Review of Selected Underwriting Guidelines to Identify Potential Barriers to Hispanic Homeownership

U.S. Department of Housing and Urban Development
Office of Policy Development and Research

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Prepared for
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Executive Summary

Recent studies have identified several underwriting guidelines as particular barriers to Hispanic homeownership: establishing a credit history; verifying income; documenting employment history; verifying assets; and meeting requirements regarding citizenship or residency status. In addition, because Hispanics are disproportionately in low-income and low-wealth households, affordability is an important barrier to homeownership.

This detailed review of mortgage underwriting guidelines used by three of the most common sources of residential mortgage finance – Fannie Mae, Freddie Mac, and the Federal Housing Administration (FHA) – finds that changes to standard products offered by these major participants over the last decade have addressed some of the barriers to homeownership for Hispanics. This is particularly true of FHA's standard product. Furthermore, where barriers continue to exist in standard products, these issues are often remedied in special products targeted to low- and moderate-income borrowers. Some of these products include features specifically designed to serve an immigrant population. Underwriting guidelines used by one subprime lender, GMAC, were reviewed as a point of comparison to the prime loan products of Fannie Mae, Freddie Mac, and FHA. The review of GMAC's guidelines suggests that subprime products also address some of the barriers to Hispanic homeownership, although they typically come at the cost of a higher interest rate.

The review is not intended to compare the financial institutions' offerings or to rank them, but rather to highlight the products that are currently available to overcome barriers to homeownership for Hispanics and to understand where gaps remain in the types of products needed to address different barriers.

Establishing Credit History

One of the biggest challenges in qualifying for a mortgage among low-income households, including many immigrants, is lack of a credit history with credit reporting agencies. Fannie Mae, Freddie Mac, and FHA all have standard products that allow a borrower to be approved for a mortgage without a formal credit history with credit reporting agencies. All allow the use of non-traditional credit reports or a credit history compiled by the lender, as long as it includes a minimum number of credit references. Credit scores are required, however, for GMAC's subprime products and for some products that allow a high degree of flexibility in other respects. For example, Fannie Mae's Flex 97 and Flex 100 products allow a wide variety of sources of cash to be used for the downpayment and closing costs, but require traditional credit reports.

For Hispanics and other borrowers with low credit scores, FHA's standard product allows more flexibility than is typically available. For example, in January through June of 2000, the average FICO score for FHA purchase loans insured using a mortgage scorecard was about 630, compared with a minimum score of 660 typically required for prime mortgage approval. Targeted products offered by Fannie Mae and Freddie Mac also provide some options. For example, Fannie Mae's Community Lending products allow approval of borrowers with credit scores of 600 to 620. In

addition, GMAC's subprime products allow credit scores of as low as 520, although this likely is associated with a higher interest rate.

Documenting Income and Employment History

Traditional mortgage underwriting verifies income by reviewing paycheck stubs and tax returns, as well as by contacting employers of the borrower and co-borrower. It also generally requires documentation of a borrower's work history over the previous two years as proof of income stability. Low-income individuals, and particularly immigrants, may not have income that can be documented by pay stubs because they are more likely to routinely be paid in cash. Potential borrowers may have difficulty documenting two years of work history if their employers are uncooperative or management has turned over. Borrowers may also have difficulty meeting this requirement if they have not been living in the U.S. for two years or if their employment history is marked by "job hopping" and lengthy gaps in employment – associated, for example, with return visits to their native country

Another challenge for determining borrower income can arise when there are household members who are not family members but who contribute toward housing costs and will continue to be part of the household when a home is purchased. For example, income from boarders is traditionally not counted toward borrower income.

Fannie Mae, Freddie Mac, and FHA do not require two years of employment history for mortgage approval in standard products (one year is acceptable for Fannie Mae and Freddie Mac; FHA has no minimum requirement). In addition, frequent job changes are generally ignored as long as the borrower can document that his or her income is stable. Documentation requirements, however, remain a barrier: some form of written documentation, such as paystubs, an employer-completed form, or W-2 forms, is required.

With minor exceptions, income received in cash cannot be included as a primary or secondary source of income. This is true for standard products offered by FHA, Fannie Mae, and Freddie Mac, as well as the targeted products offered by Fannie Mae and Freddie Mac and the subprime products offered by GMAC. While Fannie Mae, Freddie Mac, and GMAC all have products that allow low or no income documentation, these allow less flexibility than standard and targeted products in other regards. For example, Freddie Mac's stated income product requires high credit scores, a large downpayment, and large cash reserves.

Widely available mortgage products allow rent paid by family members to be included in the borrower's income. FHA's standard product allows rental income from boarders in a one-unit property to be included in the borrower's qualifying income, if the boarders are related to the borrower, and if the income is shown on the borrower's tax return. Some of Freddie Mac and Fannie Mae's targeted products allow rental income from boarders in a one-unit property to be included in the borrower's qualifying income. The income does not have to be included on the borrower's tax return, although documentation is required. For one of Fannie Mae's Community Lending products, MyCommunityMortgage, the boarder is not required to be related to the borrower.

Documenting Assets

Traditional underwriting requires verification that the borrower accumulated the funds used for downpayments over time through a review of bank statements. Borrowers who do not use banks for their savings, which is not uncommon among immigrants, will not be able to meet this requirement. FHA's standard product allows both cash accumulated through savings clubs and cash saved at home to be considered acceptable sources of funds to close the mortgage if they are sufficiently documented. Targeted products offered by Fannie Mae and Freddie Mac also allow this flexibility. The documentation required to demonstrate that the borrower could have accumulated the assets over time, however, is substantial, and may discourage lenders from using this flexibility.

Some products also allow related people living together to pool funds for closing costs and downpayments, improving borrowers' ability to accumulate sufficient assets for a home purchase.

Citizenship and Residency Status

U.S. citizenship is not required for mortgage approval for standard products by any of the financial institutions reviewed in this report, although GMAC imposes some additional requirements for non-permanent resident aliens. However, legal residence in the U.S. is required for mortgage approval. Nationwide, there are only a handful of pilot programs to extend mortgage credit to borrowers who do not have valid Social Security numbers. Given the number of undocumented immigrants in the country (an estimated 6 million), most of them Hispanic, this remains an important barrier to homeownership for Hispanics. Of course, it can also be argued that homeownership is not an appropriate goal for undocumented residents.

Affordability

Hispanics are disproportionately in low-income and low-wealth households compared to non-Hispanics, so affordability may be the most important barrier to homeownership. FHA products, as well as products offered by Fannie Mae and Freddie Mac that are targeted to low- and moderate-income households, help to address this barrier in several ways. For example, a variety of low-downpayment products are available, some requiring as little as $500 of the borrower's own funds. Higher allowed housing expense-to-income and total debt-to-income ratios available through Fannie Mae's Community Lending and Freddie Mac's Affordable Gold products, as well as GMAC's subprime products, also help to improve affordability. Some of Fannie Mae's products do not have maximum housing expense-to-income ratios at all. In addition, low or no financial reserves are required for some products. Some low-downpayment products, however, require relatively high credit scores.

Low downpayment mortgages generally come at the expense of monthly mortgage insurance payments. High-LTV products for FHA, Fannie Mae, and Freddie Mac all require mortgage insurance, and higher, more costly, levels of mortgage insurance are generally required for loans with higher LTV ratios. The low-downpayment products offered by subprime lenders typically carry higher interest rates, which also reduces the affordability of monthly payments.

Barriers Remaining in Available Products

As described above, many of the barriers to homeownership for Hispanics that recently existed in common underwriting guidelines have been addressed by some widely available standard products and by products targeted to particular populations. However, a few important obstacles remain in the form of individual underwriting guidelines. In addition, the targeted products sometimes impose new requirements that pose barriers themselves.

The requirement that borrowers be legal residents of the U.S. is obviously a challenging obstacle for the undocumented immigrants in this country. A handful of lenders are experimenting to determine whether lack of legal residence is an acceptable risk in extending mortgage credit; however, lending to illegal residents also involves political issues that may be extremely difficult to resolve.

The lack of acceptability of cash income is also an important remaining underwriting obstacle. Some smaller community lenders have begun to experiment with approving mortgages that allow a limited share of the borrower's total income to be earned in cash. If these mortgages prove to be acceptable risks, the GSEs may eventually make similar allowances in future offerings of targeted products.

Lastly, one of the trade-offs for flexibility in underwriting in some targeted products is a requirement that borrowers receive homebuyer education and counseling. Fannie Mae's Community Lending products require homebuyer education and counseling under most circumstances, as do Freddie Mac's Affordable Gold products. Although homebuyer education and counseling can be a benefit to borrowers, this requirement could pose a barrier to homeownership if Spanish-language education and counseling programs are not available widely, and if this requirement leads to lender reluctance to promote the products.

Chapter One
Introduction

This report is part of a broader research effort by the U.S. Department of Housing and Urban Development (HUD) to examine barriers to Hispanic homeownership and to identify approaches that have the greatest potential for increasing homeownership opportunities for this important segment of the U.S. population. The first stage of this research effort was a thorough review of the literature to identify what is known about the causes of homeownership gaps between Hispanics and whites and what policies may be effective in closing these gaps.[1] A key focus of the literature review was on the barriers faced by Hispanics in obtaining mortgage financing.

Following up on the literature review, the purpose of this report is to provide a detailed review of mortgage underwriting guidelines used by three of the most common sources of residential mortgage finance – Fannie Mae, Freddie Mac, and FHA – to examine the extent to which these guidelines may facilitate or impede the ability of Hispanics to qualify for a mortgage. The underwriting review covers both traditional mortgage products offered by the selected financial institutions as well as products for low- and moderate-income households that include features specifically designed to serve an immigrant population. As a point of comparison, we also review the underwriting guidelines used by one subprime lender to shed some light on the extent to which subprime products may better accommodate the needs of some segments of the Hispanic population.[2]

The review is not intended to compare the financial institutions' offerings or to rank them, but rather to highlight the products that are currently available to overcome barriers to homeownership for Hispanics and to understand where gaps remain in the types of products needed to address different barriers. Clearly, these organizations differ in their mission, market function, and regulatory constraints, all of which affect the types of products they can offer. Related to this, the use of underwriting flexibilities differs across the groups. For example, while the GSEs offer a range of affordable lending products, these loans account for a relatively small share of the GSEs' purchases.[3] In contrast, low-downpayment mortgages account for a large majority of mortgages insured by FHA,

[1] Cortes, forthcoming, Abt Associates, Inc.: Cambridge, MA.

[2] Underwriting guidelines described were accurate as of fall 2004; however, underwriting guidelines are revised regularly so some product features and guidelines may have changed since then.

[3] For example, in 2003 Fannie Mae purchased or securitized 20,400 loans through its MyCommunityMortgage products and 100,866 loans through its Flexible 100 product line. Comparable volumes for Freddie Mac's affordable loan products are not available. (Figures reported in "HUD's Housing Goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for the Years 2005–2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac; Final Rule" *Federal Register*, November 2, 2004, Vol. 69, No. 211, page 63655.

which focuses primarily on serving low-income and minority borrowers.[4] The remainder of this chapter describes the methodology used in this underwriting review and provides an overview of the rest of the report.

Methodology

FHA and the two GSEs (Fannie Mae and Freddie Mac) are included in the underwriting review because these organizations account for a large share of the home purchase mortgage market. Underwriting guidelines from these organizations are obtained from AllRegs, a public database of underwriting guides available by subscription. A review of the written underwriting guidelines was supplemented by telephone interviews with representatives from Fannie Mae and Freddie Mac to identify which products should be reviewed and to understand whether lenders could exercise discretion in how the written guidelines were implemented.

Underwriting guidelines for subprime lenders are not available through AllRegs, so we also solicited the cooperation of a large subprime lender, GMAC-RFC. Although subprime lenders originate primarily refinance mortgages, they represent an increasing share of the home purchase market. The most recent study by ACORN on the use of subprime lenders reports that in 2002 subprime lenders accounted for 19.6 percent of home purchase mortgages among Hispanic buyers, up from about 12 percent in 1997 (ACORN, 2004).[5] This share is more than twice as high as among non-Hispanic white homebuyers (7.8 percent), although not as high as the share among African-American buyers (28.0 percent). One of the factors that may lead borrowers into the subprime market is that these loans may require less documentation of credit, income, employment and assets. The review of subprime underwriting guidelines serves as a point of comparison with the requirements of the other prime market products.

Outline of the Report

The next section summarizes the key underwriting barriers to homeownership for Hispanics identified in the literature. In turn, the following sections then present findings from a review of underwriting guidelines from Fannie Mae, Freddie Mac, FHA, and GMAC-RFC. Where possible, the review of underwriting guidelines identifies trade-offs for various underwriting flexibilities offered, including tightening of other aspects of the underwriting guidelines and loan pricing. The review also identifies remaining barriers to homeownership for Hispanics, as well as differences in the use and implementation of flexible mortgage products by lenders. The report concludes with a comparison of findings across the four financial institutions reviewed and identifies the aspects of existing underwriting guidelines that are likely to represent the most significant barriers for Hispanics.

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4 See *Issue Brief: FHA's Impact on Increasing Homeownership Opportunities for Low-Income and Minority Families During the 1990s*, U.S. Department of Housing and Urban Development, Office of Policy Development and Research, December 2000.

5 ACORN, *Separate and Unequal: Predatory Lending in America*, February 2004. Updated HMDA data provided by HUD show the trend has continued to increase – considering conventional loans less than the GSE conforming loan limit, subprime lenders (as identified by HUD) accounted for 18 percent of Hispanic home purchase loans in 2002, 25 percent in 2003, and 33 percent in 2004.

Chapter Two
Key Underwriting Barriers to Homeownership for Hispanics

Two recent studies have provided a thorough review of key underwriting barriers to homeownership among low-income and immigrant households – Listokin and Wyly (2000) and Schoenholtz and Stanton (2001).[6] The findings from these studies are highly relevant for Hispanics, as the barriers they face relate to their high share among both low-income families and immigrants. The barriers identified by these studies include:

- establishing a credit history;
- verifying income;
- documenting employment history;
- affordability;
- verifying assets; and
- meeting requirements regarding citizenship or residency status.

This section summarizes the findings from these studies regarding these underwriting barriers. These barriers are a key focus of the underwriting review presented in sections three through six of the report.

Credit History

One of the challenges for low-income households, including many immigrants, is lack of a credit history with credit reporting agencies. Since traditional underwriting requires an evaluation of information from credit reporting agencies, an absence of a formal credit history may make borrowers ineligible for a mortgage loan. A considerable number of Hispanics do not have credit scores, because they have immigrated to the U.S. recently. An analysis of Community Reinvestment Act (CRA) loans found that 22 percent of Hispanics had no credit score, compared with 3 percent of African Americans and 4 percent of whites.[7]

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6 David Listoken and Elvin K. Wyly, "Making New Mortgage Markets: Case Studies of Institutions, Home Buyers, and Communities," *Housing Policy Debate* 11(3), 2000. Andrew I. Schoenholtz and Kristin Stanton, "Reaching the Immigrant Market: Creating Homeownership Opportunities for New Americans," Fannie Mae Foundation, Washington, DC, 2001. The findings from these two studies were also synthesized in a report by Schoenholtz and Stanton, "Reaching Emerging and Underserved Home Ownership Markets," LISC Center for Home Ownership, Summit 2001: Research Series.

7 Stegman, Michael, Roberto Quercia, and Jennifer Lobenhofer, "Automated Underwriting: Getting to 'Yes' for More Low-Income Applicants," Center for Community Capitalism, University of North Carolina - Chapel Hill, 2001.

Alternative approaches to documenting credit history have been developed to address this issue. These approaches involve documenting regular bill payments to demonstrate the prospective borrower's willingness and ability to meet their financial obligations. This includes information on payments for rental housing, utilities, telephone service, medical bills, personal loans, school tuition or child care – none of which is gathered by credit reporting agencies.

Many other low-income Hispanic borrowers may face limited mortgage options because of poor credit histories. Absent extenuating circumstances, the mortgage industry generally requires a credit score of 660 in order to qualify for a prime mortgage, while borrowers with scores between 620 and 660 require further review in order to qualify.[8] A recent study by Bostic, Calem and Wachter (2004) estimates that 63.3 percent of Hispanic renters in 2001 had credit scores below 660, compared to 54.2 percent of African-American renters and 35.4 percent of non-Hispanic white renters.[9]

Documenting and Determining Borrower Income

Traditional mortgage underwriting verifies income by reviewing paycheck stubs and tax returns, as well as by contacting employers of the borrower and co-borrower. There are several ways in which this traditional underwriting process may pose barriers for Hispanics. First, low-income households, particularly immigrants, may not have income that can be documented by pay stubs if they are routinely paid in cash. Second, even if their primary source of income is verifiable, these households may rely on supplemental income from part-time jobs that are "off the books," such as childcare, day labor, or house cleaning. In these cases, alternative underwriting approaches to income verification may include using certified letters from employers to document income or documenting regular patterns of deposits into bank accounts.

Another challenge for determining borrower income can arise when there are household members who are not family members but who contribute toward housing costs and will continue to be part of the household when a home is purchased. Income from boarders is traditionally not counted toward borrower income. Alternative underwriting guidelines may allow boarder income to count as part of the borrower's income if the contribution toward housing costs can be documented and the boarder will continue to be part of the household after the move.

Employment History

Mortgage underwriting generally requires documentation of a borrower's work history over the previous two years as proof of income stability. For the same reasons they may have trouble

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8 Credit scores in these ranges are not unheard of among loans purchased by FHA or the GSEs. Fannie Mae's Annual Report for 2001 reported that 6 percent of the mortgages they purchased were made to borrowers with credit scores below 620 and an additional 11 percent were made to borrowers with credit scores between 620 and 660.

9 Raphael Bostic, Paul Calem, and Susan Wachter, "Hitting the Wall: Credit as an Impediment to Homeownership," paper presented at *Building Assets, Building Credit: A Symposium on Improving Financial Services in Low-Income Communities*, November 18-19, 2003, Joint Center for Housing Studies of Harvard University, Cambridge, MA.

documenting income, some Hispanic borrowers may have difficulty meeting this requirement if their employment is "off the books." In other cases, potential borrowers may have difficulty meeting this requirement if their employers are uncooperative or management has turned over. Borrowers may also have difficulty meeting this requirement if they have not been living in the U.S. for two years or if their employment history is marked by "job hopping" and lengthy gaps in employment – associated, for example, with return visits to their native country. Alternative underwriting approaches may require a shorter work history for new arrivals or may use documentation of income through bank deposits or W-2 forms without verification directly from the employer.

Affordability

Affordability of homeownership is a challenge for a significant share of all would-be first-time homebuyers.[10] Affordability is an even greater barrier for Hispanic households, who are more likely to have low- or moderate-incomes than their non-Hispanic counterparts. In addition, Hispanic families have significantly less wealth.[11] The combination of low income and low wealth may make it difficult for Hispanic families to accumulate a sufficient downpayment for a conventional product that may require a 10 percent downpayment, even with satisfactory credit history. For the same reasons, Hispanics are disproportionately likely to have lower cash reserves, and this is a signal to lenders about their capacity to make mortgage payments on time, especially during a financial crisis. Affordable loan products help address this barrier through lower downpayments and higher qualifying ratios.

Documenting Assets

Traditional underwriting requires verification that the borrower accumulated the funds used for downpayments over time through a review of bank statements. Borrowers who do not use banks for their savings, which is not uncommon among immigrants, will not be able to meet this requirement. In some cases, immigrant groups may also use savings clubs[12] as a source of downpayment funds, and these may not be easy to document. Alternative underwriting guidelines may allow borrowers to deposit funds in a bank account to document the existence of the savings and then use information on the household budget to support the borrower's ability to have accumulated this level of savings. In the case of savings clubs, lenders may accept a certified letter from the club treasurer to document the borrower's participation in the club and verify the club as the source of their savings.

Citizenship and Residency Status

Mortgage underwriting may preclude loans to borrowers who are not U.S. citizens. This requirement reflects a concern that non-citizens are not committed to permanent residency in the U.S. and, for that reason, may pose a risk of default. However, lenders have been relaxing these standards to allow

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10 Tong, Zhong Yi. Homeownership Affordability in Urban America: Past and Future, April 2004, Special Report, Fannie Mae Foundation.

11 Cortes, forthcoming, Abt Associates, Inc.: Cambridge, MA.

12 Savings clubs are also referred to as cultural savings clubs or private savings clubs.

loans to permanent and nonpermanent resident aliens. There are an estimated 6 million undocumented immigrants in the United States, the large majority of them Hispanic, so residency and immigration status are important barriers.[13]

Recently, a few institutions have piloted programs to extend mortgage loans to borrowers who do not have a valid Social Security number. Instead, they use the borrower's Income Tax Identification Number (ITIN), which can be assigned to foreign nationals who pay taxes on income earned in the U.S. so they can file U.S. income tax returns. For example, Mortgage Guaranty Insurance Corporation (MGIC) is piloting a program, Building a Life in America, available to borrowers using an ITIN regardless of their immigration status. Underwriting borrowers with ITINs is complex, because few borrowers have established credit histories under their ITIN. As a result, alternative methods of evaluating credit history are generally required.[14] Citibank and Wells Fargo also recently piloted tax-ID loans, in a limited number of cities.[15]

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[13] Paral, Robert. 2004. The Potential for New Homeownership Among Undocumented Latino Immigrants. Prepared for the National Association of Hispanic Real Estate Professionals.

[14] Culver, Curt, "Immigrant Lending: Finding the Right Way To Do the Right Thing," Mortgage Banking, p. 15-17, May 2004.

[15] Zuniga, Janine, "Home-Buying Program Has Cash, Controversy," Copley News Service, February 6, 2006.

Chapter Three
Fannie Mae's Underwriting Guidelines

Fannie Mae offers an array of loan products targeted toward low- and moderate-income households, immigrants, and the upper end of the subprime market. Many of the products targeted to immigrants and low- and moderate-income households are referred to collectively as Community Lending mortgages. One group of the Community Lending products, called MyCommunityMortgage™, includes low-downpayment, homeownership voucher, and energy efficient mortgages. This section describes both the flexibilities for immigrants and low- and moderate-income borrowers in Fannie Mae's standard underwriting guidelines and the additional flexibilities available in the Community Lending mortgage products. Barriers to homeownership for Hispanics that remain, even with these flexibilities, are also discussed.

Standard Underwriting Guidelines

Fannie Mae's current standard underwriting guidelines address several of the barriers described in the previous section. These include barriers related to U.S. citizenship, credit history evaluation, length of employment in the borrower's line of business, and the ratio between housing expenses and income.

U.S. Citizenship

U.S. citizenship is not required to qualify for a mortgage under Fannie Mae guidelines. Permanent and non-permanent resident aliens legally residing in the country are eligible for a mortgage on the same terms as a U.S. citizen. Social Security numbers are not required.[16]

Credit History Evaluation

When a borrower does not have the type of credit report typically provided by one of the national credit repositories, a non-traditional credit report may be used to evaluate creditworthiness. Fannie Mae's guidelines require that a credit history of at least 12 months be established, and that four to six credit references be used. "Tier 1," housing and utilities, credit references must be used first; if at least four tier 1 sources cannot be documented, then "tier 2" sources of credit, which are payments for medical, life, automobile, and household or renter's insurance, can be used. If four to six total credit references cannot be obtained from these sources, then "tier 3" sources of credit can be used. Tier 3 credit includes payments to local stores; rental payments for durable goods; payments for medical bills, school tuition, and childcare; and payments on a loan from an individual.

A non-traditional credit report can be obtained from a repository that compiles the information, or the lender can compile the information him or herself by obtaining written credit references directly from creditors and reviewing the borrower's bank statements. Credit histories from foreign countries can

[16] A borrower can get a loan with an ITIN, provided that he or she is a legal resident.

also be used to evaluate creditworthiness, provided they are translated into English and meet the requirements for completeness, accuracy, and authenticity applied to other credit reports.

Employment History and Income Stability

Although two years of documentation for a borrower's employment and income history are required,[17] the borrower's history in a particular line of business is not evaluated. Income stability is evaluated, but frequent changes in employment are not considered detrimental to a borrower's ability to maintain homeownership. However, seasonal, part-time, or second job income is only considered to be stable income if the borrower has worked in the same line of business for the past two years and there is a strong likelihood of continuation. In addition, income received in cash is not included in the calculation of the borrower's stable income.

Housing Expense-to-Income Ratio

Historically, standard mortgage underwriting guidelines set maximums for both the ratio of housing expense-to-income (typically 26 to 28 percent) and the ratio of total recurring debt and housing costs to income (typically 33 to 36 percent). Fannie Mae's current standard underwriting guidelines do not set a maximum housing expense-to-income ratio, but rather have a single limit for total recurring debt of 36 percent. This flexibility allows borrowers who do not have non-housing debt (such as immigrants who are reluctant to become indebted to anyone other than a relative) to dedicate a larger share of their income to housing payments.

Principal Remaining Barriers in Fannie Mae's Standard Underwriting

Fannie Mae's underwriting guidelines for standard products continue to pose some barriers to some Hispanics seeking to attain homeownership.

First, income received in cash is not an acceptable source. Hispanics working several jobs, some of which are paid in cash, may not be able to meet income stability and total debt-to-income ratio requirements if this income is not considered.

Second, income from boarders in a one-family property generally cannot be considered as part of the borrower's income in calculating the total debt-to-income ratio. For Hispanics who live with extended family members who contribute to housing payments but would not be named as borrowers on the mortgage, this requirement underestimates the resources available to pay the mortgage.

Third, cash-on-hand is generally not considered an acceptable source of funds for the downpayment or closing costs. In addition, deposits with savings clubs are not specifically allowed in Fannie Mae's Seller/Servicer Guide, making it unlikely that lenders consider these deposits to be an acceptable source of funds.[18] Recent immigrants who do not have a relationship with a traditional financial

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[17] Lenders may also consider borrowers with an income history of less than two years (but no less than one year), as long as the income is stable and likely to continue.

[18] A staff member interviewed for this study (Wendy Wood, Director of Community Lending, October 19, 2004), thought some lenders' individual negotiated contracts with Fannie Mae might allow them to

institution and who may mistrust such institutions because of their lack of familiarity with them may be disqualified from homeownership by these requirements.

Underwriting Guidelines for Community Lending and Flex Mortgages

Exhibit 1 summarizes the features and underwriting requirements of several Fannie Mae products targeted to immigrants and low- and moderate-income borrowers, called Community Lending products. Summarized here are the Community Home Buyer's Program™, Fannie 3/2®, Fannie 97®, and the low-downpayment one- and two-family mortgage product in the MyCommunityMortgage™ suite of products.[19]

It is important to note that Community Lending products are not as widely available to borrowers as Fannie Mae's standard products as lenders must meet special requirements to be able to originate these products. For example, lenders who are approved to offer Fannie Mae products need a negotiated commitment from Fannie Mae in order to be able to sell MyCommunityMortgage™ loans to Fannie Mae. In addition, Fannie Mae places limits on the volume of MyCommunityMortgage™ loans they will commit to purchasing from each lender. Information from Fannie Mae's *Annual Housing Activities Report* for 2003 submitted to HUD indicates that Fannie Mae purchased or securitized a total of 20,400 of these loans in that year.[20]

Fannie Mae also offers "Flex" products, which are summarized in Exhibit 2. These products are not considered Community Lending products because, unlike the Community Lending products, they require traditional credit reports and do not allow other flexibilities identified below. Nonetheless, they require very low downpayments and allow a variety of sources of funds to be used for closing costs and the downpayment and, therefore, may offer opportunities for borrowers with limited downpayment funds. One advantage of the Flex products is that there is no borrower income limit, while borrowers approved for Community Lending mortgages cannot have income that exceeds 100 percent of area median income for most geographic areas.[21]

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consider deposits with savings clubs on an equivalent basis with cash-on-hand, which would make this a permissible source of funds for Community Lending products but not for standard Fannie Mae products.

19 Other products in the suite, such as energy efficient mortgages, have slightly different features and requirements, but are not as relevant to the issue of Hispanic homeownership and so are not included in this review.

20 Figures reported in "HUD's Housing Goals for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) for the Years 2005–2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac; Final Rule" *Federal Register,* November 2, 2004, Vol. 69, No. 211, page 63655.

21 There are exceptions to this limit for some high-cost areas. Also, the income limit for borrowers using the MyCommunityMortgage™ product in non-metropolitan areas is 115 percent of the area median income.

Exhibit 1
Fannie Mae Underwriting Guidelines for Community Lending Mortgages

	Community Home Buyer's Program	Fannie 3/2	Fannie 97	MyCommunityMortgage
Occupancy	owner-occupied, must not have ownership interest in any other residential dwelling			
Property Type	1-family, condo, or unit in PUD			1-family, condo, or unit in PUD; 2-family (no condo or PUD)
Loan Purpose	purchase or limited cash-out refinance		purchase	purchase or limited cash-out refinance
Downpayment	5% down, borrower's own funds	5% down, 3 percentage points from borrower's own funds	3% down, borrower's own funds	$500 minimum contribution for 1-unit, 3% for 2-unit, no minimum for limited cash-out refinance
Amortization Period	15 to 30 years, monthly or biweekly, fully amortizing			up to 30 years, fully amortizing
Interest Rate	Fixed, no temporary interest rate buydowns			fixed, 7/1ARM, 10/1 ARM, no temporary interest rate buydowns
Total Debt-to-Income Ratio	38%			43%
Maximum LTV/CLTV	95% LTV, 105% CLTV (with Community Second)	95% LTV, 105% CLTV (with Community Second)	97% LTV, 97% CLTV (subordinate financing generally not allowed)	100% LTV; 97% for 2-unit; 90% for co-ops; maximum 105% CLTV (with Community Second); minimum 95% CLTV
Credit Score	620			600 (97% LTV) or 620 (100% LTV)
Alternative to credit score (traditional credit record)	Minimum credit history of four tradelines active at least 24 months; no more than 9 open tradelines; no collections or judgments within past 24 months; no prior bankruptcy or foreclosure (w/o re-established credit); no housing payment delinquency within 24 months; no delinquency on revolving or installment debt within 12 months; no more than one revolving or installment account 30 days past due during the 13-24 months preceding application.			Enhanced credit evaluation for traditional or non-traditional credit, which require minimum credit history of four tradelines active at least 24 months; no more than 9 open tradelines; outstanding balances for the revolving accounts may represent no more than 50% of the borrower's outstanding credit at the time of the loan application. In addition, the borrower must have (1) no history of major delinquencies (bankruptcy, foreclosure, collections, or judgments); (2) no history of delinquencies on installment or housing debt; and (3) no delinquencies for revolving accounts in the last 12 months, and no more than one account that

Exhibit 1
Fannie Mae Underwriting Guidelines for Community Lending Mortgages

	Community Home Buyer's Program	Fannie 3/2	Fannie 97	MyCommunityMortgage
Alternative to credit score (non-traditional credit record)	Minimum four sources of non-traditional credit active at least 12 months. Sources must include utility company and housing payments. No delinquent rental housing payments within 24 months; maximum of one 30-day delinquency on remaining accounts; no collections or judgments.			was "1 x 30 days" delinquent in the 12 months prior to that.
Financial Reserves	One month of PITI in financial reserves after closing			None
Income Limits	Generally, borrower's income must be no more than 100 percent of AMI.			Generally, borrower's income must be no more than 100 percent of AMI or 115 percent of AMI in non-metropolitan areas.
Income Documentation	Rental payments from a relative who resides with the borrower (but who is not obligated on the mortgage debt) may be considered as acceptable stable income—in an amount up to 30% of the total gross income that is used to qualify the borrower for the mortgage—if the relative has lived with (and paid rent to) the borrower for the last 12 months.			Rental payments from a boarder (need not be a relative) may be considered as acceptable stable income.
Asset Documentation	Cash-on-hand may be an acceptable source of funds, if the borrower customarily uses cash for expenses and that usage is consistent with the borrower's credit profile and financial status. In such instances, the credit report or other verifications must reflect limited (or no) use of credit and cannot identify any depository relationship between the borrower and a financial institution. Acceptability of cash-on-hand determined on a case-by-case basis.			
Home-buyer Education and Counseling	Homebuyer education generally required (waived for previous homeowners making 5% downpayment with own funds and with two months of financial reserves).	Homebuyer education and post-purchase early delinquency counseling required.		Home-buyer education required for first-time home buyers; landlord counseling required for 2-unit borrowers
Credit Enhancements	Generally standard mortgage insurance coverage requirements apply		Generally standard mortgage insurance coverage requirements apply, but 35% required if manually underwritten.	Standard mortgage insurance coverage requirements apply; reduced MI and lower-cost MI coverage options do not apply

Exhibit 2
Fannie Mae Underwriting Guidelines for Flex Products

	Flex 97	Flex 100
Occupancy	owner-occupied principal residence	
Property Type	1-family, condo, or unit in PUD	
Loan Purpose	purchase	
Downpayment	3% downpayment required from the borrower's own funds, a Community Seconds subsidized second mortgage; or a gift or unsecured loan from other than an interested party. An interested party to the transaction may contribute up to 3% of the property's sales price toward the payment of closing costs.	No downpayment required, but borrower must contribute 3% toward closing costs, from the borrower's own funds, a Community Seconds subsidized second mortgage; or a gift or unsecured loan from other than an interested party. An interested party to the transaction may contribute up to 3% of the property's sales price toward the payment of closing costs.
Amortization Period	15 to 30 years	
Interest Rate	fixed, 7/1ARM, 10/1 ARM	
Ratios	standard: 36% debt-to-income ratio	
Maximum LTV/CLTV	97% LTV; 100% CLTV or 105% CLTV with Community Second	100% LTV; 100% CLTV or 105% CLTV with Community Second
Credit Score	None specified, but intended for borrowers with very good credit	
Alternative to credit score (traditional credit record)	Must be underwritten through Desktop Underwriter, so traditional credit report is required.	
Alternative to credit score (non-traditional credit record)	None	
Financial Reserves	DU specifies the amount of reserves required to support its risk assessment; two months' reserves generally satisfies basic risk tolerances	
Income Limits	None	
Income Documentation	Standard	
Asset Documentation	Standard	
Home-buyer Education and Counseling	None required	
Credit Enhancements	Standard mortgage insurance coverage requirements apply	

This section reviews the additional flexibilities available in Community Lending mortgages and Flex products that address barriers to homeownership for Hispanics. Some of the standard underwriting guidelines discussed in the previous section, including credit history, documenting employment, and U.S. citizenship, do not differ for these products and so are not discussed separately in this section.

Documenting Income

Rental income from boarders related to the borrower in a one-unit property can be included in the calculation of the borrower's income in Community Lending products, but not in Flex products. For products that allow this flexibility, the boarder must have lived with and paid rent to the borrower for the past 12 months. MyCommunityMortgage™ allows the additional flexibility that the boarder does not have to be a relative. As in Fannie Mae's standard products, cash income is not an acceptable source of income in Community Lending or Flex products.

Documenting Assets

Underwriting guidelines for Community Lending products allow cash on hand to be considered an acceptable source of funds for a downpayment and closing costs under some circumstances. However, the borrower must primarily use cash for expenses, and this must be reflected in the borrower's credit profile and financial status. Specifically, the credit report must show limited or no use of credit and must not identify any depository relationship between the borrower and a financial institution.

The ability to accept cash-on-hand in underwriting Community Lending products is available to lenders on a negotiated basis, and the details under which it is an acceptable source of funds, including the documentation required, are specified in individual agreements between Fannie Mae and the lender. Flex products do not allow the use of cash-on-hand.

The acceptability of cash-on-hand potentially benefits Hispanics disproportionately in helping to overcome barriers to homeownership. A number of low-income and immigrant Hispanic households distrust mainstream financial institutions and eschew relations with them.[22] For example, a 1999 survey of residents of low-income neighborhoods in New York and Los Angeles found that 45 percent of Hispanics did not have a transaction account with a bank, compared to 31 percent of blacks and 9 percent of whites.[23]

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[22] Congressional Hispanic Caucus Institute, 2004.

[23] The shares of unbanked are derived from data presented in Dunham, Constance R. 2001. "The Role of Banks and Nonbanks in Serving Low- and Moderate-Income Communities," J.L. Blanton, *et al*., eds., Changing Financial Markets and Community Development: A Federal Reserve System Conference, Federal Reserve Bank of Richmond. Since these data only pertain to low-income neighborhoods in two cities, it is not known how representative this share is for Hispanics generally. Aizcorbe, Ana M., Arthur B. Kennickell, Kevin B. Moore, 2003. "Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances," *Federal Reserve Bulletin*, Volume 89, Number 1, (January), pp. 1 to 29 serve as a point of comparison. They present tabulations of the share of families without transaction accounts based on the 2001 Consumer Finance Survey for the entire nation. These data find that 31.5 percent of families with income in the bottom quintile do not have transaction accounts. With regard to race and ethnicity, the same data find that 24.8 percent of minorities do not have transaction

In addition to some flexibility in the use of cash-on-hand, Community Lending products are flexible in that they generally require low downpayments. The one-to-two family product in the MyCommunityMortgage™ suite of products reviewed in Exhibit 1, in particular, has a very low downpayment requirement of $500 of the borrower's own funds (for a one-unit property), in addition to other closing costs.

Flex 97™ and Flex 100™ also require very low downpayments. Flex 97™ requires a 3 percent downpayment, but these funds do not have to come from the borrower's own funds. They can be from an unsecured loan or a gift from a variety of permissible parties (in particular, one that is not involved in the transaction). A party involved in the transaction can contribute up to 3 percent of the property's sales price toward closing costs. Flex 100™ does not require a downpayment. The borrower must contribute 3 percent toward closing costs, but the sources of these funds are equally flexible as those allowed in the Flex 97™ product. As noted in Cortes, *et al*.,[24] Hispanic families have significantly less wealth than non-Hispanic households. Given this relatively low wealth, low downpayment products may help to remove an important barrier to homeownership for Hispanics. The trade-off, as will be discussed more below, is that the Flex products also require very good credit.

Debt-to-Income Ratios

As noted above, Fannie Mae does not use housing expense-to-income ratios separate from overall debt ratios in its underwriting, even for standard products. In addition, Community Lending products allow higher total debt-to-income ratios than standard products: 38 percent for Community Lending and 43 percent for MyCommunityMortgage™. Flex products require the same total debt-to-income ratio, 36 percent (or higher with compensating factors), as Fannie Mae's standard products. Given that Hispanic households are disproportionately located in areas of the country with high housing costs,[25] the flexibility in the Community Lending products, particularly MyCommunityMortgage™, could be helpful in overcoming barriers to homeownership for Hispanics who must dedicate a relatively large proportion of their income for housing costs.

Credit Quality

Fannie Mae's Seller/Servicer Guide does not specify minimum credit scores required to qualify for a standard mortgage. A large majority of loans are underwritten using Fannie Mae's automated underwriting system, Desktop Underwriter® (DU™). Automated underwriting systems are technological tools that combine statistical models with historical loan performance and mortgage lending factors. DU™ produces a mortgage score based on a variety of factors, including the borrower's income, size of the downpayment, financial reserves, total debt-to-income ratio, type of product being used (such as fixed rate or adjustable rate), and the number of borrowers on the loan.

accounts compared to 5.3 percent of whites (the survey does not have enough observations to provide tabulations for Hispanics separately). Thus, the survey data for New York and Los Angeles are not inconsistent with national data.

24 Cortes, forthcoming, Abt Associates, Inc.: Cambridge, MA.

25 Ibid.

In addition, in place of credit scores, DU™ uses credit characteristics such as credit history, delinquent accounts, and foreclosures from credit reports. DU™ weighs and balances these compensating factors statistically.

However, Fannie Mae's Seller/Servicer Guide, which applies to manually underwritten loans, does recommend the use of credit scores for certain products. As a rule, the mortgage industry standard is a score of 660 or above to qualify for a prime mortgage; scores from 620 to 660 would require further review and compensating factors. Fannie Mae's Seller/Servicer Guide states that for manually underwritten Community Lending mortgages, a minimum score of 620 is generally required.

Flex products, on the other hand, generally require "very good credit," according to Fannie Mae press releases.[26] Although "very good credit" is not defined in either the press releases or Fannie Mae's underwriting guidelines, this language seems to imply that the minimum credit score is likely to be higher than that required for Fannie Mae's standard products.

Restrictions and Trade-offs Applied to Flexible Loans

The additional flexibility offered through Community Lending products is available only for borrowers who have no more than 100 percent of area median income (AMI) in most areas, or 115 percent of AMI in non-metropolitan areas for MyCommunityMortgage™ products. There is no income restriction for loans in eligible low- or moderate-income areas, and certain high-cost mortgage markets have higher income limits. In addition, there are requirements for homebuyer education and counseling and some product restrictions, as well as differences in pricing. The primary trade-off required for Flex products (Flex 97™ and Flex 100™) is very good credit.

Community Lending products require homebuyer education and counseling under most circumstances. Previous homeowners using a MyCommunityMortgage™ product are not required to undergo homebuyer education and counseling, nor are previous homeowners making at least a 5 percent downpayment using their own funds and who will have at least two months of financial reserves after closing using the Community Home Buyer's Program™. Homebuyer education and counseling can be a benefit to borrowers if it improves their understanding of the mortgage process, helps them select a product that is most appropriate for their needs, and reduces the likelihood that they will lose their home through foreclosure. Many borrowers want to find and close a loan as quickly as possible, however, and to the extent that education and counseling slows the loan process, they may view this requirement as a burden. In addition, this requirement could pose a barrier to homeownership if Spanish-speaking education and counseling programs are not available widely, and if this requirement leads to lender reluctance to promote the products. Flex products do not require homebuyer education and counseling.

Community Lending and Flex products both have some restrictions in terms of the loan purpose and interest rate. Fannie 97® can only be used for purchase loans, and the other products reviewed in Exhibit 1 can be used only for purchase, refinance, or limited cash-out refinance. Flex 97 and Flex 100 can only be used for a home purchase. In addition, adjustable-rates are not allowed in Fannie

[26] "Fannie Mae in Connecticut: Flexible 97® through Desktop Underwriter," from Fannie Mae's website, http://www.fanniemae.com/partnershipoffices/connecticut/story1.jhtml, downloaded Nov. 1, 2004.

97®, Fannie 3/2®, or the Community Home Buyer's Program™, although hybrid adjustable-rates[27] are allowed in MyCommunityMortgage™ products and Flex products.

Finally, prices paid to lenders are very slightly lower for Community Lending and MyCommunityMortgage™ products compared to conventional 30-year fixed rate mortgages. For example, according to discount and premium pricing information for whole loans on Fannie Mae's website, a 30-year fixed-rate MyCommunityMortgage™ with an LTV of 97 percent or less with a pass-through of 5.75 percent had a 90-day price of 100.358 in September 2004. In comparison, a standard 30-year fixed rate mortgage with the same pass-through had a 90-day price of 100.630.[28] The quoted price is the percentage of the loan balance that Fannie Mae will pay for the loan. In general, lenders charge borrowers lower interest rates on loans for which they receive a higher price, so Community Lending products may have slightly higher interest rates than standard products.

In addition to these price differences, some loans are eligible for sale to Fannie Mae only with a "loan-level price adjustment," which is a deduction from the proceeds of the loan. For example, a Fannie 97 conventional fixed-rate loan receiving an "approve/eligible" recommendation from DU requires a loan-level price adjustment of 1½ percent. Some lenders may also pass such lower loan sale prices on to borrowers in the form of either higher interest rates or up-front fees.

In addition to higher interest rates or up-front fees, borrowers will likely be required to pay mortgage insurance premiums, which also affect the affordability of loans. All loans that are sold to Fannie Mae that have an LTV greater than 80 percent, including Community Lending products, must include a credit enhancement, which is most commonly private mortgage insurance paid by the borrower.[29] Higher, more costly, levels of mortgage insurance are generally required for loans with higher LTV ratios. For example, Fannie Mae requires 20 percent mortgage insurance coverage for MyCommunityMortgage™ products with LTVs from 97-100 percent; 18 percent for LTVs from 95-97 percent; 16 percent for LTVs from 90-95 percent; 12 percent for LTVs from 85-90 percent; and 6 percent for LTVs from 80-85 percent. The difference in premium for higher LTVs is significant. According to one mortgage insurer, the premium for 18 percent mortgage insurance coverage on a

[27] Hybrid adjustables have fixed rates for some number of years, following which the loan converts to an adjustable rate loan for the remaining term. The hybrids allowed under these Fannie Mae programs are so-called 7/1 or 10/1 ARMs, with fixed rates for the first seven or ten years of the term before converting to one-year ARMs for the remaining life of the loan.

[28] From Fannie Mae's website, http://www.efanniemae.com/syndicated/documents/mbs/apeprices/public/30fraac.html.

[29] In addition to the use of mortgage insurance, the GSEs' Charter Acts also authorize the purchase of single-family conventional mortgages with LTVs over 80 percent if: (1) the seller retains a participation of not less than 10 per centum in the mortgage; or (2) the seller agrees to repurchase or replace the mortgage upon demand of the corporation in the event of default.

loan with an LTV above 95.0 percent is 0.55 percent.[30] In comparison, the premium for the required 6 percent mortgage insurance coverage for a loan with an LTV of 85 percent is .26 percent.[31]

Barriers Inadequately Addressed by Available Products

Although several barriers to Hispanic homeownership are addressed in Fannie Mae's Community Lending and Flex products, a few important barriers remain. These include requirements for legal residency in the United States, income documentation requirements, and asset documentation requirements.

First, although permanent and non-permanent resident aliens can qualify for a mortgage on the same terms as a U.S. citizen, undocumented residents cannot. Lenders must represent and warrant to Fannie Mae that a borrower is residing in the country legally for the borrower to qualify for a mortgage. As noted above, a sizeable number of Hispanics reside in the country illegally and therefore do not have Social Security numbers, but do have income tax identification numbers. Although some lenders are originating mortgages to borrowers on the basis of ITINs, there is essentially no secondary market outlet for these loans because they cannot be purchased by Fannie Mae (or, as discussed below, by Freddie Mac or FHA).

Second, some Hispanic borrowers, particularly those who are paid in cash, may have difficulty meeting the income and employment documentation requirements. Borrowers must document their employment for two years, although borrowers with a shorter work history than this (but no less than 12 months) may also be considered. The lender must consider previous employment gaps that are likely to recur and that affect the stability of income. Income received in cash is not considered an acceptable income source, so borrowers paid in cash are not likely to meet the total debt-to-income requirement.

Even for Hispanics who are not paid in cash, without a Spanish-speaking staff member, some lenders may have difficulty obtaining telephone verification of employment. In addition, employers of seasonal workers may be difficult to reach for verification during the off-season. Last, it is not clear how lenders treat applicants who experience gaps in employment because of lengthy return visits to their native country. These employment gaps likely increase the perception of the borrower as having unstable income.

Third, cash from savings clubs is not specifically identified in Fannie Mae's underwriting guidelines as an acceptable source of funds for the downpayment and closing costs. Although a Fannie Mae staff member suggested that this flexibility might be available to some lenders through their negotiated agreements, the ability to accept cash from savings clubs appears to be limited. For Hispanics who are uncomfortable with using banks or other formal financial institutions, savings clubs may be their primary method of accumulating cash for a home purchase. The lack of acceptability of this source of funds may be an important barrier for these Hispanics.

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30 This translates to approximately $1100 annually on a $200,000 mortgage. Premium on a fixed-rate from PMI Mortgage Insurance Company, effective February 2006.

31 Approximately $520 annually on a $200,000 mortgage. Premium on a fixed-rate from PMI Mortgage Insurance Company, effective February 2006.

Implementation and Application of Underwriting Guidelines by Lenders

Lenders are required to follow Fannie Mae's underwriting guidelines in order to sell their loans to the GSE, although there is slightly more room for lender discretion for manually underwritten loans than for those underwritten through Fannie Mae's automated underwriting system, Desktop Underwriter®. All applications that rely on non-traditional credit reports are underwritten manually, and Community Lending products are more likely to be manually underwritten than standard products.

Fannie Mae staff interviewed for this report[32] acknowledged that Community Lending products require more effort to underwrite than standard products, but said that lenders do offer the products to their clients. They noted that one tool offered by Fannie Mae, Home Counselor Online, walks borrowers and counselors through the process of developing a non-traditional credit history to streamline the underwriting process for lenders as much as possible.

[32] Wendy Wood, Director of Community Lending, and Anna Alvarez-Boyd, Director of Community Lending, telephone interview conducted October 19, 2004.

Chapter Four
Freddie Mac's Underwriting Guidelines

Freddie Mac's products include both standard mortgage products and those targeted to particular populations. Similar to Fannie Mae's products, some Freddie Mac products that target particular populations are limited to specific geographic areas or to borrowers with incomes below the area median income. This section reviews underwriting guidelines for both types of Freddie Mac products to examine how they address barriers that may limit Hispanics' access to mortgage financing. The review focuses first on aspects of standard underwriting guidelines that facilitate homeownership for Hispanics by providing some flexibility, and then turns to a review of Freddie Mac's special affordable lending products. The section concludes with a discussion of what is known about how lenders implement the written underwriting guidelines.

Standard Underwriting Guidelines

Freddie Mac's standard underwriting guidelines offer flexibility in four main areas in which flexibility has not typically been available for conventional mortgages. These are discussed in turn below.

U.S. Citizenship

Neither citizenship nor permanent residence in the United States is required for a mortgage. According to Freddie Mac's underwriting guide: "A non-U.S. citizen who is lawfully residing in the U.S. as a permanent or nonpermanent resident alien is eligible for a mortgage on the same terms as a U.S. citizen." (Freddie Mac Single-Family Seller/Servicer Guide, Volume I, Chapter 22.10.1.) A Social Security number is not required for mortgage approval, but the borrower must be a legal resident of the United States.

Credit History

Freddie Mac's standard underwriting guidelines do not require traditional credit reports to evaluate credit history. However, the guidelines require the use of a minimum number of credit references to properly assess credit history, whether or not these references appear on the borrower's credit report. The minimum number of credit references must include at least three tradelines (accounts with credit granting firms such as credit cards or loans), or four noncredit payment references that have existed for at least 12 months (such as rent, utilities, or insurance[33]), or a total of four tradelines and noncredit payment references. Credit history from another country may also be used to supplement U.S. credit history, as long as the required minimum number of credit references has been established in the U.S. Although Freddie Mac does not require credit scores, low credit scores can affect loan pricing, as discussed below.

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[33] A savings history of at least 12 months may also be used if it shows periodic deposits and a growing balance.

Documenting Assets

Some flexibility in the source of downpayment funds is provided. Related people living together can pool funds for use toward the downpayment and closing costs, as long as: they have been living together for the past 12 months; plan to continue living together in the new residence;[34] and the borrower attests that the funds are not borrowed. In addition, deposits with a Community Savings System or savings club are acceptable sources of cash as long as the borrower's deposits are documented.

Employment History

The applicant's length of employment in a given line of work is not a factor in Freddie Mac's underwriting guidelines. Freddie Mac's underwriting guidelines focus on the stability of income rather than on the source of income. This emphasis allows borrowers who frequently change jobs to qualify for a loan. In addition, the guidelines treat income from part-time and multiple jobs the same as full-time employment income, as long as the income can be reasonably expected to continue for at least three years. Income received in cash is not included in the calculation of the borrower's stable income.

Barriers Inadequately Addressed by Available Products

Despite the flexibilities in Freddie Mac's standard underwriting guidelines, there are other important provisions that potentially limit the ability of Hispanic borrowers to qualify for a loan. For example, the guidelines do not consider cash-on-hand as an acceptable source of funds for downpayment and closing costs. In addition, the relatively low housing expense-to-income (25-28 percent) and total debt-to-income ratios (33-36 percent) may also prevent low- and moderate-income Hispanic households and households in high-cost housing markets from qualifying for a loan. As described in Cortes *et al*.,[35] Hispanics are more likely to be low- and moderate-income households than their non-Hispanic counterparts, and they disproportionately reside in metropolitan areas and in central cities with high housing costs. Thus, they are disproportionately affected by the qualifying ratios required in Freddie Mac's standard products.

In addition to the qualifying ratios, requirements related to income from boarders may be a barrier to mortgage qualification for Hispanics. Income from boarders is counted as qualifying income only for disabled borrowers and only if the boarder income comes from a live-in aide, although income from other boarders (such as family members) can be used as a compensating factor for exceeding the qualifying income ratios.[36] Some of these potential barriers are addressed in Freddie Mac's Affordable Lending underwriting guidelines, which are discussed in the following section.

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[34] The borrower must attest that the related person intends to continue residing with the borrower for the foreseeable future. The affidavit does not need to be notarized or acknowledged, but must be kept in the mortgage file.

[35] Cortes, forthcoming, Abt Associates, Inc.: Cambridge, MA.

[36] For any manually underwritten mortgage for which either of the income ratio guidelines is exceeded, the loan seller must prepare and retain in the mortgage file a written explanation justifying its underwriting decision. In addition to rental income from a related boarder, conditions that can be used to justify qualifying ratios that exceed those specified in the underwriting guidelines include an energy efficient

Flexible Product Underwriting Guidelines

Several of the products offering additional flexibilities to low- and moderate-income and immigrant borrowers are considered affordable lending products, or “Affordable Gold.” Exhibit 3 presents information on three of these products, Affordable Gold 5, Affordable Gold 3/2, and Affordable Gold 97. The three products are similar across several dimensions and differ primarily on the amount and source of the required downpayment. Affordable Gold 5 requires a downpayment of 5 percent from the borrower’s funds; Affordable Gold 3/2 requires a downpayment of 3 percent from the borrower’s funds and 2 percent from another source; and Affordable Gold 97 requires a downpayment of 3 percent from the borrower’s funds.

Exhibit 4 summarizes underwriting guidelines for two additional loan products, Alt 97 and Freddie Mac 100. Because they do not offer the same flexibilities as the Affordable Gold products, these are not considered affordable lending products. Nonetheless, they offer other flexibilities not available in affordable lending products. Specifically, both products permit even lower downpayments, and Alt 97 allows “alternative” sources of funds for closing costs.

This section reviews the flexibilities available in these products that are not available in Freddie Mac’s standard products and that may address barriers to homeownership for Hispanics. Underwriting guidelines that are the same for these products and standard products, including documenting employment and U.S. citizenship, are not discussed separately in this section.

It is likely that Freddie Mac’s affordable lending and flexible products are not as widely available as their standard products. Some may require special approval or eligibility requirements that are in addition to Freddie Mac’s approval for selling standard products to the GSE. For example, in order to sell Freddie Mac 100 mortgages, the seller must also be approved as a servicer.[37] Information about the number of Freddie Mac sellers that are also approved servicers is not publicly available.

home, high levels of verifiable assets, and the borrower’s probability for increased earnings based on education or time employed in a profession. Conditions where exceeding the qualifying ratios would not be appropriate include those that would result in risk layering, such as an adjustable-rate mortgage or a marginal credit reputation.

37 *Freddie Mac Seller/Servicer Guide*, Chapter G33.1: Overview, updated February 7, 2001.

Exhibit 3
Freddie Mac Underwriting Guidelines for Affordable Products

	Affordable Gold 5	Affordable Gold 3/2	Affordable Gold 97
Occupancy/Property Type	one-unit (SF, condo, PUD) primary residence		
Loan Purpose	purchase or refinance (no cash-out)		
Downpayment	At least 5% from borrower funds	At least 5%, with at least 3% from borrower funds	At least 3% from borrower funds
Amortization Period	15, 20, or 30 years, fully amortizing		
Interest Rate	Fixed, no temporary subsidy buydown		
Ratios	No maximum housing expense-to-income, total debt-to-income is 38-40%.		
Maximum LTV/CLTV	95% LTV/105% TLTV (with Affordable Second)		97% LTV/105% TLTV (with Affordable Second); minimum 95.01% LTV
Credit Score	Credit scores recommended; otherwise non-credit payment references or non-traditional credit report permitted.		Credit scores required if available; otherwise non-credit payment references or non-traditional credit report permitted.
Financial Reserves	None required, but recommended	Minimum one month's borrower reserves	Minimum one month's borrower reserves
Income Limits	Borrower's income must be no more than 100 percent of AMI (with exceptions for high-cost areas); no income limits in a Concentrated Area.		
Income Documentation	Rental payments from a relative who resides with the borrower (but who is not obligated on the mortgage debt) may be considered as stable income if the relative has lived with and paid rent to the borrower for the past 12 months. Such rental income may account for no more than 30% of the total qualifying income for the mortgage. Evidence of rental payments must be provided.		
Asset Documentation	Cash-on-hand may be used as long as the LTV is 90%-95%; the borrower is a cash-basis individual but may be a limited user of credit (i.e., revolving or installment debt); lender documents the borrower's budget and cash receipts (6 months). Related people living together can pool funds for the downpayment. Funds on deposit with a Community Savings System are cash if documented. Funds above this amount are an unsecured loan.		Same as Affordable Gold 5 and Affordable Gold 3/2, but cash-on-hand may be used as long as the LTV is at least 90% and no more than 97%.
Homebuyer Education and Counseling	Homebuyer education and counseling is required for first-time homebuyers and borrowers making downpayments less than 5% and with less than 2 months financial reserves. Not required for refinance transactions.		Homebuyer education required.
Credit Enhancements	Standard mortgage insurance coverage requirements apply		35% mortgage insurance coverage required

Exhibit 4
Freddie Mac Underwriting Guidelines for Flexible Products

	Alt 97	Freddie Mac 100
Occupancy/Property Type	one-unit (SF, condo, PUD) primary residence	
Loan Purpose	purchase or refinance (no cash-out)	
Downpayment	No minimum downpayment from Borrower Funds; funds may be obtained from an unsecured loan, gift, or secondary financing (not HELOC).	Borrower must have 3% own funds in transaction for purchase (for closing costs, financing costs, prepaids/escrows); no borrower funds required for downpayment. No borrower funds required in transaction for refinance.
Amortization Period	15, 20, or 30 years, fully amortizing	
Interest Rate	Fixed, no temporary subsidy buydown	
Ratios	Guideline of 28% housing debt to income; 36% total debt to income.	Guideline of 28% housing debt to income; 41% total debt to income.
Maximum LTV/CLTV	97% LTV/100% TLTV (with Affordable Second); minimum 90% LTV	100% LTV/103% TLTV (with Affordable Second); minimum 97.01% LTV
Credit Score	Minimum indicator score of 700 for manually underwritten loans; no previous bankruptcy or foreclosure in the last 7 years. Non-traditional credit report not permitted.	Minimum indicator score of 700 for manually underwritten loans. Non-traditional credit report not permitted.
Financial Reserves	None required.	Minimum two month's borrower reserves
Income Limits	No income limit unless Affordable Seconds are used; then borrower's income must be no more than 100 percent of AMI (with exceptions for high-cost areas); no income limits in a Concentrated Area.	
Income Documentation	Rental payments on one-unit property not allowed in calculating income.	
Asset Documentation	Cash-on-hand not allowed. Related people living together can pool funds to be used toward a downpayment. Funds on deposit with a Community Savings System are cash if documented.	
Homebuyer Education and Counseling	Not required.	
Credit Enhancements	35% mortgage insurance coverage required	

Credit History

As noted above, Freddie Mac's standard products do not require borrowers to have a credit score to qualify. Lenders can assess borrowers' credit by analyzing directly all of the information in the credit report or can use non-traditional credit reports to assess credit quality for both standard and Affordable Gold products. Non-traditional credit reports are not allowed for use in underwriting Freddie Mac 100 and Alt 97 products. Both of these require that the lender use the borrowers' credit scores to identify the "indicator score," which must be at least 700 to be eligible for delivery to Freddie Mac if it is manually underwritten.[38,39]

Documenting Income

In addition to the flexibility allowed by the standard underwriting guidelines that do not impose requirements about stability of employment, Affordable Gold products allow rental income from boarders to be included in the borrower's qualifying income. Rental payments from a relative who resides with the borrower may be included in the borrower's qualifying income if the relative has lived with and paid rent to the borrower for the past 12 months. The rental income may account for no more than 30 percent of the total qualifying income for the mortgage, and documentation must be provided for the rental payments. Cancelled checks, money orders, and regular deposits into a savings account serve as adequate documentation. The income does not have to be reported on the borrower's tax return. Freddie Mac 100 and Alt 97 loan products do not allow income from boarders to be included in calculating income.

Documenting Assets

While Freddie Mac's standard underwriting guidelines do not allow cash-on-hand as a source of downpayments, this is an acceptable source of assets for Affordable Gold products as long as the loan-to-value (LTV) ratio is a minimum of 90 percent. In addition, the borrower must be considered a cash-basis individual – that is, someone who does not use checking, savings or other similar accounts and is a limited user of credit (i.e., revolving or installment debt). To document the borrower's ability to accumulate the cash, the borrower must provide six months of cash receipts, and the lender must provide a Monthly Budget and Residual Income Analysis that confirms that the borrower has sufficient residual income to have saved the downpayment.

Cash-on-hand is not an acceptable source of cash for Freddie Mac 100 and Alt 97. However, Alt 97 does allow alternative sources of assets to be used for the downpayment and closing costs, including an unsecured loan, a gift, or secondary financing. Freddie Mac 100 does not allow alternative sources of assets for closing costs, but does not require borrower funds for the downpayment. The borrower

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38 To identify the indicator score, the lender first identifies the appropriate "underwriting score" for each borrower on the mortgage. If a borrower has three FICO scores, the middle score is used; with only two FICO scores, the lower of the two scores is selected; and the underwriting score for a borrower with only one FICO score is the single FICO score. After the underwriting score is identified for each borrower, the preferred method for finding the indicator score across all borrowers is to take the lowest of the borrowers' underwriting scores. At least one borrower must have a usable FICO score.

39 "Affordable Gold At a Glance," Publication Number 258, September 2004, downloaded from: http://www.freddiemac.com/singlefamily/news/pdf/affgold.pdf

is required to contribute 3 percent of his or her own funds to the transaction, but these can be used for closing costs.

Debt Ratios

Qualifying ratios for Affordable Gold products are generally less restrictive than those for Freddie Mac's standard products. None of the Affordable Gold products summarized in Exhibit 3 require that a housing expense-to-income ratio be calculated, and the maximum total debt-to-income ratio (38-40 percent) is higher than the maximum allowed by standard guidelines. The higher ratio either allows borrowers to take on more housing debt than they would otherwise be able to or accommodates substantial non-housing debt.

Unlike the Affordable Gold products, both the Freddie Mac 100 and Alt 97 loan products require calculation of a housing expense-to-income ratio. The ratios allowed under Alt 97 guidelines (28 percent housing expense-to-income and 36 percent total debt-to-income) are at the high end of the range of ratios for Freddie Mac's standard products (25-28 percent housing expense-to-income and 33-36 percent total debt-to-income). Freddie Mac 100 allows higher levels of total debt, with a maximum total debt-to-income ratio of 41 percent, but the maximum housing expense-to-income ratio for Freddie Mac 100 is 28 percent.

Restrictions and Trade-offs Applied to Flexible Loans

Although Freddie Mac's flexible products help borrowers overcome a number of barriers to homeownership, there are some restrictions associated with this flexibility. There are four primary restrictions or trade-offs associated with Freddie Mac's Affordable Gold products. First, Affordable Gold products cannot be used for cash-out refinances or adjustable-rate mortgages, and they cannot be used to finance 2-4 unit properties. Second, as noted above, all of the Affordable Gold products reviewed in this section can be used only by borrowers below a certain income level or those buying in concentrated areas: central cities or census tracts with median income less than 80 percent of area median income. There are no income limits for borrowers within concentrated areas.

Third, first-time homebuyers using Affordable Gold 5 and Affordable Gold 3/2 loan products are required to participate in homebuyer education. These courses are required for all borrowers using the Affordable Gold 97 product. This requirement could pose a barrier to homeownership for Hispanics if Spanish-speaking education and counseling programs are not available widely or if this requirement leads to lender reluctance to promote the products. There is some evidence that these services have limited availability. For example, of the 42 HUD-approved housing counseling agencies in Arizona, services are offered in Spanish at only 15. Similarly, only four HUD-approved counseling agencies in Utah offer services in Spanish.

Fourth, although detailed pricing information is not available for Freddie Mac's loan products, lenders are required under some circumstances to pay a delivery fee for Affordable Gold products. A delivery fee is an up-front fee paid to Freddie Mac in exchange for Freddie Mac's purchase of the loan. Freddie Mac's delivery fees appear to range from 0.25 percent of the loan amount for adjustable rate and other types of mortgages to 3.25 percent for loans designated as more risky (referred to as "A-minus" loans). Affordable Gold 97, 3/2, and 5 all require a delivery fee if borrowers have FICO scores below a given threshold and if they are not underwritten through Loan

Prospector, Freddie Mac's automated underwriting system. For Affordable Gold 97, manually underwritten mortgages with FICO scores below 680 require a delivery fee; for Affordable Gold 3/2 and 5, manually underwritten mortgages with FICO scores below 660 require a delivery fee.[40] The delivery fee may lead either to higher up-front fees for the borrower or to a higher interest rate than a product that does not require a delivery fee.

In addition to higher interest rates or up-front fees, borrowers will likely be required to pay mortgage insurance premiums, which also affect the affordability of loans. As noted earlier, the GSEs' Charter Acts require a credit enhancement on all loans that have an LTV greater than 80 percent, including Affordable Gold products. By far the most common form of credit enhancement is mortgage insurance.[41] Higher, more costly, levels of mortgage insurance are generally required for loans with higher LTV ratios. Freddie Mac requires 35 percent mortgage insurance coverage for Affordable Gold 97, Affordable Gold Alt 97, and Freddie Mac 100 mortgages. Affordable Gold 5 and Affordable Gold 3/2 mortgages are subject to the same mortgage insurance coverage requirements as standard products: loans with LTV ratios greater than 90 percent must have 30 percent mortgage insurance coverage; loans with LTVs from 85 to 90 percent are required to have 25 percent coverage; and loans with LTVs from 80 to 85 percent are required to have 12 percent coverage. As noted in Chapter 3, the difference in insurance premiums associated with higher LTVs is significant. According to one mortgage insurer, the premium for 35 percent mortgage insurance coverage on a loan with an LTV above 95.0 percent is 0.96 percent.[42] In comparison, the premium for the required 25 percent mortgage insurance coverage for a loan with an LTV of 90 percent is .52 percent.[43]

The primary trade-off for allowing low or no downpayments and accepting alternative sources of cash in the Freddie Mac 100 and Alt 97 products is that high credit scores are required for each borrower on the mortgage. To the extent that Hispanics have good credit, documented through traditional credit reports, but low savings, these products can be useful. But these products obviously cannot help Hispanics who lack a strong, documented credit history.

Barriers Inadequately Addressed by Available Products

Freddie Mac's Affordable Gold, Alt 97, and Freddie Mac 100 products offer numerous flexibilities that deviate from standard underwriting guidelines and increase opportunities for Hispanic households to qualify for a home mortgage. Nonetheless, several important barriers to homeownership remain. First, although non-U.S. citizens can qualify for a mortgage, Hispanics who reside in the country illegally or are in the process of obtaining authorization for residency are ineligible for a mortgage.

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[40] Freddie Mac, "Single-Family Seller/Servicer Guide: Volume 1," page E19-1-6, 6/28/04.

[41] The GSEs' Charter Acts also allows for at least 10 percent seller participation in the ownership of the mortgage or agreements for the seller to repurchase or replace loans that default as means of mitigating the risk of loans with LTVs over 80 percent.

[42] This translates to approximately $1920 annually on a $200,000 mortgage. Premium on a fixed-rate from PMI Mortgage Insurance Company, effective February 2006.

[43] Approximately $1040 annually on a $200,000 mortgage. Premium on a fixed-rate from PMI Mortgage Insurance Company, effective February 2006.

Second, some Hispanic borrowers may have difficulty meeting Freddie Mac's income documentation requirements. Freddie Mac requires that the borrower's income be verified for the most recent two full years. Employment can be documented by the "Verification of Employment" form and the borrower's most recent pay stub or by a combination of W-2 forms from the two previous years, the most recent pay stub, and telephone verification with each employer. The borrower must explain gaps in employment that span 60 days or more.

These documentation requirements may significantly limit homeownership opportunities for Hispanic households. For example, applicants who are paid in cash may not receive a pay stub and may not fully report income to the IRS. Since many low-income Hispanics are migrant workers, day laborers, and other temporary workers who are paid in cash, a sizable segment of the Hispanic population will be unable to verify all employment income. Verification may be further complicated by a lack of Spanish-speaking lenders who are able to obtain telephone verification from Spanish-speaking employers and by difficulty reaching employers of seasonal workers during the off-season. It is also unclear how lenders treat applicants who experience gaps in employment because of lengthy return visits to their native country.

Lastly, the restrictions on use of cash-on-hand as a source of downpayment funds may also represent a serious barrier to homeownership. Recall that in order to use cash-on-hand, the borrower's ability to accumulate the cash must be documented with six months of cash receipts as well as a Monthly Budget and Residual Income Analysis completed by the lender that confirms that the borrower has sufficient residual income to have saved the downpayment. Applicants who do not routinely keep cash receipts and are unaware of this requirement may be forced to wait for six months while they accumulate cash receipts. A Freddie Mac employee noted that the company informs borrowers of this requirement as early in the homeownership process as possible, often during homeownership education.[44] Also, documenting cash-on-hand through the Monthly Budget and Residual Income Analysis form places a significant burden on lenders, which may discourage lenders from allowing applicants to use this flexibility.

Implementation and Application of Underwriting Guidelines by Lenders

The impact of Freddie Mac's underwriting guidelines on Hispanic homeownership opportunities is only partially understood through a review of the company's underwriting guidelines. How and whether lenders implement these guidelines and flexibilities locally will also affect the ability of Hispanic households to qualify for a loan.

A Freddie Mac employee stated that, although lenders comply with their underwriting guidelines, there are phases during the business cycle when lenders are more and less likely to use products that offer flexibility to the borrower but are more difficult to underwrite than Freddie Mac's standard products. Thus, lenders tend to use products that require complicated manual underwriting during

[44] Phone interview with Matt Miller, Freddie Mac, Housing and Community Investments, October 4, 2004.

periods when the overall level of loan applications is down, such as interest rate environments when refinancing is not as attractive.[45]

Underwriting the affordable lending products can be more time consuming for several reasons. For example, non-traditional credit is more difficult to document than a FICO score, and income from multiple sources is more effort to verify than income from a single source.[46] In addition, staff from Freddie Mac noted that the manual underwriting required to complete these Affordable Lending loan products leads to a higher likelihood of errors that might be uncovered during a post-purchase review and require the seller to repurchase the loan. The higher likelihood of errors may discourage lenders' use of these products. In addition, the widespread use of automated underwriting has led lenders to retain fewer experienced underwriters on staff. As a result, there are fewer people with the necessary skills to perform the level of manual underwriting required by these products.

[45] Ibid.

[46] Ibid.

Chapter Five
FHA's Underwriting Guidelines

FHA has long been a source of relatively low downpayment loans for low- and moderate-income borrowers. In FHA's 2003 fiscal year, for example, 79.2 percent of purchase loan endorsements were for loans to first-time homebuyers, and 37.4 percent were for minority borrowers.[47] In comparison, about 40 percent of all buyers in 2002 were first-time homebuyers,[48] and 30 percent of conventional prime purchase loans were to minorities in 2001.[49] FHA offers fixed- and adjustable-rate mortgages for purchase and refinance (including cash-out refinance), all of which are underwritten using essentially the same guidelines. Although FHA does not offer products specifically designed to target immigrants or Hispanics, their products include some flexibilities that address obstacles to homeownership for Hispanics.

Flexibilities that Address Barriers to Homeownership for Hispanics

FHA's underwriting guidelines offer several flexibilities in the areas of credit history, documenting income and employment history, documenting assets, and citizenship that address some barriers to homeownership for Hispanics. A summary of key aspects of FHA's underwriting guidelines is provided in Exhibit 5.

Credit History

FHA specifically instructs lenders not to use the lack of a traditional credit history as a basis for rejecting a loan. For borrowers lacking a traditional credit history, lenders are to use non-traditional credit reports, or to develop a credit history for the borrower using rent and utility payments and payments on installment and revolving accounts.

Income and Employment Documentation

FHA does not impose a minimum length of time a borrower must have held a position of primary employment to be eligible for a loan. Part-time and employment income from a second job may be used in qualifying the borrower, if the borrower can document that he or she has held the job uninterrupted for the last two years. Seasonal income is considered uninterrupted if there is documentation that the borrower expects to be rehired during the next season.

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[47] "FHA Outlook: Single Family Operations, August 1-15, 2004," Department of Housing and Urban Development, Housing – Deputy Assistant Secretary for Finance and Budget, Office of Evaluation. Downloaded from: http://www.hud.gov/offices/hsg/comp/rpts/ooe/olcurr.pdf on September 23, 2004.

[48] Bishop, Paul, Thomas Beers, Shonda Hightower, Kate Anderson, "The 2003 National Association of Realtors Profile of Home Buyers and Sellers," The National Association of Realtors Research Division, Chicago, IL.

[49] "State of the Nation's Housing," Joint Center for Housing Studies, Harvard University, 2004, p. 36.

Exhibit 5
FHA Single Family Underwriting Guidelines

	Single Family
Occupancy	Primary residence; secondary residence or investment property permitted in limited circumstances with approval from HOC
Property Type	1-4 unit detached or semidetached dwellings, townhouses or row houses, units in FHA-approved condo projects
Loan Purpose	Purchase, refinance, and cash-out refinance
Downpayment	3% minimum borrower investment
Amortization Period	Up to 30 years for FRM, 30 years for ARM, fully amortizing
Interest Rate	Fixed or ARM; temporary interest-rate buydowns allowed on purchase FRMs
Ratios	29%/41%
Maximum LTV/CLTV	98.75% for purchase loans; 85% CLTV for cash-out refinances
Credit Score	None specified
Financial Reserves	None specified, but can be used as compensating factor for exceeding ratios
Income Limits	None
Homebuyer Education and Counseling	Not required
Credit Enhancements	FHA provides full insurance coverage; mortgage insurance premiums depend on LTV and loan type

Rental income earned from boarders in a single-family property may be used in qualifying the borrower if the boarders are related to the borrower. The income must be shown on a borrower's tax returns to be considered "effective income;" otherwise it may be considered a compensating factor only. Compensating factors are financial strengths that are used to offset a weakness of an application. For example, if the rental income cannot be included in effective income because it is not shown on the borrower's tax returns, the borrower will have a higher housing debt-to-income ratio than would otherwise be the case. One of the permissible compensating factors for exceeding FHA's 29 percent housing expense-to-income ratio (discussed below) is receipt of documented income not included in effective income but affecting directly the borrower's ability to pay the mortgage. In general, lenders exercise some degree of judgment in what constitutes a sufficiently significant strength to compensate for a weakness.

Documenting Assets

Both cash accumulated through savings clubs and cash saved at home can be considered acceptable sources of funds to close the mortgage if they are sufficiently documented. For a savings club, borrowers must be able to document the accumulation of assets with the club based on account ledgers, receipts from the club, verification from the club treasurer, and identification of the club. It must also have been reasonable for the borrower to have saved the amount of money claimed, based on a review of the borrower's income and expenses. Similarly, borrowers who have saved cash at home must be able to provide evidence of the ability to accumulate the savings. In addition, the money must be verified by deposit in a financial institution or an escrow account.

U.S. Citizenship

Citizenship in the United States is not required for eligibility for FHA loans. Loans can be made to lawful permanent resident aliens; nonpermanent resident aliens are eligible provided they have a valid Social Security number and are eligible to work in the U.S. In addition, the lender must determine the likelihood that borrowers' authorization for temporary residency status will be renewed.

Downpayment

The downpayment required on FHA loans is relatively low. For a principal residence, FHA requires borrowers to invest a minimum of 3 percent of the sales price, but since closing costs can be financed by the mortgage, the LTV can exceed 97 percent. There are, however, limits on the total LTV that vary with the appraised value and sales price, whether the property is located in a state with high closing costs or low closing costs, and whether the property is newly constructed. The LTV ranges from a high of 98.75 percent for properties with sales prices of less than $50,000 to a low of 97.15 percent for properties with sales prices greater than $125,000 and located in states with low closing costs.

Barriers Inadequately Addressed by Available Products

FHA's underwriting guidelines offer relatively low downpayments, allow the use of non-traditional means of evaluating credit, allow the use of cash-on-hand and savings clubs, and allow income from rent paid by boarders to be included in income, all of which address barriers for Hispanics seeking homeownership. However, several important obstacles remain.

Income and Employment Documentation

While there is no minimum length of time that borrowers must have held their primary job, FHA requires that the borrower's employment be verified for the most recent two full years. Employment for two years can be documented through either a "Verification of Employment" form and the borrower's most recent pay stub or a combination of W-2 forms from the two previous years, the most recent pay stub, and telephone verification with each employer. Any gaps in employment spanning one month or more must be explained.

These documentation requirements may present obstacles for several reasons. Borrowers who are paid in cash are unlikely to receive a pay stub and may not fully report income to the IRS. Without a Spanish-speaking staff member, some lenders may have difficulty obtaining telephone verification from Spanish-speaking employers. In addition, employers of seasonal workers may be difficult to reach for verification during the off-season. Last, it is not clear how lenders treat applicants who experience gaps in employment because of lengthy return visits to their native country.

Although income from related boarders is an important flexibility in FHA's underwriting guidelines, this income may also be difficult for borrowers to document. As noted above, consideration of this rental income (other than as a compensating factor) must be documented by tax returns. Given the likely informal and cash-oriented nature of many of these arrangements, it seems likely that many Hispanic applicants would not have reported this income on tax returns. Even if used only as a compensating factor, this income must be documented. Although acceptable documentation is not specified, underwriting guidelines from other institutions require cancelled checks. For households that do not use traditional financial institutions, this documentation requirement will remain an obstacle.

Documenting Assets

While cash accumulated through savings clubs is an acceptable sources of funds, the documentation requirements are substantial. In practice, lenders may find income from this source too difficult to verify.

Citizenship

Although non-U.S. citizens can qualify for an FHA mortgage, Hispanics who are working in the country illegally or who may be in the process of obtaining authorization for residency are ineligible. Borrowers must have valid Social Security numbers; loans cannot be made using ITINs.

Housing expense-to-income ratio

The 29 percent housing expense-to-income ratio is also likely to be an important barrier to Hispanic households with low or moderate incomes, as well as those living in expensive housing markets. According to FHA underwriting guidelines, this ratio can be exceeded only with documentation of significant compensating factors. Some of these are:

- Demonstrated ability to make housing payments equal to or greater than those proposed under the new mortgage over the last 12-24 months;
- Cash reserves of 3 months or more after closing;
- A downpayment of 10 percent or more; and
- Potential for increased earnings as a result of job training or education.[50]

[50] FHA underwriting guidelines, 4155.1 REV-5, Chapter 2-12, Debt-to-Income Ratios, 10/03.

As discussed above, the focus of both Fannie Mae and Freddie Mac affordable lending products is on the total debt-to-income ratio, which provides the flexibility for borrowers who have little non-housing debt to assume more housing debt. Low levels of non-housing debt may be common for Hispanic households who are recent immigrants, many of whom dislike being in debt to anyone other than relatives.[51]

[51] Schoenholtz, Andrew I., and Kristin Stanton, "Reaching the Immigrant Market: Creating Homeownership Opportunities for New Americans," Fannie Mae Foundation, Washington, DC, 2001, p. 48.

Chapter Six
GMAC-RFC's Underwriting Guidelines

GMAC Residential Funding, part of GMAC-RFC, is a large mortgage conduit and leading issuer of non-agency prime mortgage-backed securities (MBS), Alt-A MBS, and subprime mortgage related asset-backed securities (ABS). GMAC-RFC specializes primarily in nonconforming mortgage products, including jumbo A loans, Alt-A and subprime loans, home equity loans, and 125 percent combined loan-to-value (CLTV) loans.

Although GMAC Residential Funding does not currently offer products designed specifically to address the needs of Hispanic borrowers, its subprime products include options for lower documentation requirements for income, employment, and assets than those typically available through prime lenders. These flexibilities address some of the key barriers faced by Hispanic borrowers.

AlterNet/Credit Gap Overview

The products reviewed in this section are AlterNet, GMAC Residential Funding's subprime product, and Credit Gap. AlterNet comprises a range of "credit grades" with underwriting guidelines that differ in many respects across these grades, so each credit grade can be viewed as a subset of AlterNet. The credit grades are, in order of credit quality: Ax, Am, B, B (1x60), C, and Cm. Credit Gap (credit grade A4) is intended for borrowers whose previous mortgage history fits "A" standards but are considered non-conforming because of credit score, debt-to-income ratio, bankruptcy, or foreclosure. A summary of some underwriting guidelines for AlterNet/Credit Gap products is presented in Exhibit 6.

Underwriting Guidelines that Facilitate or Impede Homeownership for Hispanics

GMAC's subprime products' underwriting flexibilities are designed primarily for borrowers with imperfect credit and high debt levels. The products do not target first-time homebuyers or recent immigrants, although these groups can use them.

Exhibit 6
GMAC-RFC Underwriting Guidelines for AlterNet/Credit Gap

	A4 (CreditGap)	Ax	Am	B	B (1x60)	C	Cm
Occupancy	Primary residence, second/vacation home, or investment property						
Property Type	1-4 unit, single-family detached, semi-detached or attached residential; condo; modular home, manufactured home (unless purchased from a manufactured home dealer); leasehold						
Loan Purpose	purchase, rate/term refinance, cash-out refinance, construction						
Downpayment	85%-95%, depending on doc type. At least 5% from borrower funds; a downpayment from gift funds is allowed for LTVs of 80% or less when no secondary financing exists	80%-90%, depending on doc type.		75%-85%, depending on doc type.	70%-80%, depending on doc type.	65%-75%, depending on doc type.	60%-70%, depending on doc type.
Interest Rate	Fixed, 1-year Treasury ARM, 6-month LIBOR ARM, 2-year/6-month LIBOR ARM, 3-year/6-month LIBOR ARM, 30/15 balloon						
Ratios	50% debt-to-income	50% debt-to-income, or 55% with an approved compensating factor.					
Credit Score	600	600	580	560	560	540	520
Housing Payment History	0x30 delinquency in past 12 months	1x30 delinquency in past 12 months. No rolling lates allowed. No more than 30 days down at closing.	2x30 mortgage/ rental delinquency in past 12 months. Rolling 30-day lates allowed. No more than 30 days down at closing.	30-day lates allowed. 1x60 non-rolling late allowed. No more than 30 days down at closing.	30-day lates allowed. 1x60 non-rolling late allowed. No more than 60 days down at closing.	30- and 60-day lates allowed. No more than 60 days down at closing.	30- and 60-day lates allowed. 1x90 non-rolling late allowed. No more than 90 days down at closing.
Foreclosure	None in past 3 years.			None in past 2 years.			None in past 1 year.
Credit Verification	Non-traditional credit not acceptable. Score must be based on minimum two-year credit history, at least five rated trade lines for first mortgage, and at least one trade reported in past six months.						
Financial Reserves	None required (can be used as compensating factor)						
Income Documentation	Income doc types: full income; lite income; fast income; and stated income (for wage earners only). All require 2 year history of employment in same business or line of work; "stated income" requires verbal verification of employment. Boarder income not allowed.	Income doc types: full income; lite income; and fast income. All require 2 year history of employment in same business or line of work. Boarder income not allowed.					
Asset Documentation	Most recent bank statement or Verification of Deposit required for verification of cash to close. Cash-on-hand not allowed. All income necessary to qualify for the loan must be derived from within the U.S.						

Credit History

To the extent that Hispanic households experience credit-related problems, products that allow borrowers with flawed credit histories access to credit help overcome an important obstacle to homeownership.[52] The minimum credit scores required for GMAC's lowest credit-grade products are quite low, at 520-560. Recent late housing payments (within the past 12 months) are allowed for all but grade A4, as are recent foreclosure and bankruptcy. However, scores must be based on a minimum of two years of credit history, and non-traditional credit is not acceptable, an important limitation for borrowers who have not been in the country long enough to establish credit or who have been reluctant to use traditional financial institutions.

The low minimum credit scores required likely come at the cost of a higher probability of serious delinquency and/or foreclosure. Although information on GMAC's delinquency and foreclosure rates is not available, subprime loans generally have higher foreclosure rates than FHA and prime loans. In the third quarter of 2005, for example, the seasonally adjusted percentage of new foreclosures was 0.18 percent for prime loans, 0.88 percent for FHA loans, and 1.39 percent for subprime loans.[53]

Documenting Income and Employment history

Four levels of income documentation are available in the AlterNet/Credit Gap products: Full, Lite, Fast, and Stated. All of these require a two-year history of employment and an expectation that income will continue for three years.

- Full documentation requires the most recent pay stub and W-2 forms from the most recent two years or written verification from the employer covering the most recent two years.
- Lite and Fast income documentation both require documentation only for the most recent 12 months. Lite income documentation is permitted only for borrowers who use only base income to qualify.[54] Fast income documentation can be used for borrowers using base income as well as commissions, overtime, and bonus income to qualify.
- Stated income requires only verbal verification of employment, with no verification of income, but is available only to wage earners with credit grade A4.

Seasonal unemployment compensation income can be considered if it is typical for the borrower's employment type.

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52 One study suggests that credit history is an important barrier to access to prime credit for Hispanics households: in 2001 a higher share of Hispanic renters (63 percent) had credit scores below 660 than either Black (54 percent) or white, non-Hispanic renters (35 percent). (See Raphael Bostic, Paul Calem, and Susan Wachter, "Hitting the Wall: Credit as an Impediment to Homeownership," working draft, November 2003.)

53 "Residential Mortgage Delinquencies Rise Due to Hurricane, Loans in Foreclosure Fall, According to MBA National Delinquency Survey," *Industry News*, American Land Title Association, December 15, 2005.

54 Base income excludes bonus, tips, overtime, and commission.

AlterNet/Credit Gap Full documentation is similar to that required by Fannie Mae and Freddie Mac. Stated income could be an important flexibility for Hispanic borrowers who are paid in cash and may not fully report income to the IRS.

Income earned from boarders is not allowed, and this is an important remaining barrier to homeownership in the underwriting guidelines for Hispanic households comprised of extended family members. Finally, all income necessary to qualify for the loan must be derived from within the U.S.

Documenting Assets

All AlterNet/Credit Gap credit grades require the most recent bank statement or a "Request for Verification of Deposit" completed by the financial institution to verify that the borrower has sufficient cash to close. Large recent deposits or newly opened accounts with large deposits must be explained, and the explanation must be documented. Cash-on-hand is not an allowable source of cash to close.

Citizenship and Residency Status

Non-U.S. citizens can qualify for a mortgage. However, non-permanent resident aliens are eligible only for primary residence or second/vacation homes, not for investment properties. In addition, non-permanent resident aliens are required to make larger downpayments than other borrowers (maximum LTVs are 10 percentage points below maximums shown in Exhibit 6), and no cash-out is permitted.

LTV Ratio

Most of the credit grades in AlterNet/Credit Gap are not low-downpayment products. Only Credit Gap, the highest credit grade, allows an LTV of up to 95 percent, for both Full and Lite documentation types. Fast documentation allows a maximum LTV of 90 percent, and Stated income requires an LTV of at most 85 percent. Thus, Hispanic borrowers who may benefit from the flexibilities of Stated income documentation will need a relatively large downpayment.

Other Underwriting Guidelines

In addition to flexible credit quality guidelines, AlterNet/Credit Gap requires no financial reserves, and debt-to-income ratios of 50 percent are allowed. No homebuyer education and counseling is required, which could be a benefit to Hispanic households if Spanish-speaking programs are not readily available. It could also be detrimental to Hispanic households if they do not have a good understanding of the loan product, the U.S. housing finance system, or their responsibilities under the new mortgage.

Trade-offs for Underwriting Flexibilities

Many of the flexibilities offered through AlterNet/Credit Gap in one underwriting guideline are associated with a tightened requirement in another guideline to compensate for the increased risk of the loan. The most important of these is evident in Exhibit 6: lower credit scores require a larger downpayment (lower LTV). Reduced levels of documentation also result in a lower maximum LTV.

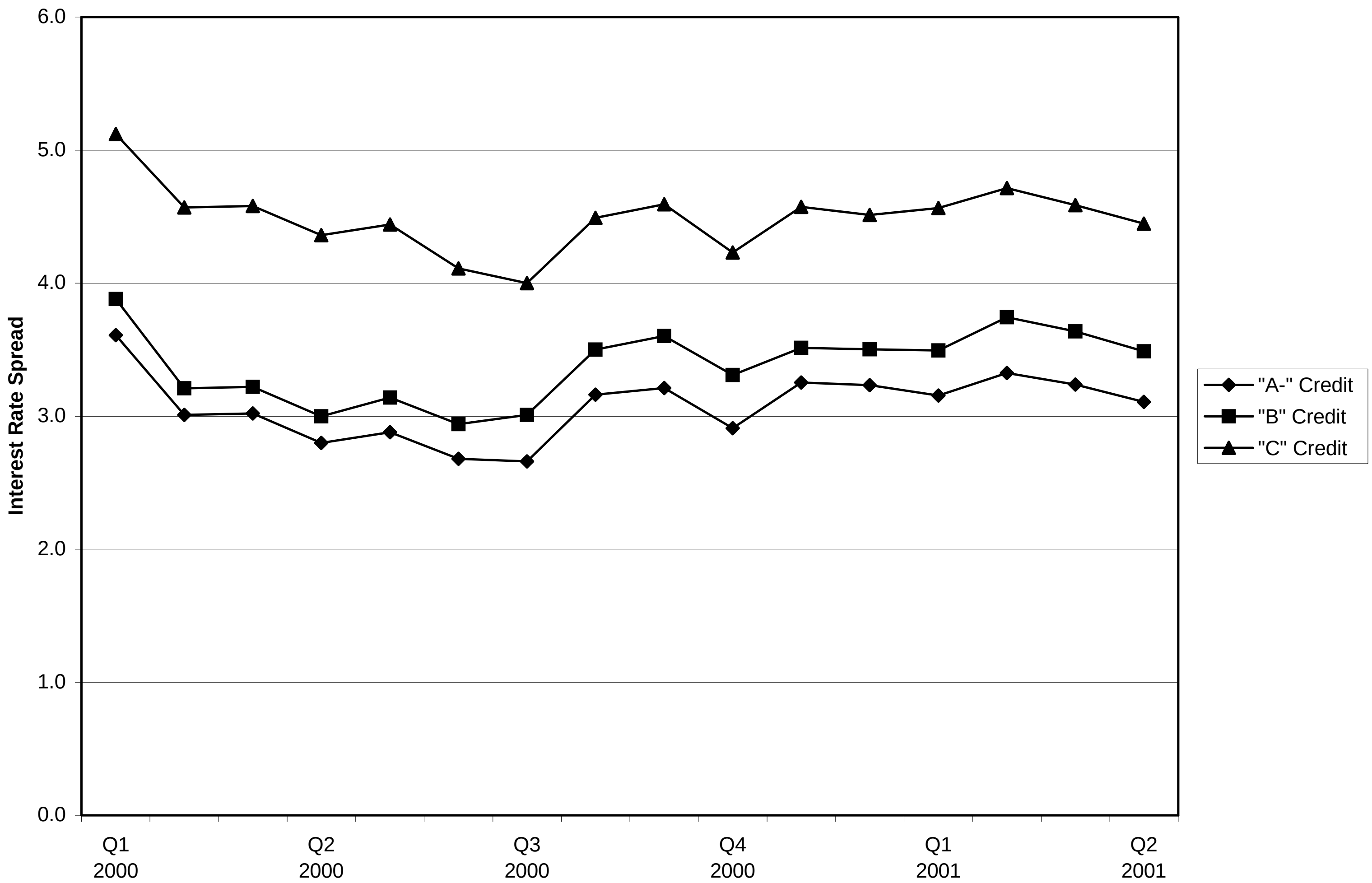
These trade-offs are important limitations to the potential benefits of the flexibilities for Hispanic households. As noted above, although Stated income documentation could be useful to Hispanic borrowers who are paid in cash, this level of documentation allows a maximum LTV of 85 percent. Hispanics making their first home purchase who could benefit from reduced documentation are likely to have difficulty accumulating a downpayment this large.

In addition, although pricing information is not available specifically for GMAC's products, subprime loans (A-minus, B, and C) generally carry much higher interest rates than prime loans.[55] For example, in the fourth quarter of 2001, interest rates on conventional 30-year fixed-rate mortgages were 6.5 percent compared with 10.1 percent for A-minus loans (Exhibit 7), a difference of 3.6 percentage points. Over the period shown in Exhibit 7, A-minus loans had rates 3.1 percentage points higher than conventional loans on average; B loans had rates 3.3 percentage points higher; and C loans had rates 4.3 percentage points higher. The difference between interest rates on A-minus loans and conventional loans was never smaller than 2.7 percentage points (in the second quarter of 2002).[56] Clearly, the flexibility of subprime products can be costly for borrowers.

55 Another factor that can affect pricing is whether or not the borrower buys mortgage insurance. Although mortgage insurance is not required, its absence almost certainly results in a higher interest rate.

56 "Inside B&C Lending," a publication of Inside Mortgage Finance, provides updated information on interest rates. Its January 20, 2006 issue reports 6.0% for a conventional 30-year, fixed-rate mortgage (FRM), compared with 8.2% for A-minus grade, 8.6% for B grade, and 9.3 percent for C grade subprime 30-year FRMs (page 10).

Exhibit 7
Interest Rate Spread for Subprime Loans
(Interest Rate Premium Compared to Conventional 30-Year Fixed Rate Mortgages)



Source: Top Subprime Mortgage Market Players and Key Subprime Data 2002, Inside Mortgage Finance, Bethesda, MD.

Chapter Seven
Summary and Conclusions

Recent studies have identified several underwriting guidelines as particular barriers to Hispanic homeownership: establishing a credit history; verifying income; documenting employment history; verifying assets; and meeting requirements regarding citizenship or residency status. Some of these barriers have been addressed recently by major participants in the mortgage market in their standard products. This is particularly true of FHA's standard product. Where barriers continue to exist, these are often removed in products targeted to low- and moderate-income borrowers. Subprime products also address some of the barriers to Hispanic homeownership.

The major barriers to homeownership for Hispanics identified in the literature, the currently available solutions, and continued challenges in overcoming the barriers are summarized in Exhibit 8.

Credit History

Fannie Mae, Freddie Mac, and FHA all have standard products that allow a borrower to be approved for a mortgage without a formal credit history with credit reporting agencies. All allow the use of non-traditional credit reports or a credit history compiled by the lender, as long as it includes a minimum number of credit references. Credit scores are required, however, for GMAC's subprime products and for products that allow a high degree of flexibility in other respects. For example, Fannie Mae's Flex 97 and Flex 100 allow a wide variety of sources of cash to be used for the downpayment and closing costs, but require traditional credit reports.

For Hispanics and other borrowers with low credit scores, FHA's standard product allows more flexibility than is typically available. For example, in January through June of 2000, the average FICO score for FHA purchase loans insured using a mortgage scorecard was about 630,[57] compared with the 660 minimum FICO score often required for prime mortgage approval. Targeted products offered by Fannie Mae and Freddie Mac also provide some options. For example, Fannie Mae's Community Lending products allow approval of borrowers with credit scores of 600 to 620. In addition, GMAC's subprime products allow credit scores of as low as 520, although this likely is associated with a higher interest rate.

Documenting Income and Employment History

Fannie Mae, Freddie Mac, and FHA also do not require two years of employment history for mortgage approval (one year is acceptable for Fannie Mae and Freddie Mac; FHA has no minimum requirement). In addition, frequent job changes are generally ignored as long as the borrower can

57 "FHA TOTAL Scorecard," presentation at MBA's National Technology Conference April 17 - 20, 2001, based on information collected from scorecards developed by third-party vendors and approved for use by the FHA. Obtained from: http://www.mortgagebankers.org/present/tech01/fha_scorce.pdf.

Exhibit 8
Summary of Barriers to Hispanic Homeownership

Barrier	Available Solutions	Continued Challenges
Lack of Formal Credit History or Poor Credit	• Underwriting generally accepts non-traditional credit • FHA and subprime accept lower credit scores	• Other underwriting flexibilities (primarily low downpayment) often require high credit score
Documenting Employment and Income	• Two year stable employment not required by all products • Some products accept boarder income • Some products permit non-traditional documentation and sources of income • Some products do not require verification of income	• Few products that allow income • Products not requiring income verification require relatively high credit scores and downpayments
Affordability	• Variety of low-downpayment products available • High total debt-to-income ratios allowed in some products • No maximum housing expense-to-income ratio for some products • Low/no financial reserves required for some products	• Some low-downpayment products require high credit scores
Documenting Assets	• Cash an acceptable source of funds for closing costs and downpayment if verified with receipts or budget and residual income analysis for some products • Related people living together can pool funds for closing costs and downpayment for some products • Savings accumulated through a savings club are an acceptable source of funds for closing costs and downpayment for some products	• Documentation requirements for cash-on-hand used to close and savings accumulated through a savings club are often cumbersome
Citizenship	• U.S. citizenship is not required for mortgage approval; permanent and nonpermanent resident aliens qualify for many products on the same terms as U.S. citizens	• Hispanics who reside in the country illegally or in the process of obtaining authorization for residency are ineligible for a mortgage

document that his or her income is stable. Although there is some flexibility in the length of employment history required for mortgage approval, documentation requirements remain a barrier, particularly for Hispanics. Some form of written documentation, such as paystubs and an employer-completed form or W-2 forms, is required.

With minor exceptions, income received in cash cannot be included as a primary or secondary source of income. This is true for standard products offered by FHA, Fannie Mae, and Freddie Mac, as well as the targeted products offered by Fannie Mae and Freddie Mac and the subprime products offered by GMAC. While Fannie Mae, Freddie Mac, and GMAC all have products that allow low or no income documentation, these allow less flexibility than standard and targeted products in other regards. For example, Freddie Mac's stated income product requires high credit scores, a large downpayment, and large cash reserves. In addition, although Freddie Mac's stated income product does not require W-2 forms, it requires IRS forms authorizing the release of tax information. This is also true for self-employed borrowers using GMAC's stated income product.

Widely available mortgage products allow rent paid by family members to be included in the borrower's income. FHA's standard product allows rental income from boarders in a one-unit property to be included in the borrower's qualifying income, if the boarders are related to the borrower and if the income is shown on the borrower's tax return. Some of Freddie Mac and Fannie Mae's targeted products allow rental income from boarders in a one-unit property to be included in the borrower's qualifying income. The income does not have to be included on the borrower's tax return, although documentation is required. For one of Fannie Mae's Community Lending products, MyCommunityMortgage, the boarder is not required to be related to the borrower.

Affordability

Hispanics are disproportionately in low-income and low-wealth households compared to non-Hispanics, so affordability may be the most important barrier to homeownership. FHA products, as well as products offered by Fannie Mae and Freddie Mac that are targeted to low- and moderate-income households, help to address this barrier. A variety of low-downpayment products are available, some requiring as little as $500 of the borrower's own funds. Flexibility in housing expense-to-income and total debt-to-income ratios available through Fannie Mae's Community Lending and Freddie Mac's Affordable Gold products, as well as GMAC's subprime products, also help to improve affordability. Some of Fannie Mae's products do not have maximum housing expense-to-income ratios at all. In addition, low or no financial reserves are required for some products. Some low-downpayment products, however, require relatively high credit scores.

Citizenship and Residency Status

U.S. citizenship is not required for mortgage approval for standard products by any of the financial institutions reviewed in this report. GMAC imposes some additional requirements for non-permanent resident aliens, however, including lower maximum LTVs and some product restrictions (for example, cash-out refinances are not permitted, nor are purchases of investment property).

However, legal residence in the U.S. is required for mortgage approval. Nationwide, there are only a handful of pilot programs to extend mortgage credit to borrowers who do not have valid Social

Security numbers. Given the number of undocumented immigrants in the country (an estimated 6 million), most of them Hispanic, this remains an important barrier to homeownership for Hispanics.

Documenting Assets

FHA's standard product allows both cash accumulated through savings clubs and cash saved at home to be considered acceptable sources of funds to close the mortgage if they are sufficiently documented. Targeted products offered by Fannie Mae and Freddie Mac also allow this flexibility. The documentation required to demonstrate that the borrower could have accumulated the assets over time, however, is substantial, and may discourage lenders from using this flexibility.

Some products also allow related people living together to pool funds for closing costs and downpayments, improving borrowers' ability to accumulate sufficient assets for a home purchase.

Some Barriers Remain in Available Products

As described above, many of the barriers to homeownership for Hispanics that recently existed in common underwriting guidelines have been addressed by some widely available standard products and by products targeted to particular populations. However, a few important obstacles remain in the form of individual underwriting guidelines.

The requirement that borrowers be legal residents of the U.S. is obviously an insurmountable obstacle for the undocumented immigrants in this country. A handful of lenders are experimenting to determine whether lack of legal residence is an acceptable risk in extending mortgage credit; however, lending to illegal residents also involves political issues that may be extremely difficult to resolve.

The lack of acceptability of cash income is also an important remaining underwriting obstacle. According to senior staff from Fannie Mae, some smaller community lenders have begun to experiment with approving mortgages that allow a limited share of the borrower's total income to be earned in cash. If these mortgages prove to be acceptable risks, the GSEs may eventually make similar allowances in future offerings of targeted products.

Last, although products that address barriers to homeownership for Hispanics exist, an important caveat is that it is not clear how widely available they are. While all FHA-approved lenders can offer the full range of FHA loan products, Fannie Mae and Freddie Mac's affordable lending products are offered only by a subset of their lenders. On the other hand, while subprime products are easily accessible, they typically come at the cost of higher interest rates.