



2024

DSCR LOANS THE COMPLETE GUIDE



DSCR Loans: What Are They?

DSCR loans stand for debt-service coverage ratio loans and are commonly used for investment properties or properties that generate income. The DSCR metric measures whether the property can generate enough income to cover its debt obligations. This ratio allows lenders to determine the risk associated with the property without using the borrower's income or credit score as part of the eligibility requirements. When it comes to DSCR, higher is better since it indicates that the property has strong financial performance.

Since DSCR loans don't follow the lending guidelines set by Fannie Mae and Freddie Mac, they're generally considered part of the non-qualified mortgage (non-QM) market. Between 2018 and February 2023, approximately half of the 201,000 non-QM loans were DSCR loans, making them a popular choice amongst real estate investors and those in commercial real estate.

The appeal of DSCR loans is largely due to rental income contributing significantly to the property's ability to pay off the debt. Because real estate investors are the primary demographic for DSCR loans, the rise in the mortgage's popularity can be seen as a direct correlation with the rise of real estate investing. Additionally, these loans are highly specialized and have specific terms and conditions that are tailored to the property's income-generating potential.



DEBT SERVICE COVERAGE RATIO, EXPLAINED

Debt Service Coverage Ratio (DSCR) is a figure that's used by lenders to determine whether an investment property is generating enough income to cover its debt payments. For DSCR loans, the DSCR figure is used in lieu of the borrower's income, which is typically used for conventional loans. DSCR is calculated by dividing the property's net operating income (NOI) by the total debt service (including interest and principal payments).

This ratio helps lenders determine whether the property is making sufficient income to "pay for itself". A DSCR above 1 suggests that the property is generating enough to meet its debt obligations, meanwhile, a DSCR below 1 would suggest that the property isn't generating enough income to fully cover debt payments. To put this figure in perspective, see the two examples below of a strong DSCR vs. a weak DSCR.



EXAMPLE:

Property 1 is a duplex with a purchase price of \$250,000. At a 7.5% interest rate, the total monthly payments are \$1,748 for a 30-year fixed mortgage. Since this property is a duplex, each unit is renting out for \$1,500 per month for a total of \$3,000 per month for the entire property. Assuming the 1% rule that estimates annual maintenance expenses to be equal to 1% of the property's value, \$2,500 is spent yearly on maintaining the property.

Annual debt service: $\$1,748 \times 12 = \$20,976$

Annual operating income: $\$3,000 \times 12 = \$36,000$

Annual operating expenses: $\$250,000 \times 1\% = \$2,500$

Annual net operating income: $\$36,000 - \$2,500 = \$33,500$

Using the DSCR formula:

Net Operating Income / Annual Debt Service

= $\$33,500 / \$20,976$

= 1.60

In this example, Property 1's annual net operating income is enough to cover the debt obligation by 1.6 times, which means it has a fairly strong DSCR.

DSCR LOAN DOWN PAYMENT REQUIREMENTS

For DSCR loans, the down payment requirements can vary depending on the lender. Generally, the down payment requirement ranges between 10% to 30% of the property's purchase price. Several factors can also impact the down payment requirements for a DSCR loan, such as:

- Lender policies: Different lenders have their own risk tolerance and minimum down payment requirements for DSCR loans.
- Loan amount and term: Larger loan amounts or shorter terms might involve stricter down payment requirements.
- Property type: Loans for certain property types, like multi-unit buildings, might require higher down payments compared to single-family homes.
- Borrower profile: Strong creditworthiness and experience with investment properties can potentially secure lower down payment options.

It's important for borrowers to discuss specific down payment requirements with potential lenders during the loan application process.



DSCR Loan Credit Score Requirements

While specific credit score requirements depend on the lender, credit score requirements for DSCR loans can typically range anywhere between 620 to 700. Though most lenders require a minimum credit score of 680 for DSCR loans, some may be willing to accept lower scores as low as 620 depending on other factors like your DSCR ratio and down payment amount.

Having a strong DSCR figure can potentially offset lender concerns about a slightly lower credit score. Additionally, a larger down payment would result in a lower loan-to-value ratio (LTV), which would also reduce the lender's risk. Even though some lenders might be open to allowing lower credit scores, keep in mind that higher credit scores, like 700 or above, generally unlock better interest rates and loan terms.

Despite credit score being an important element, other factors like the financial performance of the property and the borrower's financial stability can also play a significant role in the loan approval process. For the most accurate and up-to-date information on specific lender requirements for DSCR loans, it's recommended to contact them directly prior to applying.



DSCR LOAN PROS AND CONS: EXPLAINED

If you're still evaluating whether a DSCR loan is right for you, it's essential to consider the pros and cons to make an informed decision. For your convenience, we've explained the main pros and cons of DSCR loans below.

Pros:

- **Flexibility and Accessibility:** DSCR loans have more flexible requirements when it comes to borrower criteria. Since DSCR loans don't require any income or work history, they're more accessible to self-employed individuals or people with non-traditional sources of income.
- **Options for Foreign Nationals:** Depending on the lender, foreign national real estate investors have the opportunity to qualify for a DSCR loan for their investment property.
- **Faster Approval:** Using the property's income as a qualifying factor rather than personal income makes the approval process much more streamlined compared to traditional mortgages.
- **No Income Documents Required:** Income documents like W2s, pay stubs, or tax returns aren't required for a DSCR loan, making them ideal for self-employed individuals and those with non-traditional income sources.
- **Flexibility With Rental Income:** Use the rental income generated from your existing real estate investment properties toward loan qualification
- **LLC Ownership:** Property can be purchased under an LLC, which can be used as an asset protection strategy.
- **Potential for Higher Returns:** If the property generates more rental income than the mortgage payments, it can lead to higher returns with additional positive cash flow.
- **Potential for Lower Interest Rates:** Since a DSCR loan is secured by the property and its cash flow, borrowers might be able to secure a lower interest rate compared to other types of commercial real estate loans.
- **Allows Borrowing for Multiple Properties:** There's no hard limit on how many properties you can buy using DSCR loans, unlike traditional mortgages.

Cons:

- **Potential for Higher Down Payments:** Most lenders require a minimum of 20-25% down, which may limit the access of DSCR loans to investors with less capital.
- **More Stringent Requirements:** It may be difficult to meet the DSCR or credit score thresholds required by some lenders depending on the property.
- **Limited Lenders:** Since DSCR loans are specialized loan products, the selection of lenders may be limited.
- **Non-Standardized:** DSCR loans don't have standardized guidelines, so unlike traditional mortgages, terms and conditions can vary significantly among lenders.
- **Market Volatility:** Fluctuations in the economy can potentially impact DSCR negatively. Negative impacts can come from lower income generation, higher debt obligation, or both.

DSCR LOANS VS. CONVENTIONAL LOANS

In terms of their lending approaches, DSCR loans and conventional loans are vastly different. More commonly used in commercial real estate, DSCR loans determine eligibility mainly based on how much income the property is generating. By using the DSCR figure, lenders can assess whether the property's income can cover its debt obligations. For real estate investors who purchase properties under an LLC, using a DSCR loan can allow them to secure financing for properties with strong cash flows even if they have poor personal credit.

On the other end of the spectrum, conventional loans use a broader range of eligibility criteria. The main criteria used for determining eligibility for a conventional loan are the borrower's credit history, income, and debt-to-income (DTI) ratio. Although the property's income can also be used as an additional factor for conventional loan eligibility, it's not the sole determining factor. Because of this, conventional loans provide a wider variety of options to cater to lending needs that are outside of commercial real estate.



THE DSCR LOAN APPLICATION PROCESS

Specific loan application processes for DSCR loans may vary among lenders, but here is a general overview:

1. Preparation and Gathering of Documents

- Put together information such as rental income and operating expenses to analyze the property's financial performance and calculate estimated DSCR.
- Gathering financial documents like bank statements, credit reports, and property information to have ready for the lender's review.

2. Choose a Lender and Get a Pre-Approval

- Research lender options and speak to several of them to discuss your potential eligibility.
- Evaluate your options by considering each lender's terms, interest rates, and requirements.
- Choose a lender that fits your needs and who specializes in non-QM loans, primarily DSCR loans. We happen to be one of them!
- Get a [pre-approval](#) from your chosen lender.

3. Submit Formal Loan Application

- Complete and submit the lender's formal loan application.
- You may be required to provide additional detailed information about the property, financial documents, and anything else they ask for.

4. Property Appraisal

- The lender will order an appraisal and rent schedule to verify the property's value and market rent.

5. Underwriting Process

- The lender's underwriting team will review your application and take all eligibility criteria into consideration. Additional documentation might be requested by the lender during this step.
- This step is done by the lender to assess the loan's feasibility and risk.

6. Loan Approval

- If the underwriting process is successful, your loan will be approved and the lender will specify the terms and conditions of the loan.

7. Closing

- Submit any remaining documents and finalize the loan terms with the lender.
- Schedule a closing date to sign documents and complete the closing process.
- Once everything is finalized, the funds are disbursed and the property title is transferred.

8. Post-Closing

- After closing, be sure to stick to the agreed-upon loan terms and make regular payments.
- Some lenders might continue monitoring the property's financial performance throughout the life of the loan.

THE DSCR LOAN CLOSING PROCESS

When applying for a DSCR loan, it's important to have the necessary documents ready and be prepared for any negotiations during the underwriting process. Remember that specific requirements and application processes may vary depending on the lender. If you're still unsure how to navigate the complexities of the DSCR loan application process, don't be afraid to reach out to professionals like your realtor or loan officer.

The DSCR Loan Closing Process

The closing process for a DSCR loan is the final stage in securing financing for your investment property. While the process might be different depending on your lender, here's a general overview of what you should expect:

- Title Search and Insurance
- A title search is completed to confirm that the property has no liens that could interfere with the lender's rights.
- Typically, the borrower has to purchase title insurance to protect themselves from any potential title issues.
- Document Review
 - Review documents from the lenders, such as a loan agreement, promissory note, mortgage or deed of trust, etc.
 - Legal Consultation
 - A legal consultation can help you determine whether the documents align with your interests and protect your rights.
 - Legal professionals can help you thoroughly understand the terms and conditions outlined in the loan documents.
- 1.Coordinating the Closing Date
 - Coordinate with the lender to schedule a closing date.
 - The closing date is the day when the necessary documents are signed and the transaction is completed.
- Funding Preparation
 - Confirm that funds that are required for the transaction are ready, such as the down payment, closing costs, and reserves.
- Closing Statement Review
 - The closing statement outlines the details of the transaction, such as the loan amount, interest rate, closing costs, and any adjustments.
 - Review the closing statement carefully to make sure all of the information on it has been agreed upon and is accurate.
 - Document Signing
 - Sign all required documents at the closing meeting.
 - All involved parties including borrowers and guarantors need to be present

THE DSCR LOAN CLOSING PROCESS

- **Funding**
 - After the document signing, the lender transfers the loan amount to either the seller's account or the escrow agent.
- **Document Recording**
 - Legal documents are filed with the proper authorities to officially transfer the property title to your name.
- **Post-Closing**
 - Complete any post-closing requirements specified by the lender, which could include submitting additional documentation, providing proof of homeowners insurance, and making your first loan payment according to the schedule.

Keep in mind that each lender's closing process may vary. During the DSCR loan closing process, it's essential to be prompt with your communication and be ready with any required documents to ensure a smooth transaction. If you're having trouble navigating the closing process, it's recommended to reach out to your loan officer or a legal professional for assistance.

INTEREST-ONLY DSCR LOANS

While not all DSCR loans are interest-only, many of them offer an interest-only option. This interest-only option allows the borrower to only make interest payments during an introductory period of the loan, typically between three to 10 years. Paying only the interest during this period means that your monthly payments are significantly lower compared to a traditional loan that would incorporate both principal and interest in the monthly payments according to an amortization schedule.

Not only are your monthly payments smaller, but you may be able to reap additional tax benefits by deducting interest expenses. The extra cash can then be used for other investments or expenses, like renovations or repairs. Interest-only DSCR loans can be a valuable tool for real estate investors who are looking to maximize their cash flow during the beginning stages of owning the property.

Even though interest-only DSCRs can sound enticing due to lower payments for the first few years, borrowers usually have to transition to monthly payments that incorporate both interest and principal after the specified interest-only period. This means that their monthly payments can be expected to jump in comparison to their initial interest-only payments. On top of that, interest-only DSCR loans increase the overall cost of the loan when you factor in the total interest paid over time.

Keep in mind that not all DSCR lenders offer interest-only options, so if this is a loan feature that's non-negotiable, it's important to shop around for lenders and evaluate your options carefully.

DSCR Construction Loans

When it comes to construction loans, DSCR construction loans are different from traditional ones. Traditional construction loans typically focus on the project's costs, along with the borrower's income and credit score, which is more in line with a conventional loan in terms of eligibility requirements. Meanwhile, DSCR construction loans have a strong focus on the property's income potential in the future. Lenders use the DSCR metric to determine the property's ability to generate enough income to cover the construction loan interest on top of future mortgage payments. Using this figure, lenders can also evaluate how viable the project is and whether the borrower has the capacity to manage the debt effectively.

In the commercial real estate world, DSCR construction loans can be beneficial for real estate developers who are looking for financing during the construction phase since the income-generating potential of the future property plays such a large factor in eligibility.

DSCR CASH-OUT REFINANCE OPTIONS

For real estate investors looking for a way to unlock equity in their properties, DSCR cash-out refinance options can be a way to do this. This financial tool involves refinancing an existing mortgage to help investors cash out equity from their property, while still maintaining the income-generating potential of it. A DSCR cash-out refinance differs from a traditional cash-out refinance due to the way that the lender assesses borrower eligibility. Instead of using the borrower's income and personal credit score, the lender uses the property's DSCR figure to determine whether the income generated by the property can cover both the existing mortgage and the additional borrowed amount. Leveraging the strong income performance of the property allows the borrower to access cash for a variety of purposes, like renovations and repairs, debt consolidation, or other investment opportunities.



DSCR LOANS FOR AIRBNB AND SHORT-TERM RENTALS

Since DSCR loans are designed for investment properties, using a DSCR loan to fund an Airbnb or short-term rental is common. Instead of using the borrower's income as a main factor to be eligible, lenders use the property's income from short-term rentals to determine the property's DSCR. If the property has a strong DSCR, meaning it generates enough income to cover its debt obligation, lenders will heavily take that into account for DSCR loans. However, since income from short-term rentals can fluctuate, lenders will typically consider historical rental performance, occupancy rates, and the location of the property. A DSCR loan recognizes the unique revenue stream of Airbnbs and short-term rentals and offers a tailored financial solution for real estate investors looking for their next venture.

30-YEAR FIXED-RATE DSCR LOANS

While 30-year fixed-rate DSCR loans exist, they're generally less common compared to traditional mortgages. Considering that DSCR loans are typically associated with commercial real estate and real estate investing, they're structured differently than a standard residential mortgage. Usually, DSCR loans come with shorter terms, such as five, seven, or 10 years. Although the loan term is shorter, the total loan amount may be amortized over a more extended period. At the end of the term, borrowers can either refinance the loan or pay off the remaining balance.

Even though 30-year fixed DSCR loans might not be common at this time, lending products can evolve and new products can become available through specialized lenders. By doing research and reaching out to specific lenders, you might be able to find a lending product that's right for you.

ARE DSCR LOANS ALLOWED FOR PRIMARY RESIDENCES?

DSCR loans are typically associated with commercial real estate financing and are catered toward real estate investors who are looking to acquire income-generating properties. The main metric used to determine eligibility is DSCR, which calculates whether an investment property's income can pay off its debt obligation.

Since primary residences are usually owner-occupied, they don't generate any rental income. If the property isn't generating any income, the DSCR figure would automatically be zero, which makes it ineligible. For primary residences, traditional mortgages are generally more common. Lenders offering traditional mortgages would judge eligibility by the borrower's income, credit score, DTI, and other factors that indicate financial stability. DSCR loans are not designed for properties that are owner-occupied due to the eligibility factors required. If you're looking for financing options for your primary residence, it's recommended to explore the traditional mortgage options that are offered by lenders.



FAQ:

What Is DSCR In Lending?

In lending, DSCR stands for Debt Service Coverage Ratio and is a financial metric used by lenders to assess a borrower's ability to repay a loan. Rather than using the borrower's income, DSCR uses the property's cash flow and compares that to the debt payments to ensure the property generates enough income to "pay for itself" and cover the loan obligation.

How Do You Calculate DSCR On A Loan?

To calculate DSCR on a loan, divide the property's annual net operating income by its total annual debt service (includes both interest and principal). A DSCR above 1 means that the property's income can cover the debt obligations, whereas a DSCR below 1 means there's not enough income to cover the entire debt obligation.

Are DSCR Loans A Good Option For Rental And Investment Properties?

DSCR loans can be a great option for rental and investment properties. Since the incoming cash flow that the property can generate is taken into account, DSCRs are ideal for rental and investment properties that are making money.

What Are The Pros and Cons of DSCR Loans?

- Pros:

Doesn't require borrower's income

Tailored to income-generating properties (use rental income to qualify)

More flexible qualification requirements

Allows borrowing for multiple investment properties

Typically faster closing due to less documentation required

Potentially lower interest rates

Potential options for foreign nationals (depending on the lender)

- Cons:

DSCR loans are non-standardized and loan requirements can vary greatly between lenders

Limited lenders offering DSCR loans

Potentially higher down payment requirements

Potentially higher minimum DSCR ratios and credit score thresholds

FAQ:

What Are The Requirements For DSCR Loans?

The qualification requirements for DSCR loans vary between lenders, but generally, this is what's required:

A credit score of 640 or higher – At Defy, however, it's 620.

A down payment of 20-25% of the purchase price

A DSCR of at least 1.1 to 1.25 – At Defy, however, it's .75.

Evidence or history of stable and predictable income from the property

Usually limited to single-family homes, duplexes, and sometimes multi-family units

DSCR Loans With No Down Payment: Do They Exist?

Typically, no, DSCR loans will require a down payment. Only in very specific and rare circumstances can a borrower get a DSCR loan with no down payment.

Can You Get A DSCR Loan With 10% Down?

Most lenders will require at least 20% down, which means that generally, you can't get a DSCR loan with 10% down.

Are DSCR Loans Interest-Only?

Usually, DSCR loans are not interest-only, however, they often offer interest-only payment options for a specified period at the beginning of the loan term. If you're looking for a DSCR loan with an interest-only period, talk to your lender to see if it can be incorporated into your loan terms.

Do DSCR Loans Show On Credit Report?

DSCR loans are generally not reported on personal credit scores since they're typically associated with businesses rather than individual credit profiles. However, it depends on the specific lender and their reporting procedures. To be sure about the visibility of a DSCR loan on your credit report, ask the lender directly.

DSCR Loans With No Credit Check: Do They Exist?

It's unlikely to get a DSCR loan with no credit check. Some DSCR lenders may offer alternatives to a credit check, such as asking for tax returns or bank statements, to evaluate financial stability. However, these alternatives might come with trade-offs like stricter qualifications or higher costs due to higher risk for the lender.

DSCR Loans For LLCs: Do They Exist?

Yes! DSCR loans are commonly available for LLCs and other business entities.

FAQ:

Are DSCR Loans Non-Recourse?

DSCR loans can be structured as either recourse or non-recourse, but more commonly, they are recourse. This depends on the lender and the terms negotiated with the loan.

Do DSCR Loans Have Prepayment Penalties?

Typically, DSCR loans have prepayment penalties. Prepayment penalties may vary depending on the lender and terms.

Are DSCR Loans Available For Short-Term Rentals and Airbnbs?

Yes! DSCR loans are available for short-term rentals and Airbnbs.

Can You Get A DSCR Loan With An ITIN Number?

Yes, it's possible to get a DSCR loan with an ITIN number, but it depends on the lender's policies.

Can You Get A DSCR Loan Cash-Out Refinance?

Yes! You can get a DSCR loan cash-out refinance.

Can You Get A DSCR Loan For New Construction?

Yes! You can get a DSCR loan for new construction.

Can You Get A DSCR Loan For Your Primary Residence?

No, DSCR loans are specifically designed for investment properties and rely on income generation.

What Is The Average Length Of A DSCR Loan?

The average length of a DSCR loan is 30 years, however, some lenders may offer shorter terms, such as 20 or 25 years.

Can First-Time Home Buyers Get A DSCR Loan?

Yes, however the rates are not favorable.

Can You Get A DSCR Loan Under \$100k?

DSCR loans are typically associated with larger transactions, but some specialized lenders or private lenders may be willing to fund a DSCR loan under \$100k.