SCHWARTZ *Report*

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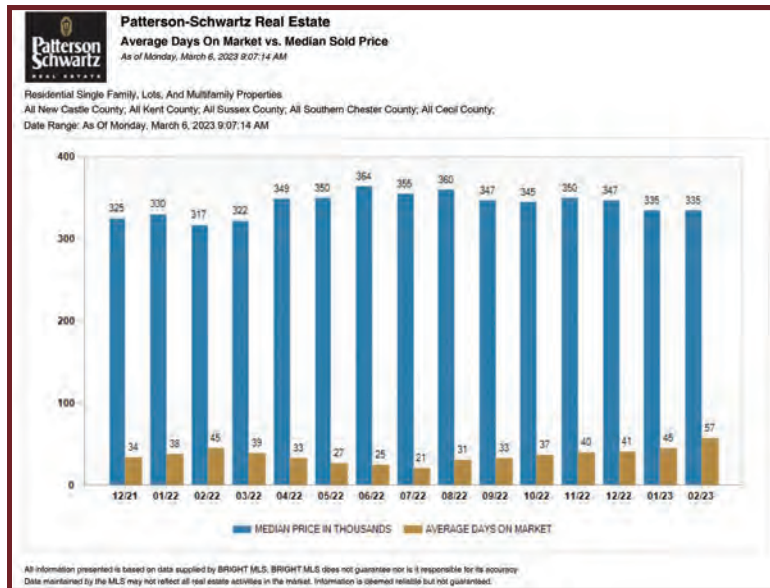
DIRECT: 302-234-5202 • OFFICE: 302-239-3000
www.charlieschwartz.com

Revisiting the 4 C's

The Wall Street Journal Editorial Board summed up last year as follows: "Reality has rudely but helpfully taught some hard economic lessons in 2022. To wit, excessive government spending has negative consequences such as inflation; modern monetary theory is a fraud; renewable energy can't keep the lights on without fossil fuels; and (most cruelly) free money can't last forever." After reading this assessment, I'm reminded of the oft quoted distinction between economics and politics repeated recently by George Will: "The first law of economics is scarcity is real; the first law of politics is, ignore the first law of economics." You might say that what's old is new and what's new is now old.



All of this turmoil has caused quite a bit of uncertainty in our real estate markets over the last three years and a steep downturn beginning in the middle of last year. If there is a lesson to be learned from all of this it is that it's high time to return to the basics. Both buyers and sellers need to get their respective houses in order. Buyers will have more options in 2023 as housing inventories rebound although rational sellers will still mostly control the market.

Certainly we are a ways away from anything resembling a balanced market of five to six month's supply of unsold homes even at the present reduced levels of absorption. The average days on market for all the areas we service from February 28, 2022 to March 1, 2023 was about 37 days so would be buyers will still have to up their game if they are going to compete in the spring market this year.

Therefore, with new buyers out looking and a rising sense of market optimism, I thought it might be a good time to revisit the basics of what lenders are looking for as they decide to approve (or not) mortgage applications. In previous additions of Schwartz Reports we've called them the 4 C's. They comprise the foundation of mortgage loan underwriting – Capacity, Credit, Cash and Collateral. Lenders' guidelines for risk tolerance change but these core criteria do not.*

CAPACITY: Capacity studies the relationship of the borrower's income to their proposed debt load. It considers the borrower's ability to repay the loan. Lenders look at two calculations that we call ratios. The first one is the housing ratio. It is simply the percentage of the proposed total mortgage payment (the sum of principal, interest, real estate taxes, homeowners' insurance and, if applicable, flood and mortgage insurance such as private mortgage insurance (PMI), FHA mortgage insurance premium or VA funding fees) divided by the applicant's monthly pre-tax income. A solid housing ratio, often referred to as the front end ratio, would be 40% or less. At times loans are approved at higher ratios. That is because the front end ratio is looked at in conjunction with the back end ratio. The back end ratio, often called the debt ratio, starts with the mortgage payment calculation from the housing ratio and adds to it the recurring debt payments that would show up on a credit report. Those would be such things as auto loans, student loans and minimum credit card payments, etc. A good back end ratio would be under 45%. A strong buyer may be able to push theirs to just below 50%.

CREDIT: A credit score is the statistical prediction of a borrower's payment likelihood going forward based on their past payment history. If Capacity studies the ability to pay, Credit indicates the willingness to do so. A credit score is like a batting average assigned to each borrower and is supposed to reflect their anticipated repayment probability. A great credit score is anything over 760 while a good credit score is anything above 680. Anything below 620 is a challenge to get approved. Though 850 is technically the top credit score, those above 800 are unusual for younger borrowers who have not had long credit histories or may not have many credit scores available to them. Suffice it to say, the higher the credit score, the lower the risk to the lender which usually results in better loan terms for the borrower.

CASH: Cash is really a combination of the equity you have in the transaction (like your down payment) and your cash reserves on hand after you go to settlement. The bigger your down payment, for example, the more of your own money is at risk. This makes

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you a stronger partner for the lender. At the same time, the more money you have in reserve AFTER closing, the less likely you would be forced to default. Consider two borrowers with the same profile as to income ratios and credit scores but one has $15,000 in the bank after closing and the other has $1,500.

COLLATERAL: The collateral for your home mortgage is the home itself. Despite all of the images of Snidely Whiplash conjured up in the press, understand that lenders do not want your home. Foreclosure is a bad word to them. They aren't in the real estate business and don't want to be. However, the lender does need to have something to secure the loan in case of default. An appraisal is used to determine the conservative value of the collateral. Appraising the collateral is usually the only one of the 4 C's that's not done ahead of the purchase although it is possible to waive the appraisal requirement. This should only be considered if the borrower is willing to do so and there are strong credit scores, ratios, cash reserves and a reasonable purchase price based on comparable sales in the area. This waiver strategy can sometimes help in a hot market because appraisals often will come in lower than the purchase price. A rising market can typically close the gap. It's a judgement call to make in consultation with the lender and your Patterson-Schwartz Realtor.

Each of the 4 C's is important but it is really the combination of all of them that is the key. Strong income ratios and a large down payment combined with strong reserves can offset some credit issues. Similarly, a long and strong credit history and excellent credit scores can overcome a lower down payment. That's why it is critical to consult a qualified loan officer at the outset because mortgage market forces can occasionally change the respective weight of the 4 C's.

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**Editor's Note: The next print edition of the Schwartz Report will appear in June, then quarterly thereafter.

Charles E. Schwartz II, CRB
7234 Lancaster Pike, 100A
Hockessin, DE 19707
302-234-5202
Fax 302-234-5212
cschwartz@psre.com
www.charlieschwartz.com

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www.charlieschwartz.com
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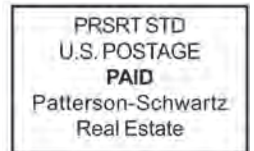

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