<u>Comments of National Consumer Law Center on FHA's Single Family Housing Policy Handbook (Application through Endorsement Section)</u>

Dec. 15, 2013

On behalf of is low-income clients, the National Consumer Law Center (NCLC) submits the following comments to the FHA Office of Single Family Housing in response to the agency's Request for Comments dated October 29, 2013.

Page 10 line 32

<u>Mortgagee Responsibilities</u>. Add to text the following definition of "mortgagee:" "The term 'mortgagee' includes the named lender and any principal or controlling entity that imposes loan terms." This section establishes that the *mortgagee* is responsible for the quality of the mortgage and must comply strictly with all applicable FHA guidance. The Handbook does not define "mortgagee" in its Glossary or elsewhere. The use of agents, affiliates, subsidiaries, and nominees often obscures who is ultimately responsible for loan origination abuses.

Page 21 line 6

<u>Borrower Minimum Decision Credit Score</u>. While we recognize that HUD adopted the MDCS cutoff of 500 in September 2010 (75 FR 54022), we have raised elsewhere in these comments our continuing concern about the use of credit scores as a rigid barrier to consideration for an FHA loan. *See* p. 181, *infra*. We also note below that the effect of stringent downpayment requirements for borrowers under 580 is the functional equivalent of a lending floor set at 580. HUD has recognized the likelihood that future adjustments to compensating factors will be needed to mitigate the impact of heightened reliance on credit scores. (Final Notice Dec. 11, 2013 Docket FR 5595-N-01).We encourage HUD to further study this issue and to seek to identify additional compensating factors that would further open up safe lending opportunities for borrowers with low credit scores.

p. 23 line 16

<u>Borrower Ineligibility Due to Delinquent Federal Non-Tax Debt</u>. This provision prohibits a mortgagee from processing an application for a borrower who has delinquent federal non-tax debt. However the text states that, if the mortgagee verifies that the borrower has "resolved" the delinquency with the federal agency in accordance with the Federal Debt Collection Improvement Act, the mortgagee may still process the application. This provision has significant implications for borrowers with student loan debt. Student loan debt is increasingly becoming a barrier to first-time homeownership. *See e.g.* Meta Brown & Sydnee Caldwell, *Young Student Loan Borrowers Retreat from Housing and Auto Markets*, Federal Reserve Bank of New York (April 17, 2013). Federal student loan programs offer various forms of payment plans that can reduce or eliminate ongoing payment obligations. These plans typically allow the student loan borrower to make ongoing monthly payments in an amount based on current income and over

periods in excess of twenty years. Compliance with any of the recognized federal repayment plans should constitute a satisfactory repayment of student loan debt.

The reference in this draft to the “resolution” of a default “in accordance with the Federal Debt Collection Improvement Act” is not clear and will likely be incomprehensible to mortgagees. The Department of Education, and presumably other federal agencies, are not limited to collection and settlement options under the Federal Debt Collection Improvement Act. Borrowers may have satisfactorily resolved a default with the Department of Education or other federal agency, but it may not be clear whether the resolution was “in accordance with the federal Debt Collection Improvement Act.” The mortgagee should process the applications of borrowers in compliance with any recognized repayment plan recognized by the government agency to which the debt is owed. This would be consistent with the provision in a later section of this draft dealing with tax liens (p. 24). There, the Handbook provides that a borrower who has been in compliance for three months with an agreement to repay a tax lien debt may be considered for an FHA loan. A similar standard should apply to all federal non-tax debts, including student loans.

On a related point, FHA should use the payment amounts due under recognized federal debt payment plans, including student loan debt repayment plans, in calculating the back-end debt-to-income ratio.

Page 24 line 25

<u>Delinquent Federal Tax Debt</u>. The language here appears to treat a tax debt differently based on whether the tax debt has become a lien. For liens, the borrower may be eligible for an FHA loan if the borrower has made timely payments for three months on a repayment plan with the federal taxing agency. The same option should apply for tax debts that were not reduced to a lien. The text should state this clearly.

Page 35 line 32
<u>Eligibility for Property Flipping Waiver</u> (Resales Occurring Between 91 days and 180 days After Acquisition. Up to 180 days after acquisition is still a relatively short time for a resale. The Handbook appropriately requires a high level of scrutiny over any resale at 100 percent or more above the acquisition price occurring between 91 and 180 days of acquisition. For a resale occurring within one year of acquisition, the Handbook should require the same level of scrutiny that it does for a sale occurring within less than 91 days of acquisition.

Page 36 line 5

<u>Required Documentation</u>. This language gives too much deference to the “owner of record” designation. The “owner of record” may be a straw party. Instead of stating that the required documentation “may include” the designated items when the seller has owned the property for less than one year, the Handbook should require that all the designated documentation be provided.

Page 40 line 1

Reconsideration of (appraisal) Value. The mortgagee must require that the appraiser be given all relevant information before undertaking the appraisal. The broad allowance for reconsideration of an earlier appraisal undercuts the stronger appraisal guidelines set out in the immediately preceding pages.

Page 44 line 13

Limitation (on LTV) Based on Borrower's Credit Score. Apply compensating factors to the maximum LTV analysis for borrowers with MDCS between 500 and 579. Compensating factors similar to those HUD recently announced for the DTI ratios should be applied to the maximum LTV analysis. Compensating factors play a critical role in mitigating the impact of the use of credit scores for key underwriting decisions. As discussed below, p. 181 *et seq.*, *infra,* credit scores in many instances have questionable predictive value due to the high rate of errors and the often disproportionate weight given to isolated hardships from the past. Their disparate negative impact on minority applicants is undisputed. On the other hand, compensatory factors identify borrowers who, despite lower credit scores, have demonstrated that they can afford the proposed payment. The ability to attain homeownership with a 3.5 percent downpayment continues to be the key feature of the FHA program for lower income applicants. The two-tiered LTV standard effectively cuts these borrowers off from FHA programs based on a credit score.

Page 52 line 16

Refer. The paragraph explicitly requires manual underwriting when the automated underwriting produces a "refer" recommendation. The text implies, but does not state explicitly, that referral is also mandatory for an "accept/ineligible" outcome and for an "ineligible" outcome. The requirement to refer all automated denials to manual underwriting must be stated explicitly.

Pages 113-115 (generally)

Add to the text a reminder that the mortgagee must comply with the Equal Credit Opportunity Act and Fair Credit Reporting Act requirements regarding denials of credit.

Page 116 line 26

Independent Verification of Non-Traditional Credit Providers. Rather than set a requirement to obtain a rental reference from "the appropriate rental management company" the text should require that the reference be obtained from the borrower's landlord or former landlord. Not every landlord uses a rental management company.

Page 119 line 34

Disputed Derogatory Credit Accounts. The draft states here that "disputed medical accounts" must be excluded from the cumulative balance in the underwriting analysis. Elsewhere, the Handbook directs the exclusion of any delinquent medical account, regardless of whether it is disputed. *See* p. 131 line 19. The Handbook should consistently exclude all delinquent medical accounts from underwriting consideration. An individual who received needed medical treatment due to an accident or illness and lacked adequate medical insurance coverage at the time should not be denied homeownership on that basis. The extent of needed medical treatment lacks a direct relation to financial discipline. Medical debts often arise from isolated events that occurred in the distant past. With greater availability of health care insurance, medical debts will likely become a less relevant factor.

Page 121 line 28

<u>Bankruptcy Chapter 13</u>. There should be no automatic disqualification of borrowers who are complying with a chapter 13 debt repayment plan. The requirement for passage of at least one year of the repayment period is unreasonable. Elsewhere, (page 24, *supra*), in the case of payment under a judgment lien or tax lien, the Handbook deems a period of repayment of three months under an agreement to be sufficient to remove any bar to consideration for an FHA loan. At most, a three month period of chapter 13 payments should allow consideration of the application under the general underwriting guidelines.

Page 122 line 18

<u>Foreclosure and Deed-in-Lieu of Foreclosures (Exceptions to Standard)</u>. Delete limitation that references "circumstances that were beyond the control of the borrower" such as illness or death. Excluding consideration of a prior foreclosure or deed-in-lieu is reasonable when the prior occurrence was the result of documented extenuating circumstances. However, excluding consideration only for "circumstances that were beyond the control of the borrower" such as illness or death sets a standard that is too limiting. For example, this section explicitly denies the exception where a divorce or inability to sell the property due to a job transfer was the extenuating circumstance. A divorce or job loss requiring relocation can certainly be a circumstance beyond the borrower's control. A prior foreclosure of a loan that was unaffordable at inception or was otherwise abusive should not be treated the same as a prior foreclosure of a properly underwritten prime loan.

Page 123 line 21

<u>Pre-Foreclosure Short Sale</u>. Delete reference to "circumstances that were beyond the control of the borrower." The same comments from Page 122 Line 18 (regarding prior foreclosures and deeds-in-lieu within three years) apply to this text regarding a pre-foreclosure short sale within three years.

Page 123 Line 38

<u>Credit-Counseling/Payment Plan</u>. Delete this section. It is not clear what type of consumer credit counseling program the Handbook is referring to here. The section suggests that a borrower who has participated in such a program is disqualified for consideration for an FHA loan unless the borrower meets a burden of showing compliance with the plan. Borrowers often enter into debt repayment plans with unscrupulous companies that prey on consumers. A borrower's

participation, past or present, in a payment or counseling program should not be given negative weight. In particular, the borrower should not be held to a standard of having to comply with one of these agreements for twelve months in order to avoid disqualification from consideration for an FHA loan. Operators of debt settlement companies may set payment terms under these agreements that were not in the best interests of the consumer. The remainder of this Handbook adequately addresses how to evaluate the applicant's indebtedness and credit history.

Page 124 line 9

General Debts and Liabilities (Standards). Delete the statement introducing this section: "The mortgagee must determine the borrower's monthly liabilities by reviewing all debts listed on the credit report, tax returns, bank statements, pay stubs, and [application]." This statement is overly broad and misleading. Elsewhere, the Handbook lists certain obligations that are not to be considered debts or liabilities for underwriting purposes (page 131, beginning line 19). For example, medical collections are expressly excluded. Aside from the eleven categories of excluded debts listed on page 131, mortgagees must be given authority to exclude certain other debts from calculation of the back end debt to income ratio. Rent-to-own and other high cost loans should not be given the same weight as legitimate financial products. Student loan debts can be reduced to affordable payments, or no payment at all may be required under certain circumstances. Mortgagees must ensure that any allocation of student loan debt payments to total debt obligations reflects amounts currently due under a payment plan and not the originally scheduled payment. In calculating DTI ratios, short term loans such as pay day loans and all rent-to-own debts for acquisition of personal property items should be added to the exclusion list on page 131 due to their short term nature.

Page 126 Line 13

Non-Borrowing Spouse Debt – Standard. Add a clarification stating that to the extent that debts of a non-borrowing spouse are considered in calculating debt-to-income ratios, the income of the non-borrowing spouse should be considered as well. The statement of the general standard in this section is not clear. It states, "Debts of the non-borrowing spouse must be included in the borrower's qualifying ratios, except for obligations specifically excluded by state law." Federal law, namely the Equal Credit Opportunity Act, limits the extent to which the mortgagee may involve the non-borrower spouse in the underwriting process. This general statement may be referring to state community property laws. However, the Handbook must instruct mortgagees underwriting loans in non-community property states that they must not include any aspect of the non-borrower spouse's financial information unless the borrower has made an informed decision to allow this.

Page 126 line 21

Non-Borrowing Spouse Debt – Required Documentation. The non-borrower spouse's credit report should be obtained and considered only upon the informed election of the borrower spouse.

Page 129 line 1

Disputed Derogatory Credit Accounts – Standard. Add specific language stating that medical accounts should be excluded from the DTI analysis whether or not the borrower formally disputed the debts. An individual who received needed medical treatment due to an accident or illness and lacked adequate medical insurance coverage at the time should not be denied homeownership on that basis.

Page 129 line 36

Contingent Liabilities – Standard. Define "timely payments" on an obligation to include payments under any form of repayment plan that modified an original payment schedule. For example, where the applicant is potentially liable as a co-signor on a student loan obligation, the twelve months of timely payments should include payments on any form of repayment plan or alternative arrangement authorized for federally-related student loans.

Page 131 line 19

Obligations Not Considered Debt. This section explicitly states that "medical collections" are not considered debt for purposes of calculation of debt to income ratios. This is an appropriate standard. However, in two other areas of this draft Handbook (pp. 119, 131), FHA authorizes the exclusion of only "disputed" medical debt from the calculations. The references to "disputed" medical debt must be changed to require the consistent exclusion of medical debt from the underwriting calculations.

Page 133 line 35

Part-Time Employment. Add cross reference to the final compensating factor listed in HUD's Dec. 11, 2013 Final Notice (allowing for consideration of part-time and seasonal income not otherwise considered effective income). HUD recognizes in Handbook 4155.1 that "[m]any low and moderate income families rely on part-time and seasonal income for day to day needs, and lenders should not restrict consideration of such income when qualifying these borrowers." (Handbook 4155.1, ch. 4, section D, p. 4-D-7). In the following sections these comments propose various changes to the Handbook's treatment of part-time, seasonal, and public benefits income. These recommendations seek to add more specificity to its compensating factors standard for part-time and seasonal income, or amend the definition of effective income to accommodate the same treatment of income. We commend HUD for recognizing the role of part-time and seasonal income in a household's financial picture.

Page 133 line 40

Part-time Employment – Required Documentation. The proposed language in this section would permit consideration of income from part-time employment only if the borrower documented receipt of income from the job on an "uninterrupted" basis over two years. This qualification must be deleted. The proper standard, as described in Handbook 4155.1, must treat as effective income the earnings the borrower receives from multiple part-time jobs. Despite interruptions and changes of employer, many individuals can show a pattern of regular income over two years. FHA should not change its policy to exclude treatment of documented earnings from multiple part-time jobs as effective income.

More generally, HUD must also allow consideration of documented part-time employment income as a compensating factor in the DTI analysis.

Page 134 line 23

Overtime and Bonus Income – Calculation of Effective Income. Add a sentence stating that if overtime or bonus income increased by 20 percent or more over the prior year, then the mortgagee must use the current year's income. As worded, this section inconsistently requires lowering of effective income when current income shows a decreasing trend, while it does not allow the contrary. By counting the most recent year either way, the underwriting is more consistent.

Page 138 line 2

Minimum Length of Self-Employment. Retain the language from Handbook 4155.1 which states, "A combination of one year of employment and formal education or training in the line of work in which the individual is self-employed or in a related occupation is also acceptable." (Handbook 4155.1 ch. 4 sec. D, p. 4-D-13). This language allows the applicant to meet the durational requirement for self- employment income under certain circumstances when for a period of less than two years was involved. This is a clear and sensible exception to the durational requirement.

Page 138 line 31

Self-Employed Borrowers – Calculation of Effective Income. Substitute the word "greater" for the word "lesser." This section mandates that the mortgagee decrease effective income when a borrower's self-employment income decreased over the preceding twelve months. However it prohibits the contrary: treatment as an increase in effective income an increase in the borrower's self-employment income over the previous year. The draft must substitute the word "greater" for the word "lesser" in the phrasing of this standard. The mortgagee must calculate self-employment income by using the *greater* of (a) the average self-employment income earned over the previous two years; or (b) the average self-employment income earned over the previous one year. There is no rational basis for the counter-empirical approach mandated by the new draft. A fairer alternative would be to use an average figure.

Page 141 line 19

Alimony, Child Support, or Maintenance Income – Required Documentation. The draft states that the mortgagee must "[p]rovide evidence that the claimed income will continue for at least three years." This is in addition to the requirement that alimony, child support or maintenance income be averaged over the previous two years. This latter requirement provides an adequate measure of reliability. The requirement to provide evidence that the income will continue for three years into the future should be deleted. Otherwise, the language would require that borrowers obtain types of evidence that they have no legal right to demand from a former spouse. In certain instances former spouses refuse to cooperate out of animosity or other concerns of their own. This evidence is not in the borrower's control.

Page 143 line 14

<u>Other Public Assistance</u>. Delete the absolute requirement that documented government benefits income must be "reasonably likely to continue for three years." Handbook 4155.1 contained a similar provision, but added that "[i]f the income will not be received for at least three years, it may be considered as a compensating factor." (Handbook 4155.1 ch. 4, sec. E p. 4-E-8). The "compensating factors" listed in Handbook 4155.1 included: "The borrower receives documented compensation or income that is not reflected in effective income, but directly affects his/her ability to pay the mortgage." (*Id*. ch. 4 sec. F p. 4-F-7). The text of Handbook 4155.1 then added, "This type of income includes food stamps and similar public benefits." (*Id*.). There are a number of public benefits, including the earned income tax credit and fuel assistance, which families receive over many years as forms of stable income. These families will not be able to obtain a document showing that they will receive the same level of benefits for a fixed number of years in the future. However, these benefits will be as likely to continue as any other routine earnings income that HUD and mortgagees routinely treat as effective income without requiring a written guarantee of several years' prospective receipt. Few employers will give an employee a letter stating that the employee will retain the same job and earnings for the next three years.

Handbook 4155.1 also allowed consideration of unemployment compensation income as a compensating factor. (Handbook 4155.1, ch. 4 sec. E, p. 4-E-8). Specifically, the Handbook allowed consideration of unemployment income that recurred on a regular basis due to seasonal employment. A borrower who can document two years of receipt of unemployment benefits during periods that recur regularly in relation to established seasonal employment should have the unemployment income considered. Recurring food stamps benefits should also be considered. As discussed above, the draft Handbook changes the treatment of public benefits income substantially. These proposed changes should be rejected in favor of the existing provisions on benefits income in Handbook 4155.1. If any changes are made, they should be along the lines of stating additional options (beyond the unemployment compensation example given in 4155.1) for consideration of other public benefits, such as the earned income tax credit, fuel assistance, food stamps, and child care subsidies as factors that have the effect of increasing effective income. If HUD does not modify the definition of effective income along these lines, it should add this definition of income to the compensating factors standards.

Page 153 line 31

<u>Non-Taxable Income (Grossing-Up)</u>. This section appropriately grosses up income based on the applicable tax rate for the income amount, based on the borrower's tax rate for the previous year.

Page 155 line 5

Asset Requirements – Mortgagee Responsibility for Estimating Settlement Requirements (Origination Fees and Other Closing Costs/Types of Prepaid Items). This section states that the mortgagee or third party originator may charge a reasonable origination fee and may charge and collect from borrowers those customary and reasonable closing costs necessary to close the file, not to exceed the actual costs. The section adds that prepaid items "must comply with the requirements of the CFPB." *See* discussion of costs and fees, p. 186 *infra*.
Cross reference section on closing costs, need to reference QM rule.

Page 164 line 14

Downpayment Assistance Programs. Delete the prohibition on nonprofit programs contributing to pay off a judgment or lien. A nonprofit program should be able to assist a borrower to pay off a lien or judgment. One may assume that a nonprofit exercises reasonable judgment in providing this assistance. The existence of a judgment or lien may have no bearing on current ability to pay. The debt could have arisen long ago from circumstances beyond the borrower's control. The nonprofit's assistance could make the difference in whether a qualified individual is able to close on a loan. Such a payment has a *de minimus* effect on an assessment of ability to repay.

Page 180 line 6

Underwriting of Credit and Debt. The text of this section includes the sentence: "The lack of traditional credit history or the borrower's decision not to use credit may *not* be used as the sole basis for rejecting the mortgage application." This guidance is appropriate. However, elsewhere in the draft the Handbook calls for the use of credit scores as an absolute bar to a loan application or as a trigger for an overly burdensome downpayment requirement. The use of the credit score alone to limit access to FHA loans is inconsistent with the quoted statement in this section. A particular credit score or no credit score at all should trigger consideration of compensating factors, but not automatic rejection or automatic tripling of the required downpayment amount.

Page 181 line 1

Calculating Qualifying Ratios – Calculating Total Mortgage Payment (PITI). The draft text states that the total mortgage payment used to calculate the qualifying debt-to-income ratios includes "principal and interest" as well as various tax and insurance charges. However, the text does not define principal and interest in a way that addresses various payment and amortization options. For example, in the past abusive lenders relied on teaser interest rates, adjustable rates, various mixed rates, as well as balloon payments to disguise potentially unaffordable payment burdens. This text must specify that the relevant principal and interest payment used for calculating DTI will be the maximum payment during the first seven years of the loan. This approach is akin to that used for Qualified Mortgage ARMs under the Dodd-Frank Act and the CFPB rules and accounts for irregularities in amortization.

Page 181 line 29

Approvable Ratio Requirements Chart. As a preliminary matter, it is unclear why HUD decided to solicit comments on this draft Handbook while leaving critically important sections of the draft "under construction." The development of comments could have proceeded with more efficiency if HUD had provided the information contained in its December 11, 2013 Notice on changes to the manual underwriting standards when it initially solicited comments on this draft handbook at the end of October 2013. It is hoped that in seeking comments on future handbook drafts HUD will coordinate the release of all documents related to a particular handbook.

In its December 11, 2013 Notice on new manual underwriting requirements (Docket No. FR-5595-N-01) HUD announced several changes to existing and proposed underwriting requirements that were very helpful. HUD substantially improved underwriting standards for FHA loans by adding a compensating factor for residual income consistent with VA guidelines. The Handbook should clarify how the VA residual income guidelines operate. If simply meeting the baseline residual income numbers constitutes a compensating factor for a stretch ratio then the Handbook should clearly state that. If it requires a percentage above the baseline, that should be clear. (And in any event, HUD should continue to examine data to determine whether this approach needs to be adjusted to a higher number above the baseline residual income to ensure stretch ratios are still affordable, especially for the lowest income borrowers.) In addition, there may be some borrowers for whom even the baseline back-end ratio of 43% is too high; borrowers with low incomes may meet the DTI requirement but not have enough cash for living expenses. The VA guidelines explicitly allow residual income as a separate factor in underwriting and note that a borrower can be found to not qualify, absent other compensating factors, if residual income is inadequate. The FHA handbook should adopt a similar standard.

The decision to reduce from 620 to 580 the minimum credit score that will allow consideration of compensating factors will encourage fair and accurate consideration of the ability to pay for a broader set of applicants. We commend HUD's change in this regard, although further changes are needed so that LTV requirements do not preclude homeowners with scores below 580 who can afford an FHA loan from obtaining one.

Finally, the compensating factor for consideration of additional income that is not considered effective income (bonus, overtime, part-time, and seasonal income) is a step in the right direction. However, the treatment of these forms of income (as well as public benefits income) must be clarified further, as described in these comments. *See* p. 134 *supra*. The key to appropriate consideration of these forms of additional income is that they be documented. If properly verified, the adjustments to allow consideration can be made either as part of the definition of effective income or in further defining the compensating factors.

HUD indicated in its December 11, 2013 notice that the development of additional compensating factors will be appropriate. We encourage HUD to follow through on this goal while vigilantly resisting opening up the compensating factors to elements that would jeopardize the sustainability of FHA lending. As matters now stand, the list of compensating factors that HUD now allows mortgagees to use is considerably shorter and more restrictive than the current standards. The current guidelines allow consideration of nine factors. Handbook 4155.1 ch. 4 sec. F part 3, pp. 4-F-6 to 4-F-9 (last revised March 1, 2011). While some of these, such as downpayment and reserves will too often allow approval of loans where the payment itself may not be affordable, others broaden access to HUD's program in beneficial ways.

The development of additional mitigating factors and a more expansive treatment of effective income is needed in order to mitigate the impact of HUD's greater reliance on credit scores. Beginning with changes proposed in 2010, HUD has required mortgagees to give substantially greater weight to these scores, first in determining downpayment requirements and then in setting allowed debt to income ratios. The increased reliance on credit scoring will inevitably have the greatest impact on low-income applicants and borrowers of color.

The recent declines in all mortgage loan approval ratings have fallen heavily upon applicants with lower credit scores. From 2008 to 2011 home purchase loans approved for applicants with scores under 620 dropped 93%, while loans to those with scores above 620 dropped by 30%. Credit scores differ substantially by race. Requiring rigid application of credit scores mandates a practice that has a well-established discriminatory impact. Studies showing racial disparities in credit scoring include: a 2012 study by the CFPB, which found that the median FICO score for consumers in majority minority ZIP codes was in the 34th percentile, while it was in the 52nd percentile for ZIP codes with low minority populations; *Consumer Financial Protection Bureau, Analysis of Differences Between Consumer- and Creditor-Purchased Credit Scores*, at 18, Sept. 2012; A 2007 Federal Reserve Board report to Congress on credit scoring and racial disparities in which, for one of the two models used by the Federal Reserve, the mean score of African Americans was approximately half that of white non-Hispanics (54.0 out of 100 for white non-Hispanics versus 25.6 for African Americans) with Hispanics fairing only slightly better (38.2); Board of Governors of the Federal Reserve System, *Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit* 80-81 (Aug. 2007). A 2006 study from the Brookings Institution found that counties with high minority populations are more likely to have lower average credit scores than predominately white counties. Matt Fellowes, Brookings Inst., *Credit Scores, Reports, and Getting Ahead in America* 9-10 (May 2006).

The new compensating factors guidelines will curtail access to FHA-insured loans for certain groups of applicants. In 2010, loans insured by FHA, RHS, and VA represented two-thirds of all purchase loans to low-income borrowers. In the same year, loans insured by the three federal agencies made up 83% of home purchase loans to African-Americans and 76% of those to Hispanics. *The State of the Nation's Housing* 2012, Joint Center for Housing Studies of Harvard University (June 2012). Of the three federal agencies guaranteeing single family home loans, FHA originates by far the most loans for borrowers of color.

In recent years the lending industry's tightened underwriting standards has had the greatest negative impact on minority borrowers. Since 2000, mortgage loan denial rates for all applicants have increased. However, the relative increase in rejection rates has been far greater for minority borrowers. Since 2000, the rejection rate for white applicants rose by 3% (from 12% to 15%). However, the rejection rate for African-Americans rose by 15% (from 23% to 38%) and for Hispanics by 8% (from 19% to 27%). (Harvard Joint Center for Housing Studies). These increased rejection rates have come on top of a massive loss of wealth due to the foreclosure crisis that fell disproportionately upon minority borrowers. During the current recession African-Americans' homeownership rate dropped at twice the level of whites. *Id.* p. 18.

Underwriting systems that limit access to homeownership based on credit scores and rigid debt-to-income ratios exacerbate a growing trend isolating minorities in rental housing. The concern over families paying increasingly high shares of their income for housing is a legitimate one. FHA's thirty-one percent front-end debt-to-income payment ratio sets a desirable goal. However, it is important to keep in mind that many renters do not come close to meeting this goal. In particular, low-income renters consistently exceed such a payment ratio. Over the past decade we have seen a trend of renters paying increasingly higher proportions of their income to meet basic housing needs. Renters account for more than half of the households paying over fifty percent of their income for housing. Twenty-seven percent of renters pay more than fifty percent of their income for housing, twice the share for homeowners.(Harvard Joint Study 2012).

While the average monthly mortgage payment has been decreasing in recent years, the typical rental in most locations has been increasing. Homeownership compares more favorably to rental now than at any time since the early 1970s. Nevertheless, the past decade has shown the highest growth in demand for rental housing for any decade since the Second World War. This demand has fueled construction of higher-end units, while middle and upper income renters take over what were formerly affordable rental units. The effect of excluding more lower income borrowers from FHA's homeownership programs will be to place greater demands on a shrinking supply of decent affordable rental housing. Ultimately, this burden falls on many of the rental housing programs that are subsidized by HUD and other federal agencies.

In considering the impact of homeowner's debt-to-income ratios, it is helpful to consider the experiences under the U.S. Treasury's HAMP program. Since 2009 over 1.2 million borrowers received permanent loan modifications under HAMP. The most recent data shows that after receiving HAMP modifications borrowers on average have front-end debt-to-income ratios of 45.4% and back-end ratios of 68.9%. U.S. Dept. of Treasury, *Making Home Affordable Program Performance Report Through October 2013*. Most homeowners perform quite well under these HAMP modifications. Redefault rates for HAMP modifications have been averaging about 11% one year after modification. *OCC Mortgage Metrics Report Second Quarter 2013* p. 36. By contrast, FHA loans originated during 2007 and 2008 have a 22% delinquency rate. (*HUD, FHA Single-Family Mortg. Ins. Fund Programs, Report to Congress* FY 2013 Q3 (8/23/2013)). FHA loans modified during 2009-2011 have a similarly high re-default rate of 22%. (*Agencies Could Improve Effectiveness of Federal Efforts With Additional Data Collection and Analysis* GAO Report 12-296 (June 2012) p. 55).

Beginning with its July 2010 announcement (75 FR 41217), HUD supported the increased reliance on credit scores and a diminished role for compensatory factors. The data HUD offered in support of this decision suffered from significant limitations. First, the data did not evaluate the use of the full range of existing compensating factors. It was not clear from HUD's data whether certain factors may have been associated with higher default rates, while others may not have been. Second, HUD focused on loans originated during 2005-2008 and examined what had happened to those loans as of 2010. In other words, the data reflected loans that had been originated shortly before the most severe recession since the Great Depression during a period of significant abuse in the market. Historically, mortgage defaults have occurred over the long term, due to chronic job loss, long-term unemployment, or divorce. Credit scores address factors in the borrower's immediate past and indicate a potential short term likelihood of default. Calvin Bradford, *Federal Reserve Mortgage Credit Partnership, Credit Scoring Committee, Perspectives on Credit Scoring and Fair Mortgage Lending*, (Spring 2000). HUD should base permanent policy changes on long term data from a variety of historical periods. Credit scores were not effective predictors of defaults associated with the mortgage crisis. Yuliya Demyanyk, *Did Credit Scores Predict the Subprime Crisis?* The Regional Economist (Federal Reserve Bank of St. Louis, Oct. 2008).

Finally, in its 2010 announcement, HUD proposed simultaneous improvements to its loss mitigation protocols. These included strengthened oversight of servicers' loss mitigation performance. Over the past year, HUD has taken concrete steps to carry out this intention. However, the needed loss mitigation changes had not been implemented during the period from which HUD derived its data in 2010. There is little doubt that during the years leading up to 2010, FHA's loss mitigation performed poorly. According to a recent GAO Report, FHA's loss mitigation during this time had the worst record when compared to all other private and public loan servicing categories. *Foreclosure Mitigation: Agencies Could Improve Effectiveness of Federal Efforts With Additional Data Collection and Analysis* GAO Report 12-296 (June 2012) p. 55 Modifications of FHA mortgages re-defaulted at rates far above those for all other loans. FHA's past record of poor loss mitigation raises the obvious question of the degree to which effective loss mitigation could have remedied many of the defaults HUD reported in 2010. It is clear that proper loss mitigation prevented many foreclosures of non-FHA loans.

The purpose of manual underwriting is to isolate applicants who need further review following an automated review. Allowing credit scores to drive manual underwriting defeats the purpose of having an alternative to automated underwriting. *See* Stanley D. Longhofer, Federal Reserve Bank of Boston, *Mortgage Scoring and the Myth of Overrides*, Perspectives on Credit Scoring and Fair Mortgage Lending, Communities & Banking Series (Fall 2002). The goal of manual underwriting is to ensure fair and accurate application of subjective factors, not eliminate them altogether.

We support adoption of standards beyond a straight debt-to-income ratio. At the same time we recognize that compensating factors should be drawn narrowly enough to ensure that proof of compliance is clear and that predictably unaffordable loans do not fall within the purview of FHA.

Page 184 line 2

<u>Closing – Mortgage and Note</u>. Proposed changes to the standard FHA note and mortgage could have significant effects on the legal relationship between borrowers and mortgagees for the long term future. It is assumed that HUD will provide notice of proposed changes and invite public comment with an adequate comment period before making any changes in content of these documents. There are two specific changes that HUD should make:

1. The note and mortgage must expressly designate the borrower as an intended beneficiary of the lender's obligation to service the mortgage in compliance with HUD regulations. While many courts have interpreted the note's current language to create a contractual

obligation on the part of the lender to comply with HUD rules in areas such as loss mitigation, some courts have taken a contrary view. HUD should dispel any possible ambiguity regarding enforceability of its servicing rules. By this drafting change HUD can ensure that courts do not allow lenders to foreclose in blatant violation of FHA's servicing rules. While HUD engages in various Quality Control measures, homeowners seeking the promise of their FHA loans should be able to rely on clear HUD direction on this matter. Because homeowners face difficulties obtaining counsel and because such cases are fact intensive, such a clarification would not substantially affect the litigation risk faced by FHA lenders. Moreover, such cases tend to be individualized and thus are more difficult to bring on a class basis.

2. Add a provision to the form note and mortgage making the award of costs and attorney's fees reciprocal to the prevailing party in litigation over enforcement of the documents' terms. As presently worded, only the lender may recover the costs of enforcement of the mortgage, while the borrower who enforces the terms of HUD's regulations must do so at his or her own cost. Form leases for most HUD-subsidized rental housing programs do not allow one-sided fees shifting in favor of the creditor.

Page 185 line 11

<u>Closing in the Mortgagee's Name</u>. Add requirement that all relations among the parties designated in loan documents must be clearly disclosed. The draft language encourages closings in names of agents for undisclosed principals and the use of straw parties. *See* comments at p. 10 line 32, *supra,* on need to define "mortgagee" in Handbook.

Page 186 line 6

<u>Closing Costs and Fees</u>. The text must specify the limits on allowable costs and fees. The draft states only that "[t]he mortgagee must ensure that all fees charged to the borrower comply with all applicable federal, state and local laws and disclosure requirements." Later on the same page (line 20), the draft states that the mortgagee or third party originator may charge the borrower "discount points, and lock-in and rate lock fees consistent with FHA and CFPB requirements."

With respect to closing costs and fees it is essential that the Handbook address two specific issues: (1) what constitute allowable closing costs and fees; and (2) what are the limits on allowable costs and fees. Important regulatory frameworks now address both issues.

The Dodd-Frank Act directed HUD to develop a standard for a "qualified mortgage" for FHA-insured loans. HUD's qualified mortgage standard must align with the ability-to-pay criteria set forth in the Truth-in-Lending Act and in the Consumer Financial Protection Bureau's (CFPB's) qualified mortgage regulations. 15 U.S.C. § 1639c; 12 C.F.R. § 1026.43. A mortgage meeting the "qualified mortgage" standard satisfies certain criteria indicating that the loan was underwritten safely based on the borrower's ability to pay. If a loan product complies with the "qualified mortgage" standard, the mortgagee gains either a presumption of compliance with ability pay guidelines or a "safe harbor" from future litigation over whether it properly considered the borrower's ability to pay.

HUD recently published its final regulations addressing the “Qualified Mortgage Definition for HUD Insured and Guaranteed Single Family Mortgages”. HUD established different “qualified mortgage” standards for different types of FHA loans. However, for the standard FHA Title II first lien mortgage, HUD will soon insure only loans that meet cap on “points and fees” assessed at closings. All loans that FHA insures must comply with this cap in order to be treated as “qualified mortgages.” The CFPB rule that HUD referenced and incorporated as its own standard provides that for a loan amount greater than $100,000 the points and fees charged may not exceed three percent of the total loan amount. The CFPB rule at 12 C.F.R. § 1026.32(b)(1) defines the types of points and fees that must be considered in making the three percent calculation.

In announcing that it will only insure loans meeting the three percentage points cap and defining allowed points and fees in reference to 12 C.F.R. § 1026.32((b)(1), HUD has given significant new importance to closing costs and fees. Mortgagees of FHA insured loans will be entitled to significant protections from legal challenges to their underwriting activities if they comply with the points and fees cap.

Given HUD’s qualified mortgage definition, a great deal rides on how mortgagees assess costs and fees at closings of FHA insured loans. The basic enforcement mechanism Congress envisioned in setting standards for the ability to pay rule will be significantly undermined if HUD routinely insures loans that exceed the points and fees cap due to inadequate guidance. Presumably, HUD will be implementing an extensive system of oversight over mortgagees’ compliance with the qualified mortgage rule. An essential element of that oversight must be clear notice to mortgagees in this Handbook of their obligation to comply with HUD’s qualified mortgage rule. The Handbook must reference the significant consequences for a mortgagor’s failure to comply, whether through deliberate misrepresentation or lack of due care in disclosing and categorizing closing fees and costs. While such consequences may be part of a seemingly separate Quality Control process (and will in some cases be the result of private liability), notice regarding the importance of compliance (for all standards in the Handbook, in fact) is essential.

Page 223

Streamline Refinance. The proposed Manual would make several changes to the governing guidance for Streamline Refinance loans. All but one of the changes do not appear to significantly alter the basic operating rules for these loans. However, we are very concerned with the basic rules for Streamline Refinances, as we have seen that they can used to perpetuate frauds on unsuspecting homeowners.

The most significant change in the Manual relating to Streamline Refinances is the addition of the sentence to the Appendix (FHA Single Family Housing Policy Handbook Appendix II – Programs and Products□D. Refinances, § D.1.c at 223) which says:

> Streamline Refinances are subject to only those requirements set forth in this section.

This sentence appears to conflict with longstanding HUD's regulations which specifically mandate that the lender underwrite the loan *as if there was no insurance:*

> (c) Underwriter due diligence. A Direct Endorsement mortgagee shall exercise the same level of care which it would exercise in obtaining and verifying information for a loan in which the mortgagee would be entirely dependent on the property as security to protect its investment. Mortgagee procedures that evidence such due diligence shall be incorporated as part of the quality control plan required under § 202.5(h) of this chapter. The Secretary shall publish guidelines for Direct Endorsement underwriting procedures in a handbook, which shall be provided to all mortgagees approved for the Direct Endorsement procedure. Compliance with these guidelines is deemed to be the minimum standard of due diligence in underwriting mortgages. (Emphasis added).[1]

This means that whatever laws, regulations, and standards of the industry are otherwise applicable to the loan, such requirements are not rendered inapplicable because the FHA has insured the lender against losses resulting from the loan.[2] Compliance with HUD's published guidelines are *minimum* standards for underwriting; HUD's guidelines should be a floor for underwriting FHA mortgages, not a ceiling.

HUD's guidelines for Streamline loans should only remove the requirement to *verify* the homeowner's income – indeed the deletion of the verification requirement is one of the ways in which these loans are supposed to be streamlined. However, that lack of a requirement to verify income should not mean that the mortgage lenders are relieved of their obligation *to evaluate* the homeowner's ability to repay the loan from her income. The evaluation of the affordability of the mortgage should always be required of the lender. And, in some cases, simply looking at whether the homeowner had the requisite credit score and had paid all their mortgage payments on time in the previous year, might be sufficient. But not always.

Both the existing and the proposed Manual fail to ensure adequate underwriting for streamline refinance loans. We have seen homeowners have their FHA home loans flipped multiple times, each successive transaction pulling out more home equity. Each withdrawal of home equity is used to make the payments on the mortgage until there is another refinance.

The Streamline Refinance program without credit qualifying only requires an evaluation of the past 12 months' payments, or less if there is less time since the previous mortgage was closed.[3] This is in addition to the appropriate requirement that the Streamline Refinance loan provide a net tangible benefit to the borrower.[4] The problem is that the evaluation of whether the previous loan's payments were made on time fails to protect against previous unaffordable loans – which

[1] 24 CFR § 203.5 Direct Endorsement process.

[2] The one exception to this blanket statement would be that certain state laws relating to interest rate limits on mortgages are preempted for FHA loans, unless the state had opted out of the preemption provided by the federal law. 12 U.S.C. § 1709-1a.

[3] 4155.1 6.C.3.f Seasoning Requirement for a Streamline Refinance.

[4] HUD 4155.1.

provided enough cash out for the homeowner to make the payments for a limited number of months.

An illustration of this problem is the case of Ms. H in Chicago.

> In 2009, a bank made a loan to Ms. H – an elderly woman living on $1,125 Social Security in Chicago – which she could not afford to pay. This 2009 loan, which required monthly payments of principal and interest of $1010 a month, refinanced a 2008 FHA loan purchased by the bank. The 2008 loan was based on income—purportedly a pension--that Ms. H never actually had. The 2009 refinance was an FHA Streamline Refinance product, which did not require either an independent verification of income or an assessment of affordability. As a result of the reliance on the payments on the previous loan, the underwriting guidelines for the streamline refinancing allowed this unaffordable loan to be made.
>
> Ms. H had situation owned her home free and clear before 2004. She then entered into five successive mortgages in a period of a little more than 4 years. Each mortgage, except the last, produced a significant amount of cash to Ms. H, which she used to cover the mortgage payments until she was able to refinance. The payments required for each mortgage exceeded her income from Social Security. In the chart below, Ms. H's Social Security income is compared to the payments required for principal, interest and escrow for each mortgage and presented as a debt-to-income ratio with the required payments for each of these mortgages.

Date of Loan	Loan Amount	Monthly Housing Payments	Debt-to-Income Ratio
10/25/04	$75,000	$662.98	72.35%
11/9/06	$127,500	$1,155.68	119.82%
5/17/07	$139,500	$1,038.87	102.32%
6/9/08	$155,295	$1,095.07	102.46%
1/26/09	$157,624	$1,008.85	89.79%

Ms. H's case only reached an attorney when she was facing foreclosure of the last mortgage – the streamlined refinance. In that case it was discovered that the mortgage originators involved with each of the mortgages made to Ms. H had forged the documents needed to substantiate the fictitious income from the pension. None of the previous loans had reached default status because sufficient funds had been withdrawn at each closing to make the mortgage payments. Note that there was over $157,000 in equity withdrawn in a little over four years. Otherwise put, Ms. H had been encouraged to withdraw so much money from her home, that after four years, she had nothing left. The Streamline refinance simply delayed the inevitable foreclosure. However, the Streamline Refinance also had the effect of shielding the originating lender of the fourth loan –which did require full underwriting – from the consequences of its accepting fraudulent documents.

To guard against these problematic loans, there are two protections we encourage HUD to add to Streamline Refinances:

1. Lenders should be required to look at the homeowner's mortgage history to assess whether excessive equity has been withdrawn in previous years, which might be an indication that previous mortgage payments had been paid from the mortgage proceeds. If there is any such indication, then the loan should not be permitted to proceed under the Streamline program. Baseline triggers for such an analysis could be developed based on FHA data. The goal would be to identify characteristics of cash-out refinancings that may be predictive of loans where subsequent installment payments have been made out of loan proceeds.

2. HUD should separately track the foreclosure rates of Streamline Refinances and conduct analysis to determine whether particular characteristics are predictive of higher default rates and whether further changes to the program are warranted.

Page 259 line 14 & page 260 line 14

Manufactured Housing. Add language expressly stating: "A manufactured home that qualifies as real property under state law may be situated on leased land and still qualify for FHA financing." In certain states a manufactured home may be defined as real property even though it is situated on leased land. For purposes of eligibility for FHA loans, such a home should qualify. The proposed language suggests the contrary.

For further information about NCLC's comments, please contact:

Geoffry Walsh
Staff Attorney
National Consumer Law Center
7 Winthrop Square, 4th Floor
Boston, MA 02110
(617) 542-8010 (ext 336)
gwalsh@nclc.org