

The Truth About Real Estate Loan Pre-Approval

By Russell Gray

An Important Service

Loan pre-approval is an important service every finance company should offer clients, especially those interested in purchasing real property. Virtually all professional real estate agents strongly prefer that a potential buyer become pre-approved before making an offer. Most agents and sellers consider an offer which includes a strong pre-approval letter issued by the lender or broker to be an offer more likely to result in a transaction that consummates.

It is important every prospective borrower understands the process and criteria by which loans are approved before deciding which type of pre-approval is suitable for their situation.

Understanding the Process

Real estate lending can be divided into two very broad categories. The first is lending for 1-4 residential units. The second category is commercial lending for virtually all real estate lending that is not in the first category. The concept and practice of pre-approval is primarily applicable to real estate lending for 1-4 residential units and is the focus of this article.

In retail residential real estate lending, whether dealing directly with a financial institution such as a bank or credit union, or with a brokerage firm which may represent hundreds of institutions, the prospective borrower will typically interact with a loan officer. The loan officer is trained to provide a preliminary analysis of a prospective borrower's financial condition based upon undocumented verbal representations made by the prospective borrower regarding his or her credit rating, income, assets and liabilities. In many cases, upon borrower approval, the loan officer will pull a credit report which verifies credit score, reported liabilities and required monthly payments as recorded by the three major credit bureaus. After a discussion of the prospective borrower's financing objectives in regard to purchase price, available down payment and desired monthly payment, the loan officer should be able to determine if the loan is feasible based on standard underwriting guidelines common to most loan programs. In cases where the feasibility is questionable, the loan officer may decide to select a particular loan program and check its specific and unique underwriting guidelines before providing the prospective borrower with an opinion as to the likelihood of getting final approval from the loan committee or underwriter. It is important to note that underwriting guidelines vary from lender to lender and from program to program. Therefore, it is impossible to get a firm approval without identifying a specific program for which to apply.

Underwriting guidelines are the rules by which a lender will fund a loan. An "underwriter" is a person who is typically not the loan officer and is employed by the lender to evaluate the prospective borrower's application and supporting documentation, and who will decide whether or not to approve and fund the loan. When it comes to final approval, it is not the loan officer's opinion that matters. The underwriter evaluating the file has the "final" say. Though the underwriter is permitted a small amount of discretion by the "investor" (the person or institution providing the funds), in actual practice most residential loan approvals are not highly flexible. This is because the "paper" (the loan)

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will be sold to third party investors in the secondary market. Much of the secondary market is supported by the privately owned, but federally chartered, organizations known as Fannie Mae and Freddie Mac. Loans supported by these organizations must conform to their guidelines. Even non-conforming loans find most of their underwriting rules in Fannie / Freddie guidelines. The result is that either your loan request meets the guidelines or it doesn't – and there isn't much room for negotiation. The real art is in what is called the “packaging” of the loan – that is, presenting your request to the lender in a way which most closely satisfies their guidelines.

Not All Pre-Approvals are Equal

Unfortunately, many companies and their loan officers do not make clear to prospective borrowers the important differences between a loan officer's preliminary opinion and an actual underwriter's final approval. Many people think a loan officer's opinion based on a cursory analysis is an actual approval - only to be surprised later when the underwriter analyzes the file against program guidelines and denies approval. In actual practice, virtually all approvals are “conditional”, which means the loan will only be funded when *all* of the conditions are met to the underwriter's satisfaction.

The bottom line is that the strongest pre-approvals are based upon a clear understanding of a prospective borrower's objectives and by doing a great deal of analysis at the very beginning.

Pre-Approval Options

There are four levels of loan pre-approval available through most loan companies. In each case, prior to requesting pre-approval, the prospective borrower should work closely with their loan officer to determine their particular criteria for loan selection. Items to be considered are target purchase price and loan amount, maximum acceptable monthly payment, interest rate risk tolerance, and future plans for the subject property and equity. Absent this information, a pre-approval should be based on a range of the highest loan amount for the lowest payment and a 30-year fixed-rate no-points loan, each with the highest allowable total debt-to-income ratio. Down payment should be based on the highest down payment the borrower can afford while still maintaining adequate cash reserves to satisfy guidelines (typically two to six months of the proposed Principal, Interest, Taxes and Insurance payment). This may not have anything to do with the actual loan program or down payment used, but it will produce a very conservative pre-approval – which means there is some wiggle room if the borrower wants to buy something slightly over the pre-approval. Remember, the purpose of the pre-approval isn't to tell the borrower what he or she can afford; it isn't to tell the borrower what loan they will actually get. The purpose of the pre-approval is to demonstrate to the seller and the seller's agent that the borrower is well-qualified to buy the property being offered upon.

- **Pre-Qualification**

Loan pre-qualification is provided by a loan officer and takes only a few minutes. Pre-qualification is an analysis of a prospective borrower's credit worthiness based upon the prospective borrower's verbal undocumented representations of his or her credit history, income (amount, type, source, durability, trend), assets (amount, type,

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seasoning, trend), and liabilities (amount, type, trend, required monthly payments). The analysis is primarily based upon debt to income ratios, credit history and proposed loan-to-value ratios acceptable to most lenders, and interest rates generally available in the market place at the time of pre-qualification.

- **Credit Pre-Approval**

A Credit Pre-Approval also only takes a few minutes and is essentially the same as a Pre-Qualification except that the loan officer will pull a three-bureau credit report through a mortgage scoring engine. The credit report provides documentation of credit score, and an itemized list of reported liabilities and their monthly required debt payments. Income and assets are still evaluated according to the prospective borrower's representations. If a particular loan program has been selected, the loan officer can electronically submit a request for pre-approval to a particular lender. The electronic pre-approval from the lender will contain a list of conditions which must be met before final approval and funding and assists the loan processor in assembling the documentation to support the loan application.

- **Documented Pre-Approval**

A Documented Pre-Approval includes building a credit file that includes an application, credit report and all supporting documentation of income, assets, and liabilities. The file is then reviewed by the loan officer and compared to underwriting guidelines of specific lenders. This service can take 1-3 business days from the time all requested paperwork is provided by the prospective borrower.

- **Hard Copy Underwritten Pre-Approval**

In this case, the credit file, which includes an application, credit report and all supporting documentation of income, assets, and liabilities, is submitted to a specific lender for approval by the actual underwriter. This service can take 5-10 business days from the time all requested paperwork is provided by the prospective borrower. Once approved, the loan is ready to fund pending receipt of a satisfactory title report, appraisal and purchase contract (if applicable) on the subject property. The benefit of this level of pre-approval is there are virtually no borrower related surprises likely to come up during the transaction, assuming nothing substantial changes in regard to the borrower's financial status between pre-approval and funding. The only conditions remaining in the file are those pertaining to the property. This level of pre-approval is the next best thing to an all cash transaction.

About the Author

Russell Gray is a real estate financial strategist and a popular speaker at seminars, college classes, investment clubs and on the radio (www.RealEstateGuysRadio.com). He is a former faculty member for the California Association of Realtors™ where he taught finance to real estate agents pursuing the prestigious GRI (Graduate Realtor Institute) designation. He co-founded Advisor Financial Alliance, the *Real Estate Investor Development Program*™ and co-authored the book *Equity Happens*™.