FOUR KEY UNDERWRITING RATIOS

Most of real estate lending can be derived from the results of four ratios:

A. Loan-To-Value Ratio (LTVR)
B. Loan-To-Cost Ratio (LTCR)
C. Debt Service Coverage Ratio (DSCR)
D. Debt Ratio (used mainly in Residential Underwriting)

The bulk of the energy spent "processing" a loan is merely an attempt to verify the numbers that go into the numerator and denominator of the above 4 ratios.

The Loan-To-Value Ratio (LTVR) is defined as follows:

$$\text{Loan-To-Value} = \frac{\text{Total loan balances } (1^{st}\text{ mtg}+2^{nd}\text{ mtg}+3^{rd}\text{ mtg})}{\text{Fair market value (as determined by appraisal)}}$$

Loan-To-Value Ratios seldom exceed 80% because the lender always wants some extra protection against default.

The second ratio that lenders use when "underwriting" (i.e., qualifying) a loan is the Loan-Cost-Ratio. This is most often used for construction loans. The Loan-to-Cost Ratio is defined as the ratio of the loan to the total cost of the project:

$$\text{Loan to Cost Ratio (LTC)} = \frac{\text{Total Loan Amount}}{\text{Total Project Costs}}$$

Typically lenders like to see no more than 85% LTC Ratio. Usually the LTC Ratio is used on newer properties or properties recently purchased.

The third ratio used in lending is the Debt Service Coverage *Ratio* (DSCR). The Debt Service Coverage Ratio is a sophisticated ratio used on larger loans for income producing properties. It is defined as:

$$\text{Debt Service Coverage Ratio} = \frac{\text{Net Operating Income}}{\text{Debt Service}}$$

Net Operating Income is the income from a rental property after deducting the real estate taxes, insurance, repairs and all other operating expenses; and Debt Service is the mortgage payment on the property. Most lenders insist that this ratio exceed 1.0. A debt service coverage ratio of less than 1.0 would mean that the property did not produce enough net rental income for the owner to make the mortgage payments without supplementing the property from his personal budget.

The final ratio that lenders use when "underwriting" is the Debt Ratio. The Debt Ratio compares the amount of bills that the borrower must pay each month to the amount of monthly income he earns. This is used primarily in underwriting residential loans. More precisely, the Debt Ratio is defined as:

$$\text{Debt Ratio} = \frac{\text{Monthly Debt Obligations}}{\text{Monthly Income}}$$

Obviously someone whose Debt Ratio is 150% is in trouble. A Debt Ratio of 150% would mean that a borrower's obligations are one and a half times his income. Debt Ratios seldom are allowed to exceed 40% in practice.

Each ratio will be covered in more detail in the following pages.