Tips in providing a Letter of Explanation (LOX) for Derogatory Credit

This guidance refers to USDA, FHA and VA loans.

Any and all derogatory showing on the credit report must be addressed in an LOX FROM THE BORROWER. The letter must be signed and dated. The letter must reference in detail, what happened to create the negative information, how it was resolved and what the borrower has done to insure the situation will not happen again.

This will include, but is not limited to:

- Bankruptcy
- Judgements
- Late payments
- Collections
- Charge offs
- Foreclosures
- Short sales
- NSF or overdrawn account showing on bank statements
- And any other negative reporting on credit bureaus

The borrower must also provide supporting documentation to validate the letter of explanation. The supporting documentation and explanation must be consistent with other information in the file.

Any reference to financial mismanagement could result in the LOX being rejected or the file being denied, depending on the explanation provided. If the letter does not provide enough information to determine the reason, it will be rejected.

When you submit a letter to explain the derogatory credit, bear in mind that the underwriter, ultimately decides whether to approve or decline your loan. Underwriters deal in facts rather than emotions. Keep your letter concise and specifically address each derogatory.

The letter MUST be signed and dated by the borrower.

Letters of Explanation Guidance

This guidance refers to Letters of Explanation that should be provided for all USDA, FHA and VA loans when submitted to Underwriting.

Letters of Explanation or LOX's are needed to document a variety of information. The Letters should be relevant, informative and stay on topic.

The standard file will need LOX's for the following:

- **Derogatory Credit** – see sheet on LOX for Derogatory Credit
- **Large Deposits** – always needed when sourcing a large deposit from bank statements
- **100% Access Letter** – needed on all jointly held accounts the borrower holds with another person who is not on the loan
- **Rent Free Letter** – needed when the application indicates that the borrower neither rents nor owns. The Rent Free Letter must indicate the address he is currently residing at and confirm that the borrower does not pay rent. The LOX must be signed by the owner of the residence they are residing at.

There are other times when an LOX helps the underwriter to understand the file better. Such cases may include:

- Gap in employment
- Non-sufficient funds or overdraft on bank statements
- Child Support
- Employment history

Letters of Explanation are seen as a valuable tool in assisting the underwriter to understand the files details. Summing the file up with a Note to the Underwriter will help her assess exactly what conditions are needed or not needed.

How to gross up fixed income

All forms of mortgages allow for grossing up of certain types of nontaxable income. The reason nontaxable income can be grossed up is because typically mortgage loans go by a borrower's gross income (pre-taxed). The amount that nontaxable income can be grossed up depends on the loan type and the tax rate that the borrower is in.

Examples of types of income that all or portions can be grossed up are:

- Social Security (if not taxed on the tax returns)
- Disability income like social security, VA, or other forms of disability income expected to continue 3+ years
- Nontaxable pension
- Retirement income
- Child Support

FHA, Freddie Mac & VA Financing:

If the borrower(s) do not have to file a tax return or the income is not taxed on their current 1040 returns, then the income may be grossed up by 10 - 12%. The grossed-up figure is determined by taking the income amount multiplying it by 112% or 1.12. The amount to allow for grossing up is determined by the tax bracket the borrower is in per the most recent Federal Tax Return.

2021 Income Tax Brackets

Tax Brackets and Rates, 2021				
Rate	For Unmarried Individuals	For Married Individuals Filing Joint Returns	Married filing separately	For Heads of Households
10%	$0 to $9,950	$0 to $19,900	$0 to $9,950	$0 to $14,200
12%	$9,951 to $40,525	$19,901 to $81,050	$9,951 to $40,525	$14,201 to $54,200
22%	$40,526 to $86,375	$81,051 to $172,750	$40,526 to $86,375	$54,201 to $86,350
24%	$86,376 to $164,925	$172,751 to $329,850	$86,376 to $164,925	$86,351 to $164,900
32%	$164,926 to $209,425	$329,851 to $418,850	$164,926 to $209,425	$164,901 to $209,400
35%	$209,426 to $523,600	$418,851 to $628,300	$209,426 to $314,150	$209,401 to $523,600
37%	$523,601 or more	$628,301 or more	$314,151 or more	$523,601 or more

To locate this information:

Determine how they filed. Single? Married?

Then determine the household income bracket and identify the marginal rate from here. The marginal rate is the amount allowed for grossing up:

The maximum allowed for grossing up is 115%

FSB will require verification of non-filing of tax returns. This is documented through ordering/processing of the 4506C. The results should read: No Return Available. This is to be uploaded as proof the borrower does not need to file returns in conjunction with the Award Letters for the income that will be grossed up.

If the borrowers DO file tax returns, the returns should be checked to see if the fixed income is listed as taxable income. If it is, the fixed income cannot be grossed up.

USDA & Fannie Mae

USDA & Fannie Mae allows for an automatic "grossing up" of 125%. The income to be grossed up must supply Award Letters and proof of non-filing for tax returns or current tax returns, as well.

Award Letters MUST be provided. Alternative documentation is not acceptable.
Award letters will verify continuance of income and confirm the most recent information for receipt of the income. Award Letters are required for the year we are underwriting in. The majority of Award Letters are issued in January for the year.

Child support will not have an award letter. A divorce decree with property settlement showing child support payments or appropriate court documentation must be provided along with proof of receipt of the support for the most recent 6 months.

Condo Documentation – what to submit for documentation

There are several options when working with a condo. Each program (USDA, VA, FHA and Conventional) offer the ability to finance condo loans. Knowing what each program needs is important when deciding the best way to finance this home type. This sheet will direct on the documentation or process for Condo Approval. For LTV requirements or limitations, please visit www.myfsbretail.com to review the program matrices. You will find these under Forms & Tools.

Conventional Condo Documentation requirements:

The options for this will be either a streamline review or a full review. To determine which review the condo will fall in, please see the *Instruction Sheet labeled "Determining the review type for Conventional Condo loans".*

Streamline review:

If the condo association will qualify for a streamline review, we will need the following to approve.

- ☐ Short form condo questionnaire (available at www.myfsbretail.com)
- ☐ Legal & recorded documents of the covenants, conditions and restrictions, declaration of condominium and by-laws of condo association.
- ☐ Homeowners Association certification
- ☐ Homeowners Association Master Insurance Policies

Full review or Established review:

- ☐ Long form condo questionnaire (available at www.myfsbretail.com)
- ☐ Legal & recorded documents of the covenants, conditions and restrictions, declaration of condominium and by-laws of condo association.
- ☐ Homeowners Association certification
- ☐ Homeowners Association Master Insurance Policies
- ☐ Project budget, financial statements or reserve study
- ☐ If new construction – project construction plans and phase information
- ☐ Completion reports – as applicable

The list of documents required for review are considered a starting point. The Condo Questionnaire will identify if further information will be required for any of the following:

- ☐ Environmental hazard reports
- ☐ Architect or engineers report
- ☐ Project marketing plans
- ☐ Attorney opinions
- ☐ Litigation Letter
- ☐ Litigation information

FHA Condo Approval

If you have a Condo Association that is not approved with FHA, but needs to be, then you will need a lender to assist you with this process through HUD. FSB will submit the documentation but will not gather the information. The Loan Officer or company wishing to get the association approved must prepare the approval package and send to govrequests@flanaganstatebank.com for FSB to submit to HUD. The approval process typically takes 2 – 4 months.

The items HUD will need for approving a Condo Association:

- ☐ Recorded documents of HOA – Bylaws (must be signed by board member), recorded CC&R's (aka Declarations or Master Deed), Articles of Incorporation on file with state
- ☐ Recent balance sheet & income statement (within 60 days)
- ☐ Current Budget
- ☐ Prior year end income statements
- ☐ Homeowners Association Master Insurance Policies
- ☐ Fidelity Bond Dec Page
- ☐ Management company agreement including services (if HOA under a management company)
- ☐ Condo questionnaire – long form

Documents can be sent to govrequests@flanaganstatebank.com.

To review the Condo Project Approval and Processing Guide, please use this link:

http://portal.hud.gov/hudportal/documents/huddoc?id=11-22mlguide.pdf

VA Condo Approval

This is completed by the Broker or Correspondent. The process with VA can take as little as 30 days and up to 90 days. Once a condo association is approved by VA it does not expire. The VA process is a 2 step process. The first review is at the Regional Loan Center where a review is completed by a VA Staff Appraiser. Once the Staff Appraiser approves the association information, it is then sent to the Legal Team. The Legal Team will review all the governing documents. The process time frame varies according to the workload of these staff members at the time of submission.

To submit to VA for Condo Approval, the following documents are required:

- ☐ Declarations of Covenants, Conditions and Restrictions (CC&R's). aka Declarations or Master Deed - recorded
- ☐ Signed Bylaws for HOA
- ☐ Articles of Incorporation for HOA
- ☐ Management Agreement (only needed if managed by a management company)
- ☐ HOA Budget
- ☐ Homeowners Association Master Insurance Policies
- ☐ Current Financial Statements (income statement and balance sheet)
- ☐ Minutes of last 2 HOA Meetings
- ☐ Recorded Amendments for annexation
- ☐ Plat Map and/or Air Lot Survey
- ☐ Condominium Plans - with county recorder's stamp that includes date
- ☐ Condo questionnaire – long form
- ☐ Cover letter requesting approval. The letter is to include: a) the name, address and telephone number of the requester submitting the package; b) the address of project (city, county, state and zip); c) total number of phases and units in the project; and d) if the complex is new or existing, how many units sold.

To locate your Regional Loan Center, visit www.benefits.va.gov/homeloans/contact_rlc_info.asp

The documentation listed here is a starting point and depending on the information that is presented, each agency may require further information.

If you have further questions, please feel free to contact us at underwriting@flanaganstatebank.com.

Determining the review type for Conventional Condo Loans

To determine the Condo review type, review the type of condo reviews and what the parameters of each type are. *Then use the "Condo Documentation" Instruction sheet to identify what documents will be needed for FSB to approve the condo.*

To assist the process of elimination, it is important to note that the following types of projects are INELIGIBLE FOR FINANCING on a conventional project:

- Project in which the unit owners do not have an undivided ownership interest or leasehold interest in the land on which the project is located
- Condominium Hotel
- A project required to be registered with the US Securities and Exchange Commission or any state securities agency
- Tenancy in common apartment project
- Project with multi-dwelling units
- Project with excessive commercial space or non – residential space
- Project in which the unit owners do not possess sole ownership of the Common Elements
- Timeshare project or project with segmented ownership
- Houseboat project
- Project that is legal nonconforming use
- Project in Litigation
- Project sold with excessive Seller contributions
- Project with excessive single investor concentration**
- Continuing Care Retirement Community (CCRC)
- Manufactured Homes
- Project with mandatory dues or similar membership fees for use of Amenities such as clubhouses or recreational facilities

Property Type	**Max # of Units owned by an individual or single entity
2-4 units	1 unit
5 – 20 units	2 units
21 or more units	10% of the total units

The options for Condo Reviews include: Streamline review (aka Limited Review), Established Condo Review (aka Full Review), New Condo Project Review, 2-4 Unit Condo Projects, and Reciprocal Project Review. Each review will be listed out and defined below.

<u>Streamline Review (aka Limited Review)</u>

To determine if you have a condo that will be eligible for a Streamline Review, the following parameters must fit the project:

- The project (all units and Common Elements & amenities) and related facilities are complete and not subject to any additional phasing

- At least 75% of the total units have been conveyed to unit purchasers other than the developer. Or, if a 2 – 4 unit condominium project, all units in the project have been conveyed to the unit purchasers, and
- The unit owners control the Homeowners Association (HOA)

It is important to note that Streamline Review does limit the LTV:

*Streamlined review for Condominium Units in Established Condominium Projects **not** located in Florida*	
Occupancy Type	Maximum LTV/TLTV/HTLTV
Primary Residence	90%
Second Home	75%
Investment Property	**75%** new

Florida Condominium Projects Only	
Streamlined review for Condominium Units in Established Condominium Projects located **in Florida**	
Occupancy Type	Maximum LTV/TLTV/HTLTV
Primary Residence	75%
Second Home	70%
Investment Property	**70%** new

Established Condo Review (aka Full Review)

If a Streamline Review cannot be completed, this is the option that must be followed. The following requirements must be met to use this review:

- Must comply with all requirements for Condo Project Review and General Condo Project Eligibility Requirements in FHLMC Seller Guide, Section 5701.2
- Meet the definition for an Establish Condo Project: The project (all units and Common Elements & amenities) and related facilities are complete and not subject to any additional phasing
- At least 75% of the total units in the project have been conveyed to the unit purchasers or if the project is a 2 to 4 unit condominium project, all units in the project have been conveyed to the unit purchasers, and
- The unit owners control the Homeowners Association (HOA)
- Owner-Occupancy Requirements:
    - *Primary residence or second home* – no owner-occupancy requirements for the project
    - *Investment Properties* – at least 50% of the total units in the project must be occupied as a primary residence or second home. This is inclusive of 2 to 4 unit projects and for 3 unit properties/projects, all but one unit in the Condo Project must have need conveyed to purchasers who occupy their units as a primary residence or second home.
- Project budget must be consistent with the nature of the project and appropriate assessments must be established to manage the project. At least 10% of the budget must provide funding for replacement reserves for capital expenditures, deferred maintenance, and replacement cost of major Common Elements. Adequate funding for insurance deductibles must be provided for. A Reserve Study may be used in lieu of the project budget providing a replacement reserve of at least 10%.
- No more than 15% of the total number of units in a project are 60 or more days delinquent on the payment of their HOA assessments

New Condo Project Review

This review applies to projects that fit this definition: All units in the Condo Project, Common Elements, Amenities and related facilities are not complete or are subject to additional phasing. Fewer than 90% of the total number of units in the project have been conveyed to the unit purchasers other than the developer or the developer has not turned control of the HOA over to the unit owners.

The following requirements must be met for financing:

- The Condo Project (all condo units, common elements and amenities) and related facilities owned by any Master Association are not complete or are subject to additional phasing, except for 2 to 4 unit condo projects that are complete and not subject to any additional phases.
- Fewer than 75% but at least 50% of the total units in the project have been conveyed to purchasers other than the developer (or its successor) who will occupy the units as their Primary Residence or Second Home.
- The HOA is still in the control of the developer.
- HOA assessment begins once Developer has ceased paying operating expenses attributable to the project

- The Developer must pay assessments attributable to the unsold units when any unit owner other that the Developer pays
- Project budget must be consistent with the nature of the project and appropriate assessments must be established to manage the project. At least 10% of the budget must provide funding for replacement reserves for capital, expenditures, deferred maintenance, and replacement cost of major Common Elements. Adequate funding for insurance deductibles must be provided for. For recently converted projects, the developer must initially fund the working capital fund.
- Along with the standard Condo Project review and general condo project eligibility requirements in Section 5701.2 of the FHLMC Seller Guide, the following must also be met:
  - Compliance with laws
  - Limitations on ability to sell/right of first refusal
  - Conversions
  - Mortgagee Consent
  - Rights of Condominium Mortgagees and Guarantors
  - First Mortgagee's Rights confirmed
  - Marketing Units in the Condominium Project
- No more than 15% of the total number of units in a project are 60 or more days delinquent on the payment of their HOA assessments

2-4 Unit Condo Projects

These consist of two, but no more than four, 1 – Unit dwellings that are each separately owned with separate legal descriptions.

- All units and Common Elements in the project and in any Master association must be completed.
- All but one unit in the condo project must have been conveyed to purchasers (other than the developer) who occupy their units as Primary Residences or second homes

This is the minimum needed to determine the review type that the project will fall under. For a full version of the guidelines regarding Condo Projects, please visit FHLMC's Seller Guide and review Sections 5701.0 through 5701.9.

If assistance is needed to determine the best review type, please contact underwriting@flanaganstatebank.com. We will need the Condo Questionnaire completed to assist in the determination.

Divorce, Separation & Mortgages

The topic of divorce is a very interesting subject in the mortgage industry. We approach this subject with caution and hesitation due to the many variables involved in a divorce or separation. *This document will outline the basics of handling these circumstances but in no way will this outline each and every option available to a borrower when going through a divorce.* It is important to know the basics and then get the facts you are dealing with to determine if we can proceed with a mortgage loan at time of application.

There are 2 situations that may occur. We will outline the basic requirements needed for both situations.

Borrower wants to purchase but has not filed for divorce

In this scenario, the borrower has indicated they will be filing for a divorce but have not done so at the time of application or discussion with the Loan Officer.

There are a few red flags that lenders will have in this scenario. The underwriters will be watching for:

1) The borrower and spouse will not actually be getting a divorce. The home will be used for income purposes and the borrower is trying to beat the system to obtain a better rate
2) The borrower is trying to bail out of their existing mortgage (they may not be on it) to obtain a new residence without wanting to show the problem with the current home.

These red flags may sound extreme, but they do occur on occasion.

For the borrower that wants to complete the purchase prior to filing for divorce, they can do this. However, there are things to consider:

1) If they own the home, they live in with the soon to be ex, they do have to count this debt against them.
2) If they are not on title or the note, we will not have to count the debts against them, but they will need a rent free letter from the ex/spouse.
3) The spouse will need to sign at closing the spouse documents or sign a homestead waiver. If the couple is not at a point where, they are amicable enough to do this, it could be a problem.

All situations are different and will bring up questions during the process. Be prepared for questions from underwriting as they want to make sure they understand the situation very well and insure they do not miss any important detail.

Borrowers are currently in Divorce or separation proceedings through the courts

This will be a more common occurrence than the situation listed above.

If the borrower is currently in divorce or separation in the courts, we will require a Property Settlement agreement executed through the courts to complete the loan and close. The divorce itself does not need to be final, but the property settlement portion, does.

The ex will also need to sign a homestead waiver if the divorce is not final at the time of closing.

Again, it is important to explore all options of your borrowers' circumstances to know if there will be any issues. Please check with our Mortgage Support Team to allow them to help you sort through the details and determine if all is well to proceed.

Borrowers that have not officially filed for Divorce of Legal Separation (Conventional Loans Only)

If the parties have not officially filed for Divorce or Legal Separation, then the following will be accepted. This will not work in a Community Property State to remove the requirement of the spouse's credit report and debt to be included. We would need an executed divorce decree or legal separation agreement for that.

A document with both parties' signatures notarized that contains the following information:

a. Spells out how subject property is being split including any funds to be paid or if purchase how marital residence is being handled.
b. Spells out if there are kids and any child support.
c. Spells out any alimony to be paid by either party.
d. Spells out any debts that either party will be liable for that are not showing on their individual credit report.
e. States if any other properties are owned jointly and how they will be handled.
f. Contains a statement that an official agreement has not yet been filed. If an agreement has been filed, then it must be provided.

VA High Balance and Jumbo Size Loans

How to know if a large loan will work using VA

VA does not have a specified limit on the loan size. VA uses a chart with examples to provide guidance on what is acceptable to their parameters. Our investors will follow the VA guidance, but they do place limitations on the loan size.

High Balance loans will always have a pricing adjustment for their large loan size. Please be sure to price out the loan before quoting a rate to the borrower.

Before we get into the actual loan calculations of a high balance loan and determining if a down payment will be required, here are some important facts to be aware of:

1) High balance loans are still 100% financing, but VA requires 25% guaranty to insure the loan in case of default. If a loan does not have the 25% guaranty in entitlement amount, then a down payment for the difference will be required.
2) The loan limit with our investors is 1,500,000. The base loan cannot exceed this amount.
3) If the loan amount is greater than 1,000,000 all borrowers must have a minimum **FICO of 700**. When the base loan amount exceeds 484,350 the minimum **FICO must be 620** or greater.
4) Loan amounts greater than 1,000,000 must use a certified appraiser. Be sure to request a certified appraiser when requesting the appraiser assignment through VA's portal

To determine if a down payment is required or how much the down payment may be

FSB has tools available for this on the website. Keep in mind, all VA guidelines do apply. If this is a prior approval loan in which the applicants are not married, the entitlement will only be applied to the Veterans portion of the loan. This may require more assistance than following the charts and calculators provided. Please email underwriting@flanaganstatebank.com for assistance with any loan calculations.

www.myfsbretail.com has a VA loan calculator and the sample calculations VA uses to reference how to calculate the max loan amount. Between these 2 tools, you will be able to confirm the required down payment, if need.

Tools you will need:

1) VA Calculator
2) VA Samples of max loan amount
3) Certificate of Entitlement

When you have these items in hand, you can follow the calculator to determine the max loan amount and required down payment by filling in the requested information. The samples of max loan amount will allow you to calculate the same information by hand to confirm you get the same answer for the situation.

We recommend that you send your information, once completed to underwriting if you would like a second opinion and to confirm that the totals are accurate.

underwriting@flanaganstatebank.com