

FHA Will Tighten Up in 2010

by Matt Carter, December 3, 2009

The Obama administration is moving to tighten underwriting standards on FHA-backed loans by increasing the amount of upfront cash homebuyers must bring to the table, raising minimum FICO scores for new borrowers, and reducing maximum seller concessions from 6 percent to 3 percent.

The most obvious way to increase upfront cash requirements would be to raise the 3.5 percent minimum downpayment requirement for loans guaranteed by the Federal Housing Administration.

A bill introduced Oct. 1 by Rep. Scott Garrett, R-N.J., would raise the minimum downpayment for FHA loans to 5 percent and prohibit financing of closing costs. **HR3706**, which has 27 co-sponsors, has been referred to the House Financial Services Committee.

Housing Secretary Shaun Donovan, **briefing** committee members on the administration's plans Wednesday, said there are several ways to make sure borrowers have more "skin in the game" currently under consideration.

HUD has "made the decision to exercise our authority to increase the upfront cash that a borrower has to bring to the table in an FHA-backed loan," Donovan said, but there "are several ways to accomplish this, and so we are currently analyzing various options to determine which is the most effective and consistent with our mission."

Testifying on behalf of the National Association of Realtors, Vicki Cox Golder urged Congress and the administration to "exercise caution before introducing proposals that may have a profound adverse impact on our economic recovery." NAR is strongly opposed to HR 3706, she said, because increasing FHA's downpayment requirements would make it impossible for many borrowers to use the program, and "not add a penny to FHA's reserves."

Dan Green, a Cincinnati-based loan officer, said an increase in minimum FICO could have "a much larger impact than increasing downpayment requirements from 3.5 to 5 percent."

The minimum FICO score for FHA-backed loans was raised from 500 to 580 earlier this year, he said, although most lenders already have even higher minimums. "Most consumers are going to walk into their bank, and their bank will say 620" is the minimum score needed to obtain a mortgage, Green said.

FHA is in a difficult position, Green said, because Fannie Mae and Freddie Mac continue to tighten their guidelines, and that pushes more borrowers who are less creditworthy into FHA loans. "They are trying to limit their exposure to the riskiest borrowers," Green said. "Your median FHA borrower looks decidedly worse today than 18 months ago."

Fannie Mae will implement a minimum 620 FICO score and other underwriting changes over the weekend of Dec. 12 as part of its rollout of its Desktop Underwriter Version 8.0 software.

With claims on its mortgage insurance fund rising, HUD is also considering raising FHA mortgage insurance premiums, Donovan told the committee. Borrowers currently pay an upfront premium of 1.75 percent, plus annual premiums of 0.5 percent on loans with loan-to-value ratios of up to 95 percent. The annual premium on loans with higher LTVs is 0.55 percent.

Although HUD has the authority to raise the upfront premium to as high as 3 percent without additional input from lawmakers, annual premiums are at their statutory limits.

Donovan said HUD is requesting authority from lawmakers to raise annual premiums for new borrowers, "as this is one of the most effective means of raising capital" for the FHA's capital reserve fund, which has dipped below statutory minimums.

Raising the annual premiums of FHA borrowers would likely be a greater hardship than increasing their upfront premiums, since the cost of upfront premiums can be financed into a mortgage.



Because an FHA-backed loan is, for all practical purposes, the only option for most borrowers who can't come up with a 20 percent downpayment, the program must survive. If FHA goes away you have nothing to fill its place right now.

One mortgage broker contacted states that he doubts that raising credit scores or minimum down payments will help FHA's bottom line in the short term, but is not opposed in principal to raising minimum downpayment requirements.

"We don't want to kill the golden goose here just to keep real estate prices inflated by making money available to a lot of borrowers," he said.

That said, he worries that the FHA is proposing to tighten its standards at about the time the Federal Reserve plans to shut down a program in which it has kept interest rates low by purchasing \$1.25 trillion in mortgage-backed securities issued by Fannie Mae, Freddie Mac and Ginnie Mae. The Fed has said it will wind the program down at the end of March, which could send interest rates up and put downward pressure on prices.

Most of the changes Donovan outlined can be made with no additional authority from Congress, and Donovan said HUD expects to provide more details and public guidance on the changes by the end of January.

"The good news is that when FHA rolls out changes, they don't do it overnight," Green said.

If HUD issues guidelines to lenders in January, they aren't likely to take effect for 60 days, meaning homebuyers have several months before the latest changes kick in. In September, FHA announced new guidelines for ordering appraisals and streamlined re-financings, which take effect January 1.

Donovan said HUD is currently analyzing what the floor for FICO scores should be, including the relationship between FICO scores and down payments. HUD is looking at whether to increase FICO minimums in combination with changes to other FHA underwriting criteria for lower-downpayment loans.

Reducing the maximum allowable seller concession to 3 percent would bring FHA "in line with industry norms," Donovan said. The current 6 percent level exposes the FHA to excess risk by creating incentives to inflate appraised value, he said.

HUD is also stepping up enforcement to make lenders more accountable, he said, increasing its review of lender compliance with FHA program requirements. HUD will develop a "Lender Scorecard" summarizing the performance of lenders who do business with FHA, and post it on the Web.

In releasing the results of an actuarial study last month that found FHA's capital reserve ratio has fallen below a 2 percent minimum established by Congress, Donovan noted that seller-funded assistance loans were the most substantial pool of troubled loans on FHA's books, with claim rates 2.5 to three times higher than other loans.

HUD has estimated that seller-funded downpayment assistance was used on more than 35 percent of all home purchase loans insured by FHA in fiscal year 2007, compared with less than 2 percent seven years earlier.

Congress abolished seller-funded downpayment assistance on FHA loans in 2008, but HUD says remaining risks to FHA include its greatly expanded market share and subprime lenders moving into FHA lending.

In the 12 months ending Sept. 30, FHA insured almost 30 percent of all purchase loans and 20 percent of total refinances in the housing market, HUD said. First-time homebuyers accounted for nearly eight out of 10 FHA-backed purchase loans in the second quarter of 2009, with nearly 50 percent of all first-time buyers relying on FHA-insured loans.

A recent **Federal Reserve report** demonstrated HUD is "not the new subprime lender," NAR's Golder said, with the average credit score for current borrowers having increased to 693, and only 13 percent of purchase borrowers having FICO scores below 620.

In September, 45 percent of FHA loans had FICO scores above 700, and less than 5 percent had scores below 620, she said. The percentage of FHA-backed loans with loan-to-value ratios above 95 percent fell from 72 percent in 2007 to 62 percent in 2008.

"The reason the capital reserves have fallen below 2 percent actually has nothing to do with FHA's current business activities," Golder said. "The decline is simply a reflection of falling value of homes in their portfolio."