SPECIAL EDITION

from the

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Your Door to FHA HOMEOWNERSHIP

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For the past several weeks, the industry has engaged in renewed discussions about taking a serious look at the credit score floors being placed as overlays on mortgage programs and about the viability of the FHA Short Refinance program.

While the continued debate about appropriate credit score floors is important, it should not be mistaken as a push from FHA for lenders and investors to exceed the risk/return balance they deem to be appropriate. We have all learned what happens when institutions do not appropriately identify and manage risk.

That is why this administration, led by Secretary Donovan and my team here at FHA, made the most significant changes in risk management policies and practices in the history of this agency.

These changes included:

- Setting realistic credit score guidelines and requiring a 10 percent minimum down payment for loans with credit scores below 580
- Reforming FHA's mortgage insurance premium structure and increasing overall rates
- Strengthening underwriting criteria for streamlined refinances
- Implementing condominium policy changes
- Increasing counter party risk measures with new capital requirements, changes to the correspondent process, and significant enforcement measures
- Creating a permanent office of risk management – the first of its kind in the history of FHA

Clearly, our goal has been to ensure FHA is operating soundly with high quality risk management protocols, practices and procedures. However, we grow increasingly concerned about access to homeownership for responsible families who may be excluded solely due to their credit score and about those families trapped in their home with negative equity.

Secretary Donovan and I continue to speak out on both of these issues because if we do not come together as an industry to address them, we slow housing recovery, which is broadly based on fairness and access and must include negative equity markets. The major points we are communicating are highlighted below.

LINKS

[HUD.gov/fha](HUD.gov/fha)

HUD press releases

CREDIT SCORE FLOORS

When FHA implemented its policy that raised the credit score floor to 580 for loan endorsements with FHA's minimum 3.5 percent down payment, it did so guided by three goals.

First, we wanted to improve the capital reserves of FHA, and we have made significant process toward accomplishing that goal. As reflected by the increases to capital we have generated this past year and a stronger actuarial report, it is clear that FHA is in a stronger position despite less robust economic variables.

Second, we were concerned about maintaining the delicate balance between ensuring appropriate risk to the taxpayer while supporting a rational and balanced recovery of the housing market.

Third, we needed to be unwavering in our commitment to fulfill our mission of providing fair access to underserved borrowers. Specifically, lower income families impacted by the economic downturn have less opportunity to save. A short term gap in employment can have significant impact on their credit score. As a result, many borrowers who may have suffered a temporary economic setback no longer have open access to today's mortgage finance markets. Without FHA and its programs, many lower income borrowers might be denied access to mortgage credit.

We know that lower credit scores, in and of themselves, indicate a higher risk of default. But, as we have discussed with industry stakeholders for months, borrowers with the same credit scores can pose very different risks. For instance, a habitual late payer is likely to pose a different risk than someone who lost his or her job but otherwise has a history of paying their bills on time. It has been well documented that homeownership produces better outcomes for health, education, and long term wealth. Denying responsible families the opportunity to own a home based solely on their credit score is in no one's best interest and may have a disparate impact on many.

Our message is clear. We are asking our industry partners to consider all the factors to determine the borrower's ability to repay their mortgage and look beyond a simple credit score. We ask the industry to consider how to provide credit to these underserved borrowers by considering the reasons behind credit score impairment, as well as considering other factors such as reasonable debt-to-income ratios, leveraged use of available credit and future job stability combined with proper controls for owner occupancy, full documentation, and primary residence. We understand these are more challenging loans to assess, but as an approved FHA lender, we need you to take the time and make the effort to help these distressed borrowers – it is fundamental to our mission.

FHA Short Refinance

The FHA Short Refinance option was created as a meaningful way to address negative equity situations. We wanted to remove any potential barriers to adoption, so we implemented this program using the existing FHA application process for ease of use and exempted the loans from Neighborhood Watch reports to alleviate institutional resistance or concern.

Most analysts agree that the likelihood of sustainable long term performance of a distressed homeowner will result from insuring a loan to value ratio that will not eliminate the opportunity for future mobility. Nearly 20 percent of mortgage households are in negative equity situations. This poses a significant challenge to the recovery of the nation's housing market.

We recommend lenders look at borrowers who have experienced a hardship to determine if the net present value of the loan is positive and assess if the FHA Short Refinance option is a viable solution.

The FHA Short Refinance option has the following attributes:

The borrower's loan must be considered current. Servicers can consider borrowers who are current on their trial modification plans after three payments eligible for the FHA Short Refinance option.

A principal write down of a minimum of 10 percent must take place. This can be done by the investor, the servicer, or any combination.

The maximum LTV is the FHA refinance limit of 97.75 percent but the CLTV can be 115 percent allowing for subordination of second liens or a new subordination of some of the unpaid first lien.

The borrower must be qualified using current information relating to income, appraisal, and debt to income. This ensures a high probability for long term sustainability.

Some industry players interested in FHA's Short Refinance option have asked about three areas of concern:

Moral hazard - This continues to be an area of concern for any modification efforts. We remain confident that industry participants can discern a borrower in need from one who is not. In the end, we have said that the market should build out the capability to use this initiative. We understand concerns about current borrowers who can still afford the payment lining up for this option, but trust the industry's ability to determine the appropriate application of the program as an option that could help families stay in their homes.

Costs to write down – We are not asking the industry to do something that does not make sense economically. This option can have a positive net present value in many circumstances. The model includes the value of monetizing the remaining debt off the balance sheet of the investor with a new FHA loan; considers savings from unmet payments by the borrower; factors in the risk of further home price declines; considers foreclosure costs and extended foreclosure time line costs, and estimates the value of a new performing servicing asset that has a lower probability of re-default than other modification efforts.

Operations cost -- We recognize the competition for IT and operations resources in an institution. It is one of the primary reasons why we leveraged the existing FHA refinance program to design the Short Refinance option. Delaying implementation of this program comes at a high cost. Families are losing their homes. Building the capability to do this now provides another option for thousands of families at a difficult time and provides participating institutions a solution that protects them from a negative NPV situation should home prices decline further.

As stated earlier, FHA has been focused on risk management unlike never before, and we are steadfast in our commitment to the recovery of the housing market. We need to be thoughtful, conservative, and fair to realize housing recovery in a meaningful way.

However, we cannot do it alone. We need the support and participation of our industry partners. That requires all of us to consider which policies, programs and practices are best to ensure that sustainable homeownership is available to as many qualified Americans as possible.

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