



Scott Anderson On Mortgages



February, 2004

Tips on the Mortgage Business for Financial Managers, Investment Managers, and Financial Professionals

Anderson to Speak at FPA Meeting

Scott Anderson, publisher of *Scott Anderson on Mortgages* will be a guest speaker on *America's Funniest Home Mortgages* at the Orange County Chapter of the Financial Planning Association meeting on February 18, 2004 at 4 pm at the

On the ARMs of Bill Gross

On January 20, 2004, *The Orange County Register* reported that over 60% of the Orange County home purchases in November 2003 were made with ARM's. ARM's are adjustable rate mortgages whose interest rate are fixed for a certain length of time and then adjust monthly, semi annually or annually based on an index and fixed margin for the remainder of the mortgage life. The adjustments are generally subject to caps. Since the fixed period of time is less than the entire life of the loan, the lender is taking less interest rate risk and thus typically offers a lower interest rate during the fixed interest rate period.

In the same article, the *Register* notes "Bill Gross, chief investment wizard at the PIMCO bond shop in Newport Beach, admits that fixed-rate mortgages near 40-year lows appear at first glance to be awfully attractive. But he says choosing an adjustable loan-an against-the-grain gamble - gets a borrower a lower starting rate which should prove to be a sensible bargain.

"Gross believes the economic recovery won't be as strong as many people think. Such weakness will keep any future jump in interest rates modest, thus allowing an adjustable-mortgage holder to keep much of the upfront savings generated by the low starting rates."

The *Register* then quotes Gross as saying "If you can live with the volatility, you'll have more in the bank over the long term."

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"Your Papers Are In Order?"

How does a lender know that you are who you say you are?

The last issue looked at three general classes of loan documentation:

- full documentation where the borrower can show 2 years of employment history;
- stated income where the borrower for the last 2 years has been self employed or has filed tax returns which do not adequately show the true economic income; and
- "no doc", "NINA", and "no ratio" where the income documentation is not available for various reasons.

The documentation for each type of loan is different. The general rule is that the more documentation, the lower the lenders risk, the lower the mortgage rate.

Full Documentation Loans Status

Documenting a "full doc" loan generally calls for copies of IRS W-2 statements for the two prior years and pay check stubs covering the last 30 days. As the recent advances in computer graphics have made forging these kinds of documents easier, it is not unusual to require copies of all pages of the appropriate signed Federal tax returns as back up to these documents. California tax returns get no respect.

Prior to funding the loan the lender will typically do a verbal verification of employment as one last check on the full time employment status of the borrower.

Retired borrowers receiving Social Security or other third party retirement income could also qualify for Finally, on a full documentation loan, the loan officer will want to verify that there is sufficient assets in place for the down payment and the closing costs.

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“Your Papers Are In Order?”

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Different lenders have different sensitivities to the “seasoning” of these assets—in other words, where did they come from? Are they truly savings or the equity from the sale of another residence? Gifts?...from whom? Or, do the assets represent hidden borrowings from friends or relatives that are not reflected on the loan application. The US Department of Justice is also sensitive to the source of large down payments which have sometimes been associated with money laundering activities.

“What Number Do You Have in Mind?”

Stated income documentation loans carry a slightly higher interest rate than full documentation loans because there is no verification offered for the income. This type of loan is for self-employed borrowers whose income is self-generated and whose tax returns may not accurately reflect the true economic income of the borrower due to heavy tax write offs. A self employed individual may mean a sole proprietor (filing tax Schedule C), an individual actually employed in their (licensed) profession, or a borrower who owns more than 25% of his employer.

This is not a loophole for the borrower to claim instant millionaire status since the income stated must be reasonable for the borrower’s occupation shown on the application. Salary.com is a good reality check to test and support claimed income. Moreover, the ethical loan officer will not let a stated income borrower state income which the loan officer knows will simply result in the borrower strangling on the inappropriate loan payments.

The lender will want to see proof that the self-employed borrower’s business has been in existence for two years or more. The loan officer will seek to verify through business licenses or sales licenses that the business is real. Expect the loan officer or the lender to look up the business in an on-line yellow pages.

Self-employed borrowers can also be employed by their profession if they have a license. The obvious licensed people are doctors, lawyers, CPA’s, CFP’s, registered professional engineers, and real estate people but licensed professionals can include anyone who has a license from the California Department of Consumer Affairs or a national licensing board. Simple membership in a professional society is not sufficient since many professional societies allow associate and other types of memberships for vendors, educators, and related industry professionals.

Stated income loans also require that sufficient assets be available for the down payment, closing costs, and three to six months PITI (“principal, interest, (property) taxes, and (fire) insurance”). Some lenders simply require these amounts to be stated. Other lenders require the assets to be verified by the loan officer with the same concerns expressed above for the validity of the assets.

“Yes, We Have No Bananas”

There is a final group of borrowers who do not want to or cannot state income for various reasons who can qualify for a “no doc”, NINA (no income, no assets) or “no ratio” (i.e. no income so no income-to-debt-service (DTI) ratio can be calculated) loan. The borrower may be in transition, have less than 2 years of self-employment status, or have passive income sources such as defined contribution benefit plan distributions. Assets to support the purchase may be stated or verified depending on the lender’s requirements. The loan rates are higher than stated income and appropriate down payments are required but such loans exist. Credit score requirements have some flexibility since the lender is relying on the borrower’s equity in the property purchased to ensure timely debt service.

Fine Print and Disclaimer

Scott Anderson completed the Personal Financial Planning certification program at UCI and is a loan officer in the Private Client Group at Platinum Properties in Newport Beach and Irvine, CA. Scott Anderson is a member of the Financial Planning Association and the Financial Executives Institute, is an associate member of the California Society of CPAs, and serves as Adjunct Professor in Accounting in the MBA program at Pepperdine University and the Executive MBA program at Chapman University. The opinions in this newsletter are those of Scott Anderson who is solely responsible for its content. This newsletter is for educational purposes only for financial, investment, and financial planning professionals and should not be construed as providing advice to readers.

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