



Home-Buying Process

What Creditors Look For

Home-Buying Process: What Creditors Look For

Ivan Hernandez and Constance Kratzer, Ph.D.

The first step in applying for a mortgage is preparing for the loan process. It is important to understand what the lender is looking for on your loan application. The main areas lenders consider are the four Cs: Credit, Capital, Collateral and Capacity.

Credit – Credit refers to how you have paid your bills or debts in the past. Your credit report is one tool lenders use to consider your willingness to repay your debts. Willingness to repay your debts is important because a mortgage usually is the largest debt obligation you will obtain.

Get a copy of your credit report before you approach a lender. Consumers in New Mexico are allowed one free report per year from each of the three major credit agencies, Experian, Equifax Inc. and TransUnion. The agencies do not always have the same information, so it is important to check all three reports.

Get a free credit report electronically by logging on to www.AnnualCreditReport.com. You can access all three credit agencies from this Web site.

Click: Check to see when your state is eligible for free reports

Select: n

New Mexico

Click: GO

Complete your personal information

You also can call the credit agencies:

Equifax: 1-800-685-1111

Experian: 1-888-397-3742

TransUnion: 1-800-888-4213

Make sure all the information is accurate when you receive your report. If there are errors, contact the reporting company and credit bureau to find out how to correct them. Errors can keep you from getting credit or getting the best rates.

Another score that is important is your FICO® credit score developed by Fair Isaac and Company, Inc. This can be obtained for a fee from the Credit Bureau Web sites. This score can range from 300 to 850. Most people score in the 600s and 700s.

It is important when the lender asks about your past credit history to be truthful. If you know there are problems in your credit report, you may be able to explain why they happened. If your report does not meet the lending guidelines of your bank you may have to correct any credit problems before applying. There are some financial institutions that may lend you the money despite credit concerns – usually with higher fees and interest rates. Before accepting any loan product it is your responsibility to learn how much the loan will cost now and in the future. It is wise to correct problems on your credit report

Home Buying Process: What Creditors Look For

and then apply for a loan with a lower interest rate. For more information on credit refer to the Managing Money module of the curriculum.

Capital – Capital refers to financial resources.

Lenders are interested in the financial resources you have available in your credit union, savings and loan, or bank accounts (including checking and saving accounts and other resources such as money market funds and certificates of deposits). These financial resources may be used to make a down payment and pay closing costs. Lenders also want to know that you will have money left to cover additional costs after purchasing the house.

Collateral – Collateral is an asset (such as a car or a house) that guarantees the repayment of a loan. The house you purchase will be used as collateral for your loan. If you fail to make your monthly payments, you could lose the house. Prior to purchasing the house the lender will want to know if the house you want to buy is worth as much as the loan you are receiving. This information is obtained by an appraisal of the house by a certified appraiser. In most cases your loan officer will take care of ordering the appraisal. Once the value of the house has been established your loan should not exceed that amount.

Capacity – Capacity is your ability to repay the loan. Your occupation, employment history, salary, and the length of time in your present job are used to determine capacity. Your monthly expenses and current level of debt also are important. How long you must continue paying on existing debts is a factor as well. Other considerations will include how many dependents you have, whether you pay alimony or child support and the amount of any other obligations.

- Many people estimate they can afford a house that costs up to 2 or 2½ times their gross household income before taxes. For example, if their annual

income is \$30,000, they could afford a \$60,000 to \$75,000 house.

$$\$30,000 \times 2 = \$60,000$$

$$\$30,000 \times 2.5 = \$75,000$$

- Lenders review your debt-to-income ratio (DIR) when considering your application for a mortgage loan. The DIR is a percentage used to determine how much money you can borrow. It is calculated by adding all your monthly debt payments and dividing the total by your gross monthly income (income before deductions). To calculate your DIR, complete the Debt Repayment and the Gross Monthly Income work sheets. Transfer these totals to the Debt-to-Income Ratio Work Sheet to determine your DIR.

Financial institutions have different guidelines when it comes to using the DIR. The financial institution may see you as high risk if your DIR is too high. The more outstanding debt you have, the lower the house payment you can afford. In some cases you will have to pay off some of your debts before you can qualify for a mortgage loan.

Other financial institutions will allow you to have a higher DIR and still qualify for a loan. Keep in mind that just because you qualify for the loan, it does not mean you can comfortably afford the monthly payments. You need to consider your particular circumstances. Before you take on a mortgage loan ask yourself, with this mortgage payment will I:

- Have enough money at the end of the month to save for unexpected expenses?
- Have enough to maintain my current lifestyle?
- Have enough income to make the mortgage payment if my partner loses his or her income?
- Lenders consider the monthly housing payments and total monthly debt as percentages of income. Both ratios are important factors in determining whether or not the lender will make the loan.

Home Buying Process: What Creditors Look For

Lenders usually require the PITI (principal, interest, taxes and insurance) or your housing expenses to be less than or equal to 25 to 28 percent of your monthly gross income. Lenders call this the front end ratio. If your monthly gross income is \$2,500 (\$30,000 annually), your mortgage payment should be \$700 or less:

$$\mathbf{\$2,500 \times 28\% = \$700}$$

**Maximum monthly mortgage payment

Lenders usually require your mortgage payment plus long-term debt to be less than or equal to 33 to 36 percent of your monthly gross income. Lenders call this the back end ratio. If your monthly gross income is \$2,500 (\$30,000 annually), the combination of your mortgage, \$700, and other long-term debt should not be more than \$900.

$$\mathbf{2,500 \times 36\% = \$900}$$

**Maximum monthly total debt

If your ratios exceed these guidelines, talk to your lender about your options for the mortgage loan

Gross Monthly Income Work Sheet

Pay period is:

Weekly

$$\begin{matrix} \$ \underline{\hspace{2cm}} & \times & 52 & = & \$ \underline{\hspace{2cm}} & / & 12 & = & \$ \underline{\hspace{2cm}} \\ \text{(Gross Pay)} & & & & \text{(Annual Income)} & & \text{(Months in a year)} & & \text{(Gross Monthly Income)} \end{matrix}$$

Bi-Weekly

$$\begin{matrix} \$ \underline{\hspace{2cm}} & \times & 26 & = & \$ \underline{\hspace{2cm}} & / & 12 & = & \$ \underline{\hspace{2cm}} \\ \text{(Gross Pay)} & & & & \text{(Annual Income)} & & \text{(Months in a year)} & & \text{(Gross Monthly Income)} \end{matrix}$$

Bi- Monthly

$$\begin{matrix} \$ \underline{\hspace{2cm}} & \times & 24 & = & \$ \underline{\hspace{2cm}} & / & 12 & = & \$ \underline{\hspace{2cm}} \\ \text{(Gross Pay)} & & & & \text{(Annual Income)} & & \text{(Months in a year)} & & \text{(Gross Monthly Income)} \end{matrix}$$

$$\begin{matrix} \text{Monthly:} \$ \underline{\hspace{2cm}} \\ \text{(Gross Pay)} \end{matrix} = \begin{matrix} \$ \underline{\hspace{2cm}} \\ \text{(Gross Monthly Income)} \end{matrix}$$

Monthly Total

\$ _____

\$ _____

\$ _____

\$ _____

Other Forms of Income:

Investment Earnings
 Pension / Social Security
 Unemployment Compensation
 Part-Time / Seasonal Employment
 Alimony / Child Support
 Other

\$ _____

\$ _____

\$ _____

\$ _____

\$ _____

\$ _____

In order to use other forms of income most banks verify that you have received that income for a minimum of a year. Contact your local loan officer to find out what the guidelines

Total \$ _____

Debt-to-Income Ratio (DIR) Work Sheet

Debt-to-Income Ratio (DIR)

Current Debts \$ _____

Divide by Total Gross Income (/) \$ _____

Equals: (DIR) (=) \$ _____

Front End/Back End Ratio Work Sheet

Front End:

Gross Monthly Income or GMI (Total from Work Sheet #1): \$ _____

Multiply by 28% (This percentage varies with type of loan): (GMI x .28)

Equals: (=) \$ _____

Back End:

GMI (Total from Work Sheet #2) \$ _____

Multiply by 36% (This percentage varies with type of loan): (GMI x .36)

Equals: (=) \$ _____

Minus Current Debts (Total from Work Sheet #1) (-) \$ _____

Equals: (=) \$ _____

Lesser of Both: **Maximum Housing Payment:** \$ _____

Once you figure out both amounts the lesser of both totals will equal the maximum amount of mortgage you can afford including taxes and insurances.

Debt Repayment Work Sheet

Type of Account	Minimum Monthly Payment
Credit Cards (Ex. Visa, Master Card, Discover)	
#1	
#2	
#3	
#4	
#5	
Department Store Cards (Ex. Sears, JCP, Gap)	
#1	
#2	
#3	
#4	
#5	
Car Payments	
#1	
#2	
#3	
Loan Payments (Bank loans, Finance Companies)	
#1	
#2	
#3	
Other (Any other monthly expense that may show on your credit report. Ex. Judgments, Child Support, Liens)	
#1	
#2	
Monthly Total	\$

Home Buying Process: What Creditors Look For

This resource is one in a series on the Home-Buying Process which include:

Financial Readiness

What Creditors Look For
Finding Mortgage Money
Types of Financial Institutions
Mortgage Options
Down Payment and Closing Costs
Pre-Qualification or Pre-Approval

Factors to Consider in Housing Selection

Personal Needs and Wants
Location
Type and Style of House
Type of Construction
Interior and Exterior Space
Special Needs
Building as an Option

Locating a House

Finding the House
Using Real Estate Professionals
Buying Direct From Owner

The Sales Contract

Components
Acceptance

Home Inspections

Reasons for Home Inspections
Locating an Inspector
What Inspections Include
Limits of Liability

The Mortgage Process

Loan Application Process
Approval or Rejection
The Mortgage Payment

Purchasing Homeowners Insurance

Before You Start Looking for a Home
Stability of the Insurance Company
Costs and Coverage
Customer Service

Warranties

The Closing

Preparation for Closing
Final Walk Through
Closing Day Procedures

Sponsored by New Mexico State University and the City of Las Cruces. Supported by U.S. Department of Housing and Urban Development. New Mexico State University is an equal opportunity/affirmative action employer and educator. NMSU and the U.S. Department of Agriculture cooperating. © 2005 NMSU Board of Regents. All rights reserved.



Home Buying Process: What Creditors Look For
