

Consumer Guide: Understanding & Overcoming a Loan Denial



CREDIT.ORG

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About Credit.org



Credit.org is a non-profit agency formed in 1974

Our mission is simple, yet vital: Improve the financial well-being of individuals and families by providing quality financial education and counseling. We offer personal assistance with money, credit, and debt management through educational programs and confidential counseling.



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Our Services

Financial Education Programs

We offer seminars, workshops, and educational materials on topics such as budgeting and money management, identity theft, and understanding credit.

Debt Management Programs

If you choose this option, we can work with your creditors to reduce costs and repay debt through one monthly payment.

Confidential Debt Counseling

Our certified consumer credit counselors will discuss your financial situation with you, help you understand what may cause financial stress, and help you create a personalized budget, an action plan and give you options to help manage your finances more effectively.

Credit Report Review

Our certified coaches work with you to break down your credit report, answer questions, and give guidance for improving your credit score over time.

Housing Counseling

We are a HUD-approved comprehensive housing counseling agency. We provide homebuyer education seminars, mortgage coaching, foreclosure prevention assistance, landlord/ tenant counseling, post homebuyer education and reverse mortgage coaching (please call ahead for reverse mortgage appointments).

Bankruptcy Pre-petition Credit Counseling

We provide counseling (and a certificate of completion as mandated by the bankruptcy reform law) for those considering bankruptcy. We also provide financial education (and a certificate of completion as mandated by the bankruptcy reform law) for those completing their bankruptcy discharge.

The Top 10 Reasons Loans are Denied

Every day, thousands of people are denied when they apply for home loans. While the law requires credit bureaus to provide a free credit report & score to the borrower if the loan is denied because of something in the credit report, some borrowers are often still left in the dark about why the loan application was denied.

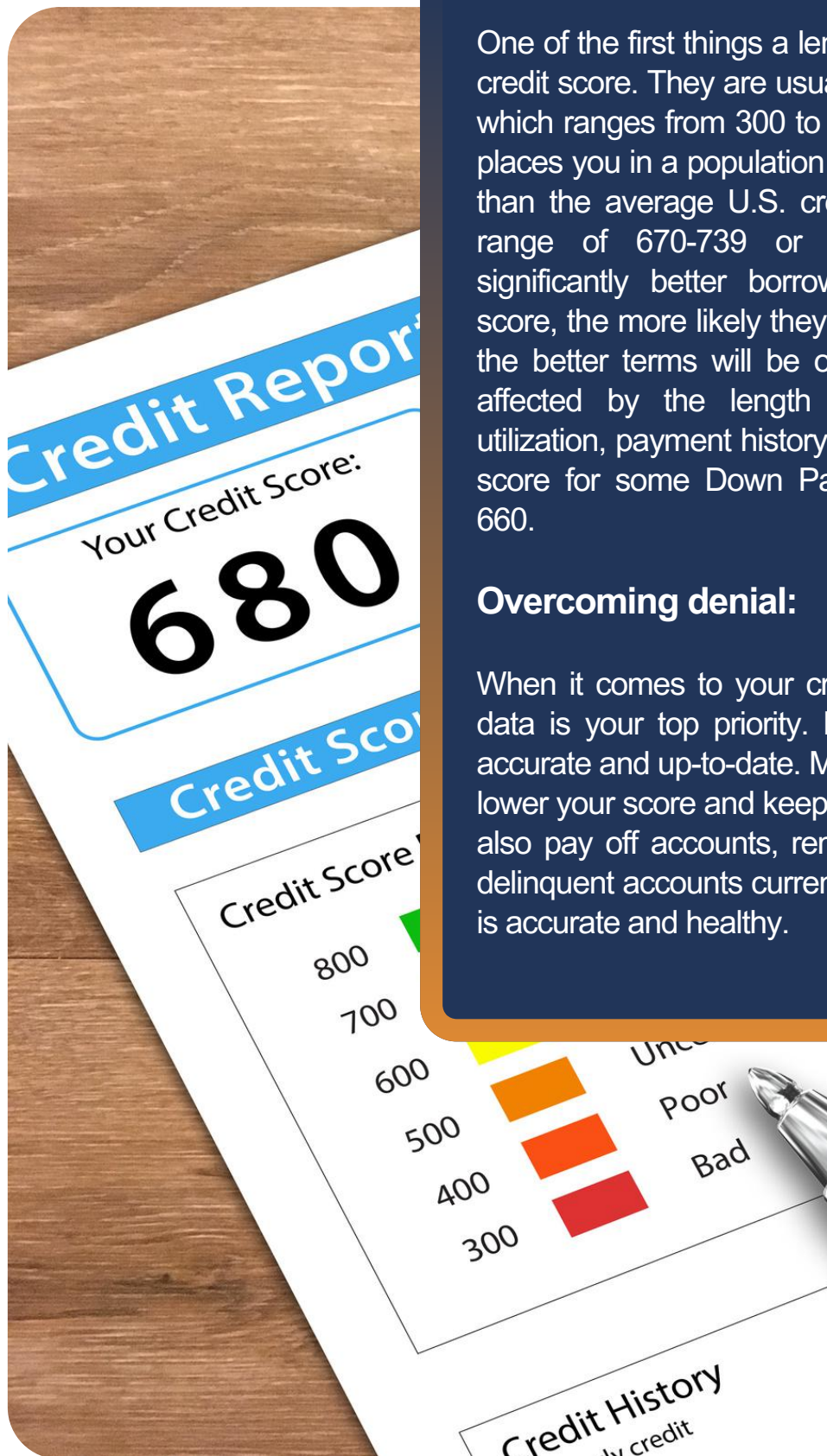
We're here to help you understand some of the common reasons loans get denied, and what you can do to improve the situation so your application will be improved.

1 Credit Score


One of the first things a lender will look at is the borrower's credit score. They are usually looking at the FICO™ score, which ranges from 300 to 850. Generally, a score of 620+ places you in a population seen as Fair, with a score lower than the average U.S. credit score. Scores in the Good range of 670-739 or higher are generally offered significantly better borrowing terms. The higher one's score, the more likely they will be approved for a loan, and the better terms will be offered. The credit score will be affected by the length of your credit history, credit utilization, payment history, and more. The minimum FICO score for some Down Payment Assistance programs is 660.

Overcoming denial:

When it comes to your credit score, fixing the underlying data is your top priority. Make sure your credit report is accurate and up-to-date. Many reports have errors that can lower your score and keep you from getting loans. You can also pay off accounts, remove outdated debts, and bring delinquent accounts current to make sure your credit score is accurate and healthy.



2 Recent Credit History/Bankruptcy



The info on your credit report isn't just turned into a score—your lenders will review the whole report and look for anything that makes you look like a risky borrower. If you had a recent bankruptcy, you recently applied for a lot of new credit, or you have some unpaid collections or legal judgments, then you can be denied even if your credit score is technically good enough to get a loan. Some public record information will damage your chances of getting a loan, even if they have no impact on your score. Bankruptcy will remain on your credit for seven to ten years, depending on the kind of bankruptcy filing you use.

Overcoming denial:

A recent bankruptcy can derail a loan application, but there are lenders who will still work with you. First, you need to make sure your credit report is updated properly; if old debts that were discharged by the bankruptcy filing are still listed, they can be unfairly damaging your score. You can add a 100-word statement explaining the circumstances of your bankruptcy. These statements can go a long way toward helping a lender understand your situation and make the right lending decision.

See Chapter 7 in our Consumer Guide to Good Credit for information about a Bankruptcy Relist. This is a process to ensure everything on your credit report is reported accurately after a bankruptcy (i.e., no open charge offs), plus tips to reestablish your credit history after a bankruptcy (e.g., secured credit card).

3 Debt-to-Income Ratios

A major reason lenders reject borrowers is the debt-to-income ratio (DTI) of the borrower. Simply, a debt-to-income ratio compares one's debt obligations to his/her income on a monthly basis. If you earn \$5,000 per month and your total debt payments are \$2,000, your DTI is 40%. This is also known as your "back-end ratio" if it includes all of your debts, like mortgage, credit cards, auto, student loans, and more. Your "front-end ratio" only considers your mortgage payment compared to your income.

These ratios are expressed as front/back. If your monthly income is \$5,000, your mortgage payment is 1,200, and your total debt payments are \$2,000, your ratio is 24/40.

Please note the mortgage payment is included in both calculations. The back-end is different in that it also includes other debt obligations. Things like child support and alimony are considered a kind of debt and are included in the back-end ratio.

Overcoming denial:

Improving your debt-to-income ratios can involve paying down debt, increasing income, or doing something to adjust your mortgage payment. There are a lot of strategies that you can use to improve these numbers and increase your chances of getting approved. See "Get Your Back End Into Shape" later in this booklet for more information.

4 Employment History



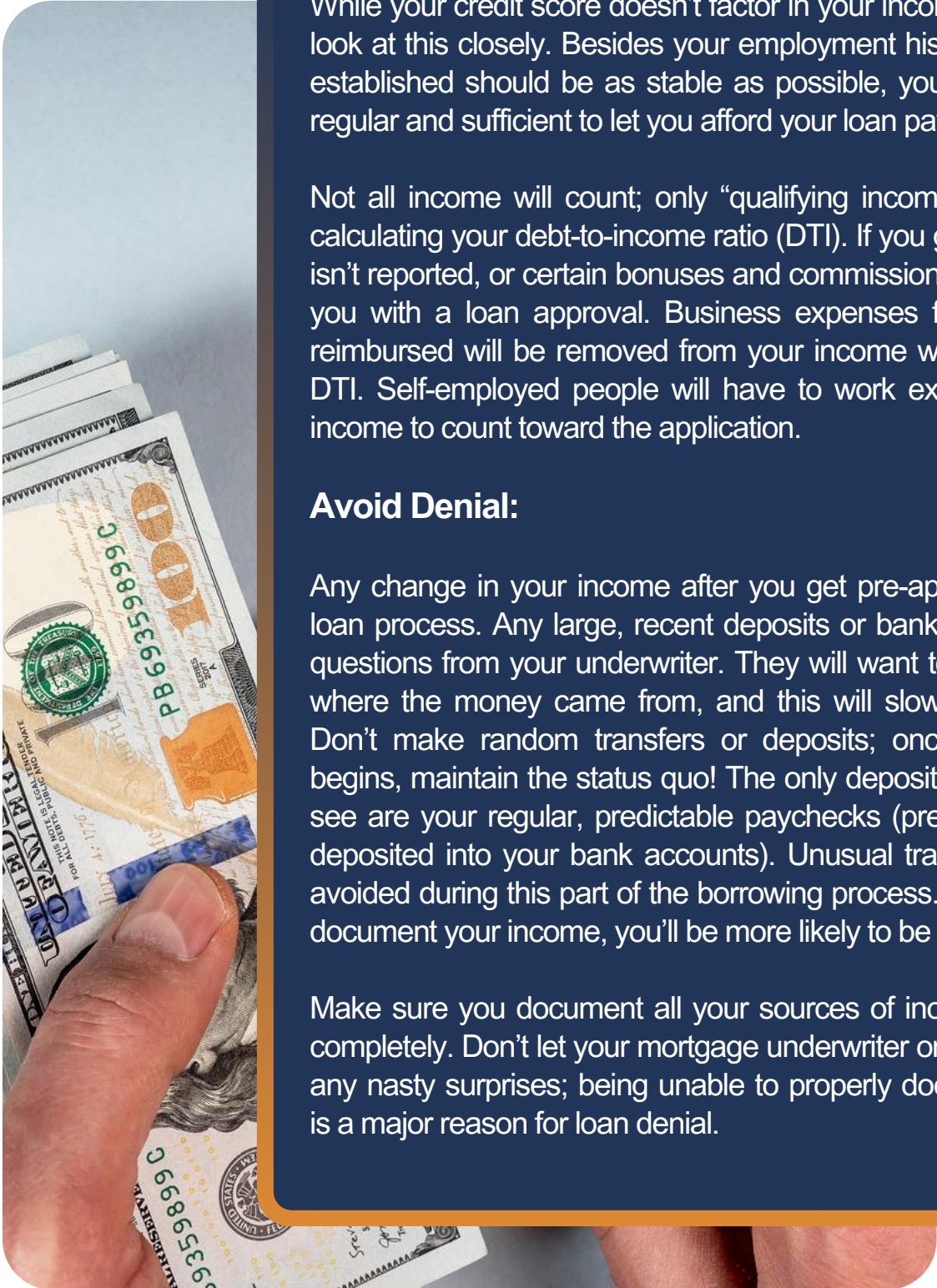
One factor lenders take seriously is your job security. They want to be sure you are going to be able to make your mortgage payments for years to come. If you've recently changed jobs, or are in the process of changing jobs, this can be a red flag for a loan officer.

Even if you are changing positions for the same employer, lenders can become skittish. If your new position doesn't seem similar enough to your previous one, you can look like a riskier proposition; if your new job doesn't work out, you could be out of work or demoted to a position where you might not be able to afford your loan.

Avoid Denial:

Never change anything after your loan gets pre-approved. Don't change jobs, don't make large deposits, and don't take on any new debt. Any big changes once the lending process starts will definitely make it harder to get approved.

5 Income



While your credit score doesn't factor in your income at all, lenders will look at this closely. Besides your employment history, which we have established should be as stable as possible, your income should be regular and sufficient to let you afford your loan payments.

Not all income will count; only “qualifying income” is included when calculating your debt-to-income ratio (DTI). If you get cash income that isn't reported, or certain bonuses and commissions, they may not help you with a loan approval. Business expenses for which you aren't reimbursed will be removed from your income when calculating your DTI. Self-employed people will have to work extra hard to get their income to count toward the application.

Avoid Denial:

Any change in your income after you get pre-approval will derail the loan process. Any large, recent deposits or bank transfers will trigger questions from your underwriter. They will want to document when & where the money came from, and this will slow down the process. Don't make random transfers or deposits; once the loan process begins, maintain the status quo! The only deposits your lender should see are your regular, predictable paychecks (preferably being direct-deposited into your bank accounts). Unusual transactions should be avoided during this part of the borrowing process. If you can't properly document your income, you'll be more likely to be rejected.

Make sure you document all your sources of income accurately and completely. Don't let your mortgage underwriter or loan officer uncover any nasty surprises; being unable to properly document your income is a major reason for loan denial.

6 Debts

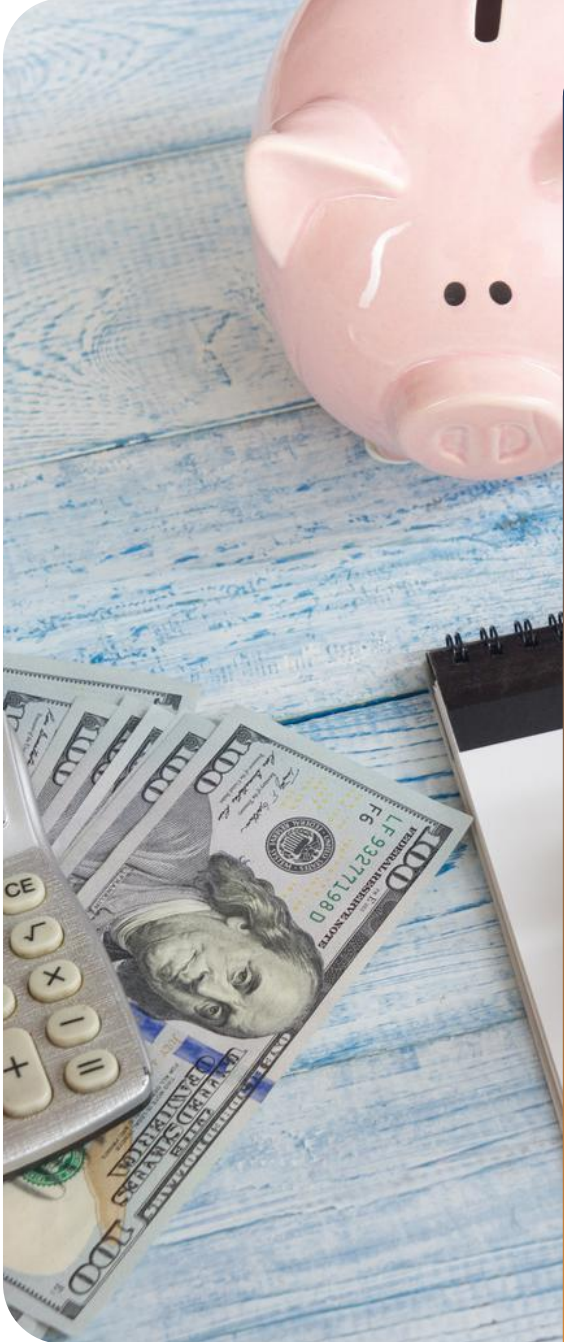
Like changing jobs or making deposits, it's important not to take on any new debts after the loan process begins. The underwriter will go back and check your credit report prior to final approval, even if you've been pre-approved. You don't want to leave any nasty surprises for them on your credit report. Going out and getting an auto loan while you're trying to get approved for a mortgage could potentially get your application denied. Even if your loan is still approved, it will be delayed by the new information on your credit file—this could cause you to not meet your planned closing date, and then your seller would have to extend the escrow period in order to sell to you.

Some private debts that aren't in your credit history may still come up in a public records search, so make sure you disclose them early on to avoid problems later in the loan process. Things like child support might not seem like debt per se, but they must be included in your application, since they are financial obligations you must meet, and will be factored into your DTI.

Avoid Denial:

Don't leave out any of your debt obligations on your application, even debts that might not appear on your credit report. Lenders are thorough and they will find out about all of your debts—so you might as well own up to all of your obligations right up front.

7 Down Payment, Collateral, Cash Reserves



Secured loans need collateral to be approved. If you get a secured loan against your car title, the lender will repossess your car if you don't pay. With a home loan, the property itself can be foreclosed on if you can't pay, but lenders take a risk of big losses if they have to auction off the house. If you make a large down payment, you make it less risky for the lender since they can make their money back even if they auction your home off at below-market prices.

Lenders also want to see that you have cash reserves left after you make your down payment. Taxes, moving expenses, home repairs...these things can take a bite out of your savings, and lenders know that. They want to be sure you have enough cash on hand to get through the first few months of homeownership and aren't going to have trouble making your payments right away.

Avoid Denial:

Save up—build the biggest down payment you can, and set aside cash reserves to make sure you can truly afford home ownership.

8 Your Application



If your application has any mistakes or errors, the lender will see them and your loan application can be rejected on the spot. Lenders have a lot of applications to review, and one that is incomplete or riddled with errors is not going to be worth their time.

If anything is exaggerated on your application, like your income, this will create problems. You need to document every source of income you state on your application, as well as every debt obligation you have. Anything you leave out or exaggerate will come back to bite you during the underwriting process.

Avoid Denial:

Fill out your application completely; don't leave out any prior bankruptcies, foreclosures, or short sales. Report any losses you have—lenders will check your tax returns carefully, so make sure you document what they will see there on your loan application.

9 Bad Timing

A recent bankruptcy, divorce, legal battle, or health issue can make it a bad time for you to be getting a home loan. Sometimes you have to wait until the circumstances are right.

With a cash-out refinance, lenders have a waiting period if the home has been for sale recently. Don't apply for this kind of refinance if your home has recently been on the market.


Sometimes, the loan is derailed through no fault of your own. If the seller of the property you are trying to buy can't get clear title, or has some problem getting mortgage insurance coverage on the property, then you can be denied even if your application is perfect.

Finally, a bad or inexperienced mortgage professional can lead to a denied loan. Whether they missed legitimate early warning signs on your application that could have been corrected, or they make rookie mistakes, you may have just caught a case of bad luck when you applied for your loan.

Avoid Denial:

Do some advance work to make sure your timing is right. Pull your credit report early and make sure there are no surprises when you go in to apply for the loan. Gather all the documents you need ahead of time, including W2 and tax returns, pay stubs, bank statements, etc. Be ready to document all of your sources of income and all of your financial obligations.

10 Subjective Rejection



Even after everything else is done and the application looks good, a mortgage officer can look over your application and downgrade it to a rejection based on subjective factors. If you're self-employed, have been on the job for a short time, have a short credit history, or simply don't have enough cash reserves in the bank, your underwriter can reject a loan application that was initially approved.

This is called “layered risk”. Even though the application is approved by a computer, a human can look at multiple negatives and decide it's just too risky. Even if you have a down payment, you can get rejected if those funds were a gift, rather than money you earned. Lenders can also be uncomfortable if they see your new mortgage payment is going to be dramatically higher than the rent you are used to paying.

Avoid Denial:

Pick the right property—if the property has problems, your lender will not be comfortable with the sale. Make sure the home you purchase is truly worth the selling price, and if there are problems on the seller's end, be prepared to walk away and shop for another property.

Don't necessarily borrow every penny you can—just because you have a certain capacity for debt doesn't mean you have to borrow that much. Live within your means to make it easier for the lender to approve your loan (and for you to afford the payments after it gets approved).

General Strategies for Overcoming Loan Denial:

Prior to the loan:

1. Gather all of the documents you need. Missing docs lead to rejected loans.
2. Build savings to afford a down payment and build cash reserves.
3. Pay down debts to improve your credit and DTI.
4. Review your credit and make sure everything is accurate and up to date. Address any negative items.
5. Calculate your income completely and correctly.
6. Get counseling from a certified consumer credit counseling service like [credit.org](https://www.credit.org). Free, nonprofit counseling can help you make sure you have all the documents you need, your credit looks as good as possible, and your budget is designed to help you afford a new loan payment.

If you've already been rejected:

1. If you didn't do so before, check your credit report. Make sure your positive credit history is included along with the negative. Correct any erroneous or outdated info.
2. Talk to your lender; under the Equal Credit Opportunity Act, the lender must provide a written explanation for why you were turned down. A qualified counselor can look over this document with you and help you understand everything it says.
3. Work to remove any negative credit entries on your reports; you may be able to negotiate this removal in exchange for paying off a collection account, for example.
4. Work to re-establish good credit, either by bringing delinquent accounts current or establishing new credit that you can manage successfully.
5. If you were denied for not having enough resources or income, look into programs for low-to-moderate income borrowers, or loans with lower down payments, like FHA or VA loans if you qualify. Homeowner counseling services can help you determine what programs would be best for your situation.

General Strategies for Overcoming Loan Denial:

6. Renegotiate the loan or seek a loan without PMI—if the loan was too close to 100% of the property value, you may get denied. You should strive to borrow 80% or less of the home's value to avoid paying PMI (private mortgage insurance). If you simply must borrow more than that, keep the loan below 95% of the home's value. By increasing your down payment you may be able to get another chance. Consider a new appraisal if you think the property wasn't valued correctly. From time to time, lenders and banks create their own programs, and, sometimes they don't require PMI. For instance, a major financial institution, at the time of this writing, offers the Affordable Loan Solution® mortgage. It requires just 3% down and does not require PMI.
7. Once you get counseling or assistance to correct everything you can that held you back the first time, apply for a new loan and present yourself in the best light possible. Do everything as if you are trying to impress someone important, like you are applying for an important job. Think of counseling as job coaching or help putting together your resume. A well-prepared application to a new lender can give you different results, especially considering you may have a new loan officer and a different appraiser. Each fresh set of eyes on your improved application can mean an approval the second time around.
8. Get free counseling—credit & debt counseling is available to help you pay down outstanding debt and prepare you to manage a new loan. A certified counselor can make sure your budget is on the right track and prepare you for success. Pre-purchase housing counseling can help you understand the specific reasons for your loan denial and come up with a targeted strategy for improving your likelihood of qualifying for the loan the next time you apply.

Get Your Back End Into Shape

Back-end ratios are used by banks to make loan decisions. What can you do to improve yours?

If you are applying for a loan, your debt-to-income ratios, especially your back-end ratio, are very important. Here's a quick overview of the subject so you'll understand debt-to-income ratios and how they factor into lending decisions.

What is a back-end ratio?

- The “back-end ratio” is the portion of your monthly income that goes toward monthly debt payments. The ratio is calculated against your monthly income as a percentage.

What debts are included in the calculation?

- In a back-end ratio, your monthly debt includes credit card, mortgage & auto loan payments, as well as child support and other loan obligations.
- A back-end ratio is different from a front-end ratio due to the debts included. The “front-end” ratio is only the ratio of your mortgage payment to your income. For example, if you earn \$48,000 per year, your monthly income is \$4,000. If your total mortgage payment is \$1,000, your front-end ratio is 25%.
- In that same scenario, if your total debt payments are 1,800 (\$1,000 for mortgage, \$350 auto loan, \$300 credit cards, \$150 student loan payment) your back-end ratio is 45%.
- Your total debt-to-income ratio, or DTI, would be expressed as 25/45 (front/back).

How do lenders use this calculation?

- Some lenders consider only the back-end ratio, and give no weight to the front-end ratio when granting mortgage loans. Debt-to-income ratios are a very important factor in the lender's decision, along with the borrower's credit score, income, work history, the property being purchased, and more.

Get Your Back End Into Shape

- The back-end ratio is more conservative than the front-end. That is, lenders with tighter lending standards are more likely to look at the back-end rather than the front.
- Lenders have criteria when they enter into the loan negotiation. Generally, lenders strive to grant loans with a back-end ratio of 36% or lower. In the example we listed above, with a back-end ratio of 45%, the loan might not be approved. Some lenders will make exceptions if the borrower has good credit, allowing ratios over 50%.
- Lenders who look at both the front and back-end ratios might specify that they require a particular ratio, like 28/36. FHA average loan ratios are 31/45. VA loans only look at the back end, which can be as high as 60% in some cases, though applicants with ratios over 41% will face extra scrutiny.

How can you improve your back-end ratio?

- Because your debt-to-income ratio is just as important as your credit score to mortgage lenders, improving your ratio is important to ensure that you can get the loans you need, and also to guarantee that you'll be able to afford your loan payments after the loan is approved.
- Paying down debt is the number one way to reduce your back-end ratio. If you can pay off credit cards and stop incurring new revolving debt, that will help your ratio greatly. In the scenario we listed above, if you paid off your credit cards, you'd be left with \$1500 in monthly payments (\$1000 mortgage, \$350 auto loan, \$150 student loans.). With \$4000 in income, the new back-end ratio will be 37.5%. That is much closer to the desired 36%, and with a good credit score, may even be approved by most lenders.
- Increasing income also improves the ratio. Say that in our example, you get a 3% cost-of-living raise. Your new monthly income of \$4,120, coupled with your \$1,500 in monthly debt payments, gives you a back-end ratio of 36.4%. This ratio is much more likely to get your loan application approved.

Get Your Back End Into Shape

- Decrease your mortgage payment to improve your ratio. If you make a larger down payment, opt for a 20 or 30-year mortgage instead of 15, or shop for a more affordable property to buy, you can lower your payment and make both your front and back-end ratios lower. Getting more affordable insurance helps here too, since your mortgage payment includes PITI (principal, interest, taxes, and insurance).
- Because paying down debt is the most common thing that homebuyers need to do to improve their debt-to-income ratios, debt counseling is a great option to improve your back-end ratio.
- If you've already applied for a loan and been denied, call us for immediate help. Reach us at 800-294-3896 for free, confidential counseling that is tailored to your unique situation.



Pre-Purchase Counseling from Credit.org

Contact us today for free, comprehensive counseling, education and support!

1-800-294-3896

We offer comprehensive financial and mortgage loan education counseling.

Our counseling is unique and tailored to each borrower's situation. We offer counseling and strategies for a successful re-entry for a mortgage loan after a denial decision. We provide people with the best chance for a successful reapplication.

- ✓ **Extensive Support:** Our highly skilled counseling specialists are available on demand. They are ready to support your efforts to gain mortgage loan approval.
- ✓ **Impactful Education:** We offer access to extensive financial education, information, tools and resources to guide you through the rebuilding process.
- ✓ **Tailored Action Plans:** We provide relevant, tailored and tangible strategies to improve personal finances and increase your odds of mortgage approval.

Contact us today for free, comprehensive counseling, education and support!



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