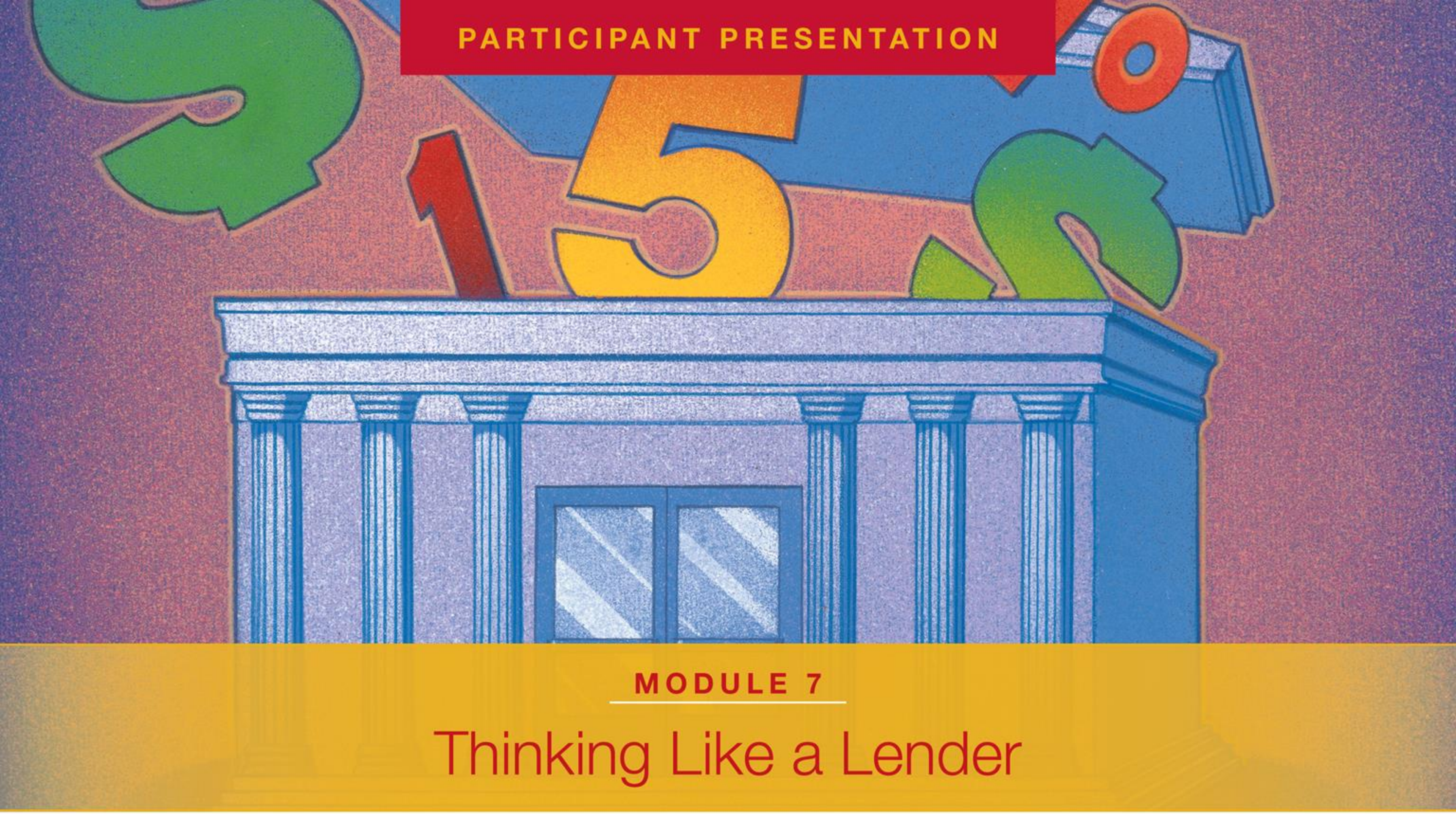
PARTICIPANT PRESENTATION



MODULE 7

Thinking Like a Lender

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A Guide to Better Credit, Money Management, and Responsible Homeownership

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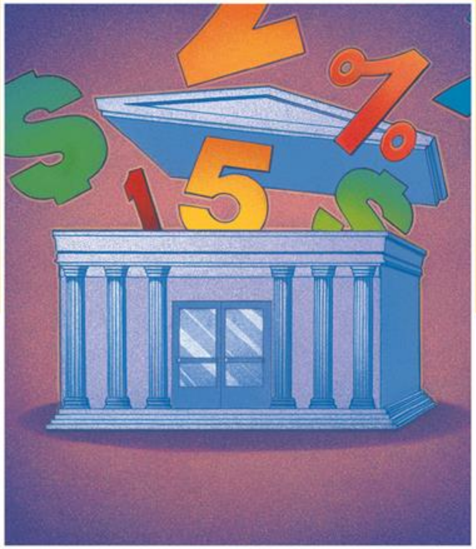

Freddie Mac CreditSmart®
Module 7: Thinking Like a Lender

Dear Workshop Participant:

Welcome to CreditSmart, Freddie Mac’s premier financial education curriculum, designed to help you learn how to build and maintain better credit, and prepare for successful long-term homeownership. Freddie Mac’s curriculum is designed to help you increase your financial literacy by providing life-long money management skills. It provides important information about credit and money management and how to avoid financial traps; insight into how lenders assess credit histories; and how credit plays a profound role in achieving your financial goal of buying a home and ensuring successful long-term homeownership.

As a participant, you’ll be using a Participant Presentation to follow along through the 12 modules with your instructor. In addition to attending a workshop like this one, you can also complete all 12 modules at your leisure by accessing the Web-Based Training (WBT) online at www.freddiemac.com/creditsmart/consumer_training.

On behalf of Freddie Mac and our CreditSmart affiliates, thank you for participating in our CreditSmart workshop. We wish you great success as you gain the skills and information necessary to achieve homeownership and build a sound financial future.

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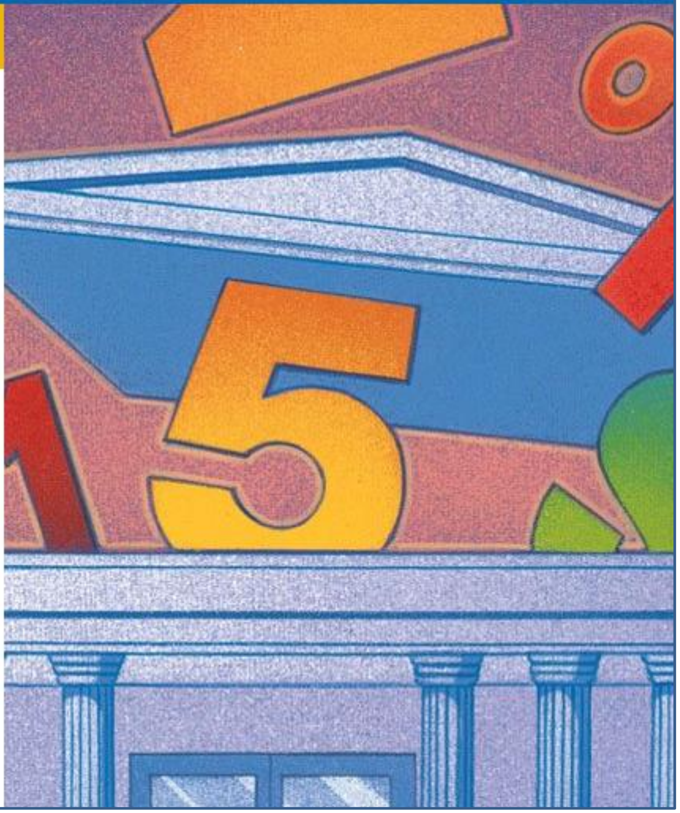
Module Introduction

What does it mean to be "creditworthy?" How do lenders determine who is and who is not creditworthy?

This module was developed to help you to better understand some of the key credit-related factors evaluated by creditors and lenders when making decisions about extending credit, approving loans and mortgages, etc.

Its goal is to help you to understand how lenders and other financial institutions determine your creditworthiness.



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The Four Cs of Lending

Getting a **mortgage** is based on many factors, including the risk that the **lender** takes on.

When determining your **creditworthiness**, lenders and **creditors** consider four primary factors. They are called the 4 Cs of lending:

- **C**apacity
- **C**apital
- **C**redit
- **C**ollateral

Automated underwriting is used as a tool to assess any **borrower** and the associated risk to the lender on the borrower's ability to repay the mortgage. Some lenders may also require an underwriter to review the entire loan package, in addition to the assessment provided by an automated underwriting system.

Let's learn a bit more about each of the 4 Cs.

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The 4 Cs: Capacity

When making a decision about whether or not to approve your **loan** request, lenders and other creditors will look to see if you have the **capacity** to repay the loan - that is, do you have enough income to make the monthly payments?

One of the ways that lenders verify your income is by reviewing several years of your federal income tax returns and W2s along with current pay stubs.

Qualifying income is evaluated based on:

- The source of the income
- The length of time in which it has been received
- How long that income is expected to continue into the future

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The 4 Cs: Capacity (cont.)

A lender determines the percentage of your qualifying **gross monthly income** that is needed to cover the new house payment and compares this percentage to the established guidelines of the loan program you are applying for. This percentage is called the "**housing expense ratio**" and is based on the total house payment which includes:

- **Principal** and **interest** payments on the loan (frequently referred to as P&I)
- Property taxes
- **Homeowner's insurance**
- **Private Mortgage Insurance (PMI)**
- Any other special assessments, such as homeowner's association (HOA) dues

In general, housing expenses should not exceed 28 percent of your gross monthly income. For example, if the loan program you are seeking has a maximum housing ratio of 28 percent, and you have qualifying gross monthly income of $3,000, your new house payment could not be any more than $840, or 28 percent of $3,000.

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The 4 Cs: Capacity (cont.)

In addition to the housing expense ratio, the lender will look at your recurring monthly **debts** or liabilities, such as:

- Car payments
- Student loans
- Credit card payments
- Personal loans
- Child support
- Alimony
- Other debts that you are obligated to pay

These liabilities may show on your **credit report** or perhaps as deductions on your pay stub.

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The 4 Cs: Capacity (cont.)

The monthly payment amounts are added to the house payment to determine the total "**debt-to-income ratio**."

This ratio is the sum of all recurring monthly debt payments, including the house payment divided by your qualifying gross monthly income. It does not include other monthly household expenses, such as utilities or automobile insurance. The lender submits this information to an underwriter or an automated underwriting system to determine your basic eligibility.

In addition to ratio analysis, many mortgages have different minimum **credit score** requirements. Your credit score could dictate the type of financing you are able to obtain and how much of a **down payment** will be required as a result.

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Exercise: Debt Worksheet

Take a moment to open and print the ***Debt Worksheet*** (also accessible via the **Resources** icon above). This worksheet will help you to calculate your total monthly debt payments and your total overall indebtedness.

Use this worksheet to list all of your debts (financial obligations) which you normally pay on a monthly basis, such as car loans, student loans, credit cards, or other loans.

Include the name/type of the account, the interest rate, the monthly payment, and the balance remaining on the loan.

Include only the debts that have more than 10 monthly payments remaining; however, bear in mind that a large monthly payment with less than 10 months remaining may still be considered in ratio calculations if the underwriter determines it should be included.

Debt Worksheet

A. Name/Type of Account	B. Interest Rate	C. Monthly Payment Amount	D. Remaining Balance Owed
TOTAL MONTHLY DEBT PAYMENTS: (add the numbers in column C) = $ ________			
TOTAL INDEBTEDNESS: (add the numbers in column D) = $ ________			

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Use the Debt Worksheet below to list all of your debts (financial obligations) which you normally pay on a monthly basis, such as car loans, student loans, credit cards, or other loans

A. Name/Type of Account	B. Interest Rate	C. Monthly Payment Amount	D. Remaining Balance Owed
TOTAL MONTHLY DEBT PAYMENTS: *(add the numbers in column C)*		*+ $ ________*	
TOTAL INDEBTEDNESS: *(add the numbers in column D)*			*+ $ ________*

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Self Check

The percentage of your gross monthly income that goes toward paying for your housing expenses is called the "housing expense ratio" and is based on total house payment which includes: (Select all that apply.)

- [ ] Principal and interest payments on the loan
- [ ] Monthly property taxes
- [ ] Amount of debt
- [ ] Homeowner's insurance
- [ ] Mortgage insurance
- [ ] Other special assessments (e.g., HOA dues)

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The 4 Cs: Capital

Capital is another term for the cash needed to close on a property including the down payment, **closing costs**, and any reserves.

Acceptable sources of capital along with your own **savings** might include:

- Gifts from family members
- Down payment assistance programs
- Grants or matching funds programs

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The 4 Cs: Capital (cont.)

Lenders typically look more favorably on your loan application if you will have cash reserves in the bank after closing. Cash reserves demonstrate to the lender that you have responsibly managed your money and have savings and other assets to fall back on in the case of an emergency.

Cash reserves include:

- Savings
- Money market funds
- Other investments that can be converted to cash and are not needed for closing

Lenders define investments to be **Individual Retirement Accounts (IRAs)**, certificates of deposit (CDs), stocks, bonds, 401(k) accounts and other similar types of assets. Lenders will count as reserves any assets that are considered liquid, in other words, assets that can be turned into cash quickly. There are, however, certain types of accounts that cannot be touched, such as pension accounts. Consequently, a lender will not count those as part of your cash reserves.

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Exercise: Cash and Asset Worksheet

Take a moment to open and print the ***Cash and Asset Worksheet*** (also accessible via the **Resources** icon above).

This worksheet will help you to determine your net worth. Lenders who calculate your net worth will generally average your **checking account** and **savings account** balances over the past three months.

▶ *Cash and Asset Worksheet*

Type of Account or Asset	*Account Name and Account Number*	*Account Balance*
Checking Account(s)		$
		$
Savings Account(s)		$
		$
		$
Mutual funds, stocks, and bonds		$
		$
		$
		$
Cash value of life insurance policy (policies)		$
		$
Other liquid assets		$
		$
		$
Total Net Worth:		**$**

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Use the Cash and Asset Worksheet below to help you determine your net worth.

Type of Account or Asset	*Account Name and Account Number*	*Account Balance*
Checking Account(s)		$
		$
Savings Account(s)		$
		$
		$
Mutual funds, stocks, and bonds		$
		$
		$
		$
Cash value of life insurance policy (policies)		$
		$
Other liquid assets		$
		$
		$
Total Net Worth:		***$***

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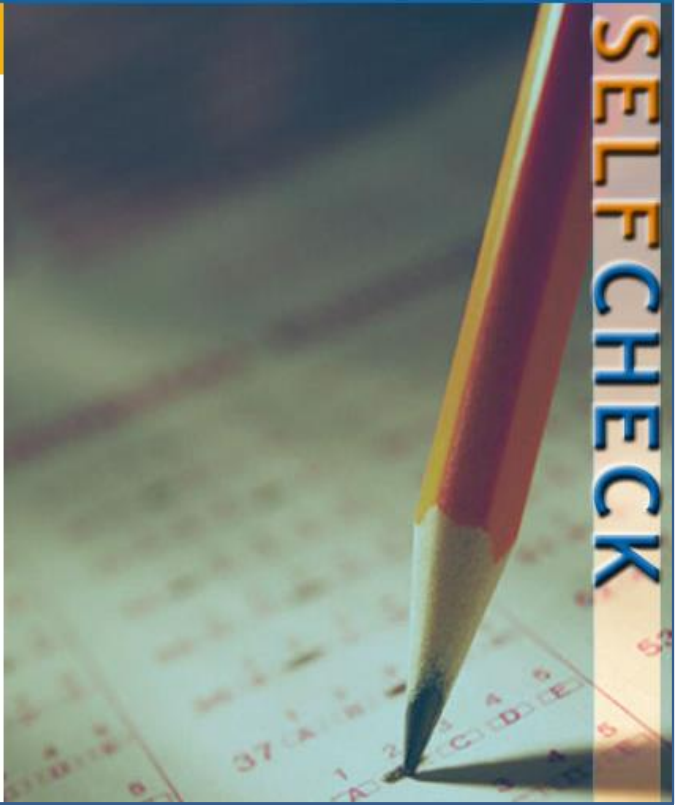
Self Check

True or False:

Having adequate cash reserves demonstrates to the lender that you have responsibly managed your money and have savings and other assets to fall back on in the case of an emergency.

- True
- False



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The 4 Cs: Credit

Lenders will review your **credit history** to determine your overall creditworthiness.

Your ability to secure loan approval will be hindered if a lender or creditor finds that your credit report contains several **late payments** or other negative factors (called **derogatory information**) such as:

- **Collection accounts**
- **Charge-offs**
- **Judgments**

More severe types of derogatory credit, such as **bankruptcies** and **foreclosures**, may severely limit your loan options for an extended period of time.

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The 4 Cs: Collateral

Collateral is the property that you pledge as security for a debt. In the case of a mortgage, the collateral is the home you are buying. If a borrower defaults on a loan, he or she could lose his or her home.

Most home mortgage lenders will make loans on 1-4 unit residential properties. This category includes:

- Single-family homes
- Multi-family dwellings up to four units
- Condominiums
- Planned unit developments (i.e., townhouses)
- Some types of manufactured homes

Requirements are more stringent on condominiums, manufactured homes, and many planned unit developments.

Be sure to check with your lender for any additional guidelines or restrictions they may have regarding the type of property you are interested in purchasing.

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The 4 Cs: Collateral (cont.)

Lenders are also very concerned about the condition of the property and any repairs that must be made in order to meet local housing standards or ensure the property is habitable.

When you begin your search for a home, you should be concerned about these things as well. Buying an older home that needs lots of repairs may not fit into your budget.

Choosing the right home may take some time, but the wait is often worth it when you eventually find the best match for your situation.

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The 4 Cs: Collateral (cont.)

Once the seller has accepted your offer, it is time to order a whole house inspection. This often must be done very quickly, since you may have only a few days to cancel the agreement based on the results of the inspection.

The best person to do this type of inspection is a certified home inspector who has qualified experience and training in the business of home inspections. He or she will know what to look for as he or she goes through the inspection process.

The whole house inspection report will provide you with all of the important facts about the condition of the house from roof to foundation.

You need to know about the structural condition of the home and the types of renovations and repairs you can expect to make immediately or farther down the road.

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The 4 Cs: Collateral (cont.)

If you are ready to move ahead, the lender will order an appraisal which is done by an independent licensed appraiser. It is the appraiser's job to determine the fair market value of the property compared to other similar homes in the neighborhood.

Appraisers are required to note any repairs that they see that need to be completed. These items may need to be completed before the loan closes and lenders could require the appraiser to re-visit the property and verify that the repairs have been made. Most lenders require that the property be rated in "good" condition by the appraiser with all required repairs completed.

It is important to remember that appraisals are no substitute for a thorough home inspection. Don't rely on the lender's appraiser to identify anything other than obvious flaws in the property.

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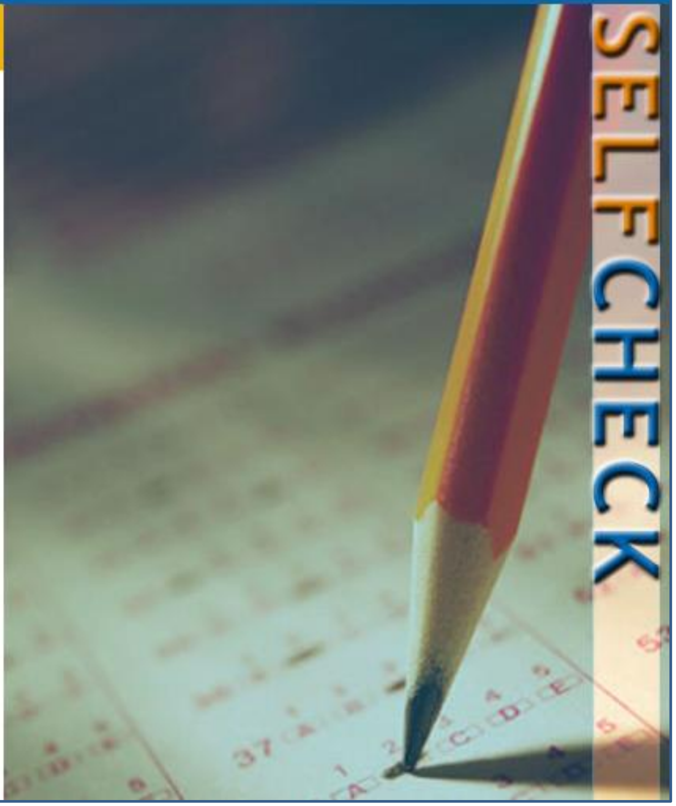
Self Check

Lenders and creditors consider four primary factors when determining your creditworthiness -- the 4 Cs of lending. What are they? (Select all that apply.)

- ☐ Closing costs
- ☐ Credit
- ☐ Capacity
- ☐ Co-signers
- ☐ Capital
- ☐ Collateral



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Module Conclusion

Congratulations! You have completed the **Thinking Like a Lender** module of the CreditSmart Online Training Program.

The goal of this module was to help you to understand how lenders and other financial institutions determine your creditworthiness.

By understanding the key credit-related factors and tools utilized by lenders and creditors, you will be better prepared to successfully secure credit at favorable terms and better positioned to build and maintain a good, solid credit history.

Click **Home** to review the module from the beginning, or click **Exit** to close this browser window and select another CreditSmart module to view.

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Module 7: Thinking Like a Lender | Glossary

Term	Definition
Automated Underwriting	Automated underwriting systems are designed to dramatically speed up the lending process by assessing key borrower information, such as employment, income, assets, liabilities, credit history, debt ratios, and property securing the loan. Lenders rely on these systems to identify the risk characteristics of the mortgage loan transaction. Automated underwriting systems never use factors such as a borrower's race, ethnicity, age, or any other factor prohibited by the nation's fair housing laws to approve or deny a loan. The final approval may still fall to the underwriter as each of the 4 Cs (capacity, capital, credit, and collateral) is evaluated based on additional criteria that the lender may have.
Bankruptcy	Bankruptcy is the term used to describe the legal process undertaken by individuals in the situation of being unable to pay his or her debts. Although there are several types (chapters) of bankruptcy, consumers generally may explore either Chapter 7 Bankruptcy or Chapter 13 Bankruptcy. Chapter 7 Bankruptcy results in "liquidation" of the debtor's assets, meaning that most assets are sold to pay as much debt as possible. The rest of the debt is forgiven or "discharged." Chapter 13 Bankruptcy is used for "rehabilitation" of the debtor, meaning that at least a portion of all debt is repaid according to a plan set up by the bankruptcy court.
Borrower	Borrower is the term for the person or entity using someone else's money or funds to purchase something. The term borrower can generally be used interchangeably with the term debtor.
Capacity	Capacity is another term for income. Lenders examine the ability of a potential borrower to demonstrate that his or her income is sufficient to repay a loan.
Capital	Capital refers to the cash reserves (savings), investments, or assets possessed by an individual.

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Module 7: Thinking Like a Lender | Glossary

Term	Definition
Charge-Off	A charge-off is the term used to describe loans or debts which have gone unpaid by the borrower. Simply put, in the case of a charge-off, the creditor “gives up” on collecting payment and reports the “charge-off” to the credit reporting agency for inclusion on an individual's credit report. Most lenders, however, regard “charge-offs” as debts which are still owed.
Checking Account	An account that lets you write checks to pay bills or to buy goods. The financial institution takes the money from your account and pays it to the person named on the check. The financial institution sends you a monthly record of the deposits made and the checks written.
Closing Costs	Closing costs are the costs to complete the real estate transaction. These costs are in addition to the price of the home and are paid at closing. They include points, taxes, title insurance, financing costs, items that must be prepaid or escrowed, and other costs. Ask a lender or real estate professional for a complete list of closing cost items.
Collateral	Collateral is the borrower's pledge of property to a lender to secure repayment of a loan. Relative to home mortgages, collateral is the property the borrower wishes to purchase. If the debtor fails to pay the loan, the creditor may force the debtor to sell the collateral to satisfy the debt or may foreclose and repossess the property to satisfy the debt.
Collection Account	A collection account is the term used to describe a loan or debt that has been referred by a creditor to an agency whose primary business is to collect outstanding debt obligations. These types of accounts will normally appear on the debtor's credit report.
Credit History	A credit history is a record of credit use. It is comprised of a list of individual consumer debts and an indication as to whether or not these debts were paid back in a timely fashion or "as agreed." Credit institutions have developed a complex recording system of documenting your credit history. This is called a credit report.

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Term	Definition
Creditor	Creditor is the term used for the person or entity that is providing credit or a loan to a borrower at specific terms and conditions. The term creditor can generally be used interchangeably with the term lender.
Credit Report	A credit report provides a history of your use of credit. Specifically, it's a file maintained by a credit reporting agency that contains information about a person, such as where the individual works and lives; information reported to the credit reporting agency by creditors regarding money borrowed and payments made; and public record information, such as whether the person has filed for bankruptcy.
Credit Score	A credit score is a numerical value determined by a statistical model based upon past credit behaviors, which predicts the likelihood of future loan default.
Creditworthiness	Creditworthiness is the term used to describe the state or condition of an individual's overall credit. Individuals who have established credit and maintained a positive credit history are considered to be creditworthy, i.e., an acceptable risk for the extension of additional credit based upon their ability and willingness to repay past and current debt obligations.
Debt	What is owed to a person or institution for obtaining merchandise or services without immediately paying for them. Usually, a debt is acquired through a loan or the use of credit.
Debt-to-Income Ratio	A debt-to-income ratio is the mathematical calculation of debts to income. Debts divided by gross income equal the debt-to-income ratio. Typically, the credit industry recommends that no more than 20 percent of one's net income should be spent on long-term debts (excluding a home mortgage).
Derogatory Information	Derogatory information is information on a person's credit report that can be legally used to turn down a loan application; it includes late payments, charge-offs and bankruptcies. As a general rule, derogatory information remains on a person's credit report for seven years; however, there are exceptions, including bankruptcies, which can remain for 10 years. (*Source: Investopedia.com)*

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Term	Definition
Down Payment	A portion of the price of a home, usually between 5 and 20 percent, not borrowed and paid up front.
Foreclosure	A legal process in which collateral property is sold in an attempt to satisfy the outstanding debt of a mortgage.
Gross Monthly Income	The income you earn in a month before taxes and other deductions. Under certain circumstances, it may also include rental income, self-employed income, income from alimony, child support, public assistance payments, and retirement benefits.
Homeowner's Insurance	Homeowner's insurance is a policy that protects you and the lender from losses resulting from things like fire or flood, which may damage the structure of the house, create liability (such as injury to a visitor to your home), or cause damage to or theft of your personal property (such as to furniture, clothes, or appliances).
Housing Expense Ratio	The percentage of your gross monthly income that goes toward paying for your housing expenses.
Individual Retirement Account (IRA)	A tax-deferred plan that can help build a retirement nest egg.
Interest	Interest is a charge for using someone else's funds. Interest is typically indicated as a percentage of the amount borrowed.
Judgment	Judgments are formal orders, generally court orders, that are displayed on a credit report if a debt or loan obligation is unpaid.

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Term	Definition
Late Payment	A late payment is the term used for loan or credit payments that do not reach the lender or creditor on or before the payment due date. The indication of late payments on a credit report is very damaging to an individual's credit report.
Lender	Lender is the term used for the person or entity that is providing credit or a loan to a borrower at specific terms and conditions. The term lender can generally be used interchangeably with the term creditor.
Loan	Money you borrow from a financial institution with a written promise to pay it back later. With a loan, financial institutions will charge you fees and interest to borrow the money.
Mortgage	A mortgage is a document that is signed by a borrower when a home loan is obtained and gives the lender the right to take possession of the property if the borrower fails to make loan payments.
Private Mortgage Insurance (PMI)	Private Mortgage Insurance or PMI is a type of insurance which helps to protect lenders from losses in the event that a homeowner defaults on his or her mortgage and loses his or her home to foreclosure. PMI is generally required by lenders when a homebuyer pays less than 20 percent as a down payment on a loan. PMI coverage will cost approximately 1 percent of the loan amount up front, plus an additional .50 percent annual premium paid monthly. The annual mortgage insurance premium may be canceled when the mortgage amount is reduced to 80 percent or less of the property value.
Principal	Principal is the actual amount of money borrowed or the remaining amount of the loan that has not yet been paid back to the lender. The principal balance of a loan is the borrower’s debt.
Savings Account	An account where you keep money for safekeeping or as an investment that earns interest.