CHAPTER 11: RATIO ANALYSIS

11.1 INTRODUCTION

Ratios are used to determine whether the borrower's repayment income can reasonably be expected to meet the anticipated monthly housing expense and total monthly obligations involved in homeownership. Weighing the circumstances that affect the borrower's ability and willingness to meet mortgage payments is an important part of the underwriter's ratio analysis. The Agency has established standards for principal, interest, taxes and insurance (PITI) and total debt (TD) ratios; however, there is flexibility in applying these standards. It is the Agency's intent to permit ratios to be exceeded when significant and valid compensating factors exist and clearly demonstrate unusual strengths exceeding basic program requirements.

11.2 THE RATIOS

The primary consideration when determining whether an applicant can afford to purchase a home is the applicant's repayment income. Repayment income, as described in Chapter 9 Section 2 of this Handbook, is the amount of dependable and stable income parties to the note will have available to repay the debt.

However, other household expenses and debts also greatly affect an applicant's repayment ability. To qualify for a guarantee, borrowers must meet the Agency's standards for both the PITI and TD ratios.

A. The PITI Ratio

Applicants are considered to have repayment ability if they do not have to pay more than 29 percent of repayment income for monthly housing expenses. Monthly housing expenses include the following:

- Principal and interest payment on the mortgage;
- Hazard insurance premiums, whether escrowed or not;
- Real estate taxes, whether escrowed or not;
- Monthly escrow required for annual fee;
- Homeowners association dues;

- Flood insurance premiums, whether escrowed or not; and
- Special assessments.

B. The Total Debt Ratio

Applicants are considered to have repayment ability when they do not have to spend more than 41 percent of repayment income on total debt.

Total debt includes monthly housing expense PITI plus any other monthly credit obligations incurred by the applicant. Obligations for child care, voluntary contributions to retirements such as a 401K, and open accounts with zero balance, are not considered a debt. The lender must document an applicant's debt through various records including a credit report, direct or third-party verifications, court documents, and verification of deposits for loans. All applicant debts incurred through the note date must be included in the calculation of debt payment-to-income ratio. Monthly obligation expenses include:

- PITI.
- Regular assessments, such as homeowner assessments.
- Long-term obligations with more than ten months repayment remaining, including all installment loans, revolving charge accounts, alimony, child support or separate maintenance payments, student loans and other continuing obligations.
- Revolving accounts. The minimum monthly payment is required for all revolving credit card debts. Monthly payments on revolving or open-ended accounts are counted as a liability for qualifying purposes even if the account appears likely to be paid off within 10 months or less. If the credit report shows an outstanding balance, but no specific minimum monthly payment, the payment will be calculated as the greater of 5 percent of the balance, or $10. If the lender obtains a copy of the current statement reflecting the actual monthly payment, that amount can be used for qualifying purposes. The lender must retain documentation in their permanent loan file. If loan costs paid outside of closing (POC) and early in the application process, such as lock-in fees, origination fees, commitment fees, credit report fees and appraisal fees are charged to the borrower's credit card, but are not reflected in the remaining balance of the credit report obtained, the lender must recalculate the credit card payment to account for the new charges and include the updated payment in the repayment ratio calculation. Revolving accounts with no outstanding balance do not require an estimated payment to be included in the debt ratio.

- Child support, alimony, garnishments. Applicants obligated to pay child support, alimony, garnishments, or other court ordered debts must have payment included in the total debt ratio. If the applicant has a release of liability from the court/creditor, and acceptable evidence is obtained, the debt can be excluded. Lenders will utilize select pages from the applicable agreement/court order to document the required monthly payment due and the duration of the debt. For GUS transactions, the lender will manually enter the obligations on the "Additional Expenses" on the "Assets and Liabilities" page. A manual entry of obligation does not require an underwriting recommendation of "Accept" to be downgraded to a "Refer." Lenders will ensure repayment agreements are current.

- Child care expenses. Child care expenses are not required to be considered as a recurring liability when calculating the total debt ratio.

- Student loans. Lenders must include the greater of ~~the greater of~~ one percent of the outstanding loan balance ~~reflected on the credit report~~ or the verified fixed payment ~~due by the loan servicer~~ as reflected on the credit report. Exception: Monthly payment amounts listed on the credit report, which are less than one percent of the outstanding balance may be used when evidence from the loan servicer is obtained indicating; 1)the applicant is on a fixed repayment plan not subject to chnge under the terms of the current agreement and 2) and the monthly payment amount due. Fixed payments have a monthly amount that is not subject to change through the fixed repayment time frame. Income Based Repayment (IBR) plans, graduated plans, adjustable rates, interest only and deferred plans are examples of repayment plans that are subject to change and do not qualify for the exception. ~~will require a calculation of one percent of the loan as these plan types do not represent a fixed payment.~~ No additional documentation is required if a credit report is obtained and the lender can confirm the payment represented is a fixed payment as noted in this paragraph.

- Previous mortgage. Previous mortgage liabilities disposed of through a sale, trade or transfer without a release of liability will be included in the total debt ratio unless evidence can be obtained to confirm the remaining party (or new owner) has successfully made the payment in the previous 12 months prior to loan application.

- Co-signed non-mortgage debt/obligations. Debts which have been co-signed by the applicant for another party will be considered in the total debt ratio unless the applicant provides evidence another party has made the payment in the previous 12 months prior to loan application. Acceptable evidence includes canceled checks, money order receipts and/or bank statements of the co-obligor or other third party. Late payments reported in the previous 12 months prior to application will require the monthly liability to be included in the long-term repayment ratio of the applicant. Lenders must confirm the applicant is an actual co-signor as opposed to a joint obligor to the debt in question. When jointly obligated, the debt will be included in the total debt ratio. Debts identified as "individual" will always be considered in the debt ratio regardless of what party is making the monthly payment (as an example, parents making car payments on behalf of applicant; loan in applicant's name). The legal obligation resides with the applicant when identified as "individual."

- Business debts. Business debts (for example – car loan) reported on the applicant's personal credit report may be excluded from the debt ratio if the debt is paid through a business account. An example of acceptable evidence the debt is paid through a business account includes canceled business checks or bank statements for the previous 12 months.

- 401(k) loans/personal asset loans. Loans pledging personal assets, such as a 401(k) account, retirement funds, savings account or other liquid assets are not considered in the total debt ratio.

- Debts of a non-purchasing spouse (NPS). For applicants who reside or are purchasing in a community property state, the debts of the NPS must be included in the applicant's total debt ratio unless specifically excluded by state law.

- Collection/judgment accounts. Collection accounts, as outlined in Paragraph 10.9 and 10.1- of Chapter 10 of this Handbook will be included in the total debt ratio.

- Self-employed. Negative income (loss) for a business will be deducted from repayment income prior to calculating the total debt ratio.

- Automobile Allowances and Expense Account Payments~~expense~~. The amount of actual expenditures exceeding the amount of automobile allowance or expense account payments will be treated as recurring debt. Lenders will utilize IRS Form 2106, *Employee Business Expenses*, for the previous two years and employer verification that the payments will continue as documentation to support the calculation. ~~Additionally t~~The applicant's monthly car payment will be treated as recurring debt and will not be offset by any car allowance. If an applicant utilizes the standard per-mile rate as opposed to the actual cost method on IRS Form 2106, the portion that the IRS considers depreciation may be added back to income for repayment purposes.

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- ~~Unreimbursed employee expenses. Unreimbursed employee expenses reported on on IRS Form 2106, "Employee Business Expenses" will be deducted from repayment income prior to calculating the total debt ratio.~~

- Rental loss. Negative net rental income will be treated as a recurring liability and included in the total debt ratio.

- Short-term obligations that are considered to have a significant impact on repayment ability, such as large medical bills and car or other credit payments.

- Payments that will come due in the next 24 months, including personal loans with deferred ~~loans~~ installments and balloon payments. Additional guidance surrounding student loan repayment is provided earlier in this section and not applicable under this subject. If the interest rate on a deferred loan is unknown, the lender should estimate the monthly payments using an interest rate that is reasonable and customary for the type of loan.

11.3 DEBT RATIO WAIVERS AND COMPENSATING FACTORS

An applicant's PITI ratio may exceed 29 percent and the total debt ratio may exceed 41 percent if the lender determines that strong meaningful compensating factors demonstrate that the household has higher repayment ability.

A. Debt ratio waivers

Manually underwritten loans – purchase transactions. Agency concurrence with a lender request for debt ratio waiver may be granted if all of the following conditions are met:

1. Either:

   a. The PITI ratio is greater than 29 percent, but less than or equal to 32 percent, accompanied by a TD ratio not exceeding 44 percent; or

   b. The TD ratio is greater than 41 percent, but less than or equal to 44 percent, accompanied by a PITI ratio not exceeding 32 percent;

   And:

2. The credit score of all applicant(s) is 680 or greater; and

3. At least one of the acceptable compensating factors listed below is identified and supporting documentation is provided to the Agency.

Acceptable Compensating Factors and Supporting Documentation:

- The proposed PITI is equal to or less than the applicant's current verified housing expense for the 12 month period preceding loan application. Verification of housing expenses may be documented on a verification of rent (VOR) or credit report. The VOR or credit report must include the actual payment amount due and report no late payments or delinquency for the previous 12 months. Rent or mortgage payment histories from a family member will not be considered unless 12 months of canceled checks, money order receipts, or electronic payment confirmations are provided. A history of less than 12 months will not be considered an acceptable compensating factor.

- Accumulated savings or cash reserves available post loan closing are equal to or greater than 3 months of PITI payments. A verification of deposit (VOD) or two most recent consecutive bank statements document the average balance held by the applicant are required. Cash on hand is not eligible for consideration as a compensating factor.

- The applicant(s) (all employed applicants) has been continuously employed with their current primary employer for a minimum of 2 years. A "Request for Verification of Employment" (VOE) (Form RD 1910-5, comparable HUD/FHA/VA or Fannie Mae form, or other equivalent), or VOEs prepared by an employment verification service (e.g., The Work Number.) must be provided. This compensating factor is not applicable for self-employed applicants.

Debt Ratio Waiver Request and Agency Approval:

Debt ratio waivers must be requested and documented by the approved lender. The lender requests Agency concurrence with the debt ratio waiver by submitting a signed underwriting analysis that cites one or more of the above acceptable compensating factors. Lenders may utilize Fannie Mae 1008 / Freddie Mac 1077, "Uniform Underwriting and Transmittal Summary," or similar form. Evidence of the compensating factor, such as a VOR, VOD, and/or VOE, must be submitted to the Agency for review.

Manually underwritten loans –refinance transactions. The debt ratio waiver requirements in this Paragraph do not apply to refinance transactions. See Section B below on compensating factors to consider when requesting a debt ratio waiver for a refinance transaction.

GUS underwritten loans receiving an "Accept." The debt ratio waiver requirements in this Paragraph do not apply to GUS files that receive an "Accept" underwriting recommendation or an "Accept" underwriting recommendation that requires a "Full Documentation" loan submission as part of a quality control message on the GUS Underwriting and Findings Report.

B. Compensating factors for refinance transactions.

For manually underwritten refinance loans, the lender must thoroughly document the compensating factors that justify an exception. Higher repayment ratio exceptions are feasible when an applicant demonstrates compensating factors indicating the capacity, willingness and ability to pay mortgage payments in a timely manner. The presence of compensating factors does not strengthen a ratio exception when multiple layers of risk, such as marginal credit history, are present in an application. The following are examples of compensating factors:

- Credit score of 680 or higher. Credit scores of 680 and higher can be documented as a standalone compensating factor for a debt ratio waiver request, if no additional risk layers are present (e.g., adverse credit, or payment shock, etc.).

- The borrower(s) has successfully demonstrated the ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage over the past 12 months.

- The borrower(s) has demonstrated a conservative attitude toward the use of credit.

- The borrower(s) has demonstrated an ability to accumulate savings comparable to the difference between current housing costs and projected costs.

- Cash reserves post closing. The use of retirement accounts as compensating factors and as cash reserves is limited to 60% of the vested amount of the retirement asset to offset potential withdrawals by the applicant(s). Retirement accounts that restrict withdrawals to circumstances involving the borrower's employment separation, retirement or death should not be considered as a compensating factor or as cash reserves.

- Continuous employment with the current primary employer.

The Agency will consider all requests for exception and weigh the proposal based on any additional layers of risk. Written approval by the Agency is represented if a Conditional Commitment for Loan Note Guarantee is issued by Rural Development in response to the lender's request. Lenders who utilize the Agency's automated underwriting system and receive an underwriting recommendation of "Accept" will not be required to document the need for a repayment ratio waiver.

11.4 MORTGAGE CREDIT CERTIFICATES

Authorized State or local housing finance agencies may issue a mortgage credit certificate that documents a Federal income tax credit to a qualified first-time homebuyer and/or low- or moderate-income homebuyer. Lenders may consider the tax credit available to the borrower as ~~additional borrower income~~ a deduction from the monthly PITI payment.

Lenders using the tax credit to qualify the applicant for the loan must determine the amount of the mortgage credit available. Loan files must contain copies of the mortgage credit certificate, a copy of the lender's calculation of the adjustment to income, and a copy of the IRS Form W-4 that was given to the borrower's employer. See Chapter 9, Section 9.11A of this Handbook for additional information regarding mortgage credit certificates.

11.5 FUNDED BUYDOWN ACCOUNTS

Funded buydown accounts are designed to temporarily reduce the borrower's monthly payment during the initial years of the loan. Buydown funds may come from the seller, lender or other interested third party. The borrower is not permitted to fund the escrow account and must not be required to repay the funds. Lenders should not use funded buydowns to qualify a borrower who would not otherwise qualify for a mortgage. Careful evaluation should be made of the borrower's ability to manage the payment increases that will occur under the terms of the buydown agreement.

Funded buydown accounts must meet the following requirements:

- The mortgage loan must be underwritten at the note rate;
- Buydown funds may come from the seller, lender or other third party;
- Buydown funds may not come from the borrower;
- A buydown rate will not reduce the interest rate more than two percent below the note rate;
- The assistance may not result in more than a one percent annual increase in the interest rate and the increase may only occur once a year;

- The borrower must agree in writing that the buydown funds will be placed in an escrow and paid directly to the lender each month to reduce the monthly mortgage payment;

- If the qualifying ratios exceed 29 and/or 41 percent at the full note rate, the lender must establish that the eventual increase in mortgage payments will not affect the borrower adversely and lead to default. The lender must document the compensating factors which indicate the borrower's ability to meet the expected increases in loan payment such as:

    - The borrower has a potential for increased income that would offset the scheduled payment increases, as indicated by job training or education in the borrower's profession or by a history of advancement in the borrower's career with increases in earnings.

    - The borrower has demonstrated ability to devote a greater portion of income toward housing expenses.

    - The borrower has substantial assets available to cushion the effect of the increased payments.

- The buydown account must be fully funded at origination; and

- The funds must be placed in an escrow account with a financial institution supervised by a Federal or state agency.

A copy of the escrow agreement, signed by the borrower and the provider of the funds, must be retained in the lender's loan file. The underwriter's documentation that establishes whether the borrower is likely to be able to handle the payment increases and the possible "payment shock" associated with such financing arrangement will be provided with the request for guarantee. Additional information regarding a temporary interest rate buydown can be found at Chapter 9, Paragraph 9.11 B. of this Handbook.

11.6 SECTION 8 HOMEOWNERSHIP VOUCHERS

Section 8 Homeownership Vouchers may be used for qualifying applicants. This income is not included in Annual Income. For repayment income purposes, the monthly subsidy from the Section 8 Homeownership Vouchers may be treated in either of the ways described below.

A. Repayment income

The subsidy may be treated as repayment income when calculating a homebuyer's qualifying ratios, and if the subsidy is paid directly to the borrower, it must be treated in this manner. Since the subsidy is non-taxable, it may be "grossed up" by 25 percent and then added to the borrower's income from employment and/or other sources when calculating repayment income.

B. Offset to Principal, Interest, Taxes and Insurance (PITI)

Lenders may treat the monthly homeownership assistance payment as an "offset" to the monthly PITI, i.e. reduce PITI by the amount of the homeownership assistance payment before dividing by the monthly income to determine the debt-to-income ratios. However, in order to use this procedure for qualifying the borrower, the homeownership assistance funds must not pass through the hands of the homebuyer, i.e. the homeownership assistance payment must be paid directly to the servicing lender or placed into an account that only the servicing lender may access. If the homeownership assistance payment is made directly to the borrower, that amount may only be considered as repayment income in qualifying the borrower as described in paragraph 11.6 A. above.

11.7 OBLIGATIONS NOT INCLUDED IN DEBT-TO-INCOME RATIOS

Obligations not considered or included in total debt-to-income ratio calculations include:

- Federal, state, and local taxes;
- Federal Insurance Contribution Act (FICA) contributions;
- Other retirement contributions such as 401(k) accounts, including the repayment of loans secured by 401(k) funds;
- Automatic deductions to savings accounts, mutual funds, stocks, bonds, certificates of deposit, including the repayment of loans secured by such funds;
- Commuting costs;
- Union dues;
- Open accounts with zero balances;
- Child care; and
- Voluntary deductions.