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Getting back to the basics: Understanding the mortgage industry better

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My five year old son recently joined a flag-football league and I feel lucky to be afforded the opportunity to coach his team. Before the first practice, the commissioner of the league had a coaches meeting to explain the rules for the league. He warned us not to have visions of running a high powered NFL offense, but rather a simple basic offense so that the kids would learn the game of football. During practice, we taught the kids the positions, how to line-up and how to stretch. We also practiced fundamental football technique drills and introduced two plays: run right and run left. On the eve of our first game, I am impressed with how well these 5 and 6 year olds can execute these two basic plays and their increased knowledge about the game of football is equally as impressive and rewarding.

I couldn't resist in making the same "basics" correlation to the mortgage industry. The media has thoroughly covered the demise of various lenders. Dozens of mortgage lenders have either declared bankruptcy in the past year or exited the business by shutting down troubled lending divisions, mostly in the subprime market (high risk or poor credit borrowers). At the top of the list is Irvine, California-based New Century Financial, a subprime specialist which originated over $50 billion in loans and employed more than 7,000 individuals in 2006. However, the bankruptcy of Long Island, New York-based American Home Mortgage, an Alternative A (Alt-A) specialist which also originated over $50 billion in loans and employed more than 7,000 individuals in 2006, was harder to predict. America Home originated loans primarily to low risk or good credit borrowers that generally conform to "prime or A" credit guidelines but with limited documentation on income and/or high loan to value (LTV) ratios.

Alt-A loans with risk increasing features such as higher LTVs, interest-only options, adjustable rates, negative amortization and limited check on borrower's assets have increased tremendously over the last few years. Investors' fears that the default rates in these Alt-A products would be greater than prior years were substantiated by Countrywide, the largest U.S. mortgage lender and Standard & Poor's in their recent publication on Alt A - Residential Mortgage Backed Securities. Therefore, the demand for Alt A products by investors has become non-existent and lenders such as American Home couldn't survive without selling such loans.

How did this happen? A high credit or FICO score (see my article in this publication dated 9/13/05) became false assurance that the borrower would always meet their housing and other debt obligations and the borrower's actual ability to meet such debt obligations based on their income level was taken for granted.

What can we do as mortgage professionals? Go back to the basics:

* Meet in person and have a conversation with the borrower. A good interviewer will put the prospective candidate at ease and the borrower will feel more inclined to divulge information if they

are comfortable with you.
* Understand the borrower's current stage in life. For example, a recently married couple may be looking to have a baby which may limit their gross income level in the near future.
* Explain to the borrowers that the "standard" debt to income ratio (DTI) is between 40%-45%.
* Explain what the other 55%-60% will cover (savings, kids, utilities, taxes, meals, entertainment, etc.). I often utilize a pie chart and it seems to be is very helpful to my clients.
* Ascertain the borrower's debt comfort level based on their gross income.
* Make sure that you are comfortable with the borrower's income based on their profession if proof of income such as W-2s, pay-stubs is not provided.

Taking an interest in the borrower's financial situation will assure repeat business and referrals. Mortgage clients are time sensitive and "tech savvy" and the Alt A loan products are still a good option for high credit individuals but only if other risk increasing elements are limited. Stronger Alt A guidelines will eventually re-establish the demand for this loan product by investors.

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