Income	The borrower receives documented compensation or income that is not reflected in effective income, but directly affects his/her ability to pay the mortgage. This type of income includes food stamps and similar public benefits.
Minimal Housing Expense Increase	There is only a minimal increase in the borrower's housing expense.

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3. Compensating Factors, Continued

4155.1 4.F.3.b Compensating Factors Benchmark Guidelines (continued)

Compensating Factor	Guideline Description
Substantial Cash Reserves	The borrower has substantial documented cash reserves (at least three months worth) after closing. The lender must judge if the substantial cash reserve asset is liquid or readily convertible to cash, and can be done so absent retirement or job termination, when determining if the asset can be included as cash reserves, or cash to close. Funds and/or "assets" that are *not* to be considered as cash reserves include • equity in other properties, and • proceeds from a cash-out refinance. The lender may use a portion of a borrower's retirement account, subject to the following conditions. To account for withdrawal penalties and taxes, only 60% of the vested amount of the account may be used. The lender must document the existence of the account with the most recent depository or brokerage account statement. In addition, evidence must be provided that the retirement account allows for withdrawals under conditions other than in connection with the borrower's employment termination, retirement, or death. If withdrawals can only be made under these circumstances, the retirement account may not be included as cash reserves. If any of these funds are also to be used for loan settlement, that amount must be subtracted from the amount included as cash reserves. Similarly, any gift funds that remain in the borrower's account following loan closing, subject to proper documentation, may be considered as cash. ***Note***: Reserves from retirement accounts and gifts as described above may be considered as cash reserves when scoring the mortgage application through TOTAL. ***Reference***: For information on acceptable sources of cash reserve funding, see HUD 4155.1 5.B.

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3. Compensating Factors, Continued

4155.1 4.F.3.b Compensating Factors Benchmark Guidelines (continued)

Compensating Factor	Guideline Description
Substantial Non-Taxable Income	The borrower has substantial non-taxable income. ***Note***: This applies if no adjustment was previously made when computing ratios.
Potential for Increased Earnings	The borrower has a potential for increased earnings, as indicated by job training or education in his/her profession.
Primary Wage-Earner Relocation	The home is being purchased because the primary wage-earner is relocating, and the secondary wage-earner • has an established employment history • is expected to return to work, and • has reasonable prospects for securing employment in a similar occupation in the new area. ***Note***: The underwriter must document the availability of the potential employment.