Appendix

HUD Handbook Excerpts

HUD Handbook 4000.4 REV-1
Chapter 2

CHAPTER 2. MORTGAGEE APPROVAL

2-1 ROLE OF MORTGAGEE. The authority to participate in the Direct Endorsement program is a privilege, granted on the basis of demonstrated qualifications, experience and expertise. The privilege is maintained by recommending for mortgage insurance endorsement only those mortgages which meet HUD guidelines. A Direct Endorsement mortgagee must conduct its business operations in accordance with accepted sound mortgage lending practices, ethics and standards.

2-2 ELIGIBILITY REQUIREMENTS. Each office of a mortgagee (main office and branches) must be approved by the HUD Field Office(s) to which it intends to submit mortgages for insurance. There is one exception to this general rule. A mortgagee which has been approved for Direct Endorsement in at least one HUD Field Office, may process and submit streamline refinance cases to any HUD Field Office after notifying the office of its intentions. Streamline refinances are described in Chapter 4 of HUD Handbook 4155.1.

To be approved as a Direct Endorsement mortgagee, an applicant must meet and maintain the following requirements:

A. Must be a HUD-approved mortgagee. This includes supervised mortgagees, non-supervised mortgagees and governmental institutions. Mortgagees approved by HUD only as loan correspondents are not eligible to be Direct Endorsement mortgagees; but, may participate to the limited extent described in paragraph 2-13 .

B. Non-supervised mortgagees must have a net worth in assets acceptable to HUD of at least $250,000.

C. Have five years experience in the origination of single family mortgages, or have a principal officer with a minimum of five years managerial experience in the origination of single family mortgages.

D. Have on staff an underwriter who meets the qualifications stated in paragraph 2-4 of this chapter and has successfully completed a Direct Endorsement training program.

E. Have developed and implemented a Quality Control Plan which accommodates the objectives stated in paragraph 2-6 of this chapter.

F. Have satisfactorily completed the pre-closing case review phase of Direct Endorsement.

2-3 REQUIRED DOCUMENTS. Any office of a mortgagee (main or branch)

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which intends to submit mortgages for insurance endorsement must apply for approval to the HUD Field Office(s) in the jurisdictions where they do business (see exception noted in paragraph 2-2). The following documents, as applicable, must be submitted.

A. Application for Approval. The mortgagee is to complete Form HUD-54112, Application for Approval As Direct Endorsement Mortgagee and Nomination of Underwriting Personnel (Appendix 1). The first part concerns basic mortgagee eligibility, including qualifying status and single family origination experience. If the mortgagee (not necessarily the particular branch) has not had five years single family origination experience, the application must be completed to show such experience by principal officers.

B. Quality Control Plan. A copy of the Quality Control Plan.

C. Nomination and Resume of Underwriter. Each application for mortgagee approval is to include a nomination of the individual(s) to serve as the mortgagee's underwriter(s).

The nomination includes a verification by the President or Vice President (or other authorized corporate officer) that the nominee has the authority to bind the corporation and the nominee has been found to meet the qualifications of paragraph 2-4 of this Chapter.

A resume must be submitted for each underwriter nominated. Form HUD-92563, Application for Fee Personnel Designation, may be used in lieu of a resume. Whether the resume or HUD form is used, information provided must clearly show that the nominee meets the qualifications of paragraph 2-4 of this Chapter.

D. Nominations and Resumes of Technical Personnel. As part of the application, the mortgagee is to advise HUD whether or not mortgagee staff will be used to perform appraisals, inspections and mortgage credit analyses. As with the underwriter, a resume or Form HUD-92563 is to be submitted for each nominee. The resume or the Form HUD-92563 must clearly show that the technician meets the applicable qualifications of paragraph 2-7 of this Chapter. When using a resume, include the information required on Form HUD-92563. That form is appended to HUD Handbook 4020.1.

E. Use of Form HUD-92563, Application for Fee Personnel Designation. When using Form HUD-92563 to qualify personnel, the form may be modified. Items 14, 15, 22 and 24 may be deleted. In item 23, certifications a, b and c may be deleted. If being used for the approval of an underwriter, the top of the form should be so noted.

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(2-3)

F. Evidence of Prior HUD Approval. Once one office of a mortgagee has been approved by a HUD Field Office, evidence of that approval will facilitate subsequent approval to do business in other HUD offices. Similarly, if mortgagee technical staff intend to qualify with more than one HUD Field Office, once the first approval has been obtained, evidence of the approval will facilitate subsequent approvals. If a Direct Endorsement underwriter has already been approved by one HUD Field Office, the Department will grant automatic approval of the underwriter in any HUD Field Office where the lender is approved to do business.

1) Mortgagee Approval. Each subsequent application must include an executed application form (Appendix 1) in addition to a copy of the approval letter from another HUD Field Office.

2) Underwriter Approval. CHUMS will recognize any underwriter's approval in all HUD offices. Once an underwriter has obtained approval and a CHUMS identification number, it will be automatically recognized in each Field Office where a lender has been approved to do business.

3) Technician Approval. A copy of another office's letter approving the appraiser or inspector should be submitted with the application form.

2-4 UNDERWRITER. The mortgagee must have on staff a full-time employee to serve as underwriter. The underwriter must be a corporate officer with signatory authority or otherwise authorized to bind the mortgagee in matters involving the origination of mortgage loans. The underwriter may be employed by only one mortgagee, and this function may not be contracted out by the originating mortgagee. The underwriter must meet the qualifications and assume the responsibilities which follow.

A. Qualifications.

1) General. The underwriter must be a reliable and responsible professional skilled in mortgage evaluation. The underwriter must be able to demonstrate his or her knowledge and experience regarding the principles of mortgage underwriting.

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(2-4A.)

2) Location of Underwriter. HUD has no requirement regarding the location of the underwriter (i.e. main office or branch office).

3) Experience. The underwriter must have a minimum of three years full-time recent experience (or equivalent experience) reviewing both credit applications and property appraisals. Experience related solely to mortgage credit or appraisal review counts for one-half of the total requirement.

This experience should have been with an institutional investor originating for its own portfolio or purchasing these types of mortgage loans, or with an originator selling these types of mortgage loans to investors. Experience may also include quality control reviews for investors, etc.

The Mortgage Bankers Association of America (MBA) course "Appraisal Techniques for Direct Endorsement Underwriters" may be substituted for one full year of full-time experience reviewing appraisals.

The nominee's resume must give detailed descriptions of job experiences that demonstrate knowledge of principles, practices, and techniques of mortgage underwriting, including: (1) real estate appraisal, (2) mortgage credit evaluations, (3) factors affecting property values and real estate trends.

B. Field Office Review of Underwriter Qualifications. Each underwriter's credentials must be analyzed and the underwriter approved in at least one HUD Field Office where the lender is approved to do business with the Department. The Field Office must determine that the underwriter has the experience and other qualifications as required above. The Field Office must contact references, former employers, etc., to determine the validity of the underwriter's experience claims. If the underwriter's experience includes advanced education, including college-level courses or specialized training from providers such as the Mortgage Bankers Association or other HUD Field Offices, the approving Field Office may require verification that the underwriter successfully completed the course(s). The Field Office may also request a pre-approval meeting with the underwriter, especially if there is any uncertainty regarding experience or expertise.

HISTORICAL REFERENCE ONLY

(2-4B.)

In addition, the HUD Field Office reviewer must check to make sure that the underwriter has not had sanctions taken against him or her or otherwise be listed on HUD's Suspended and Debarment list, Limited Denial of Participation List, or appear on HUD' Credit Alert Interactive Voice Response System.

C. Responsibilities. HUD looks to the underwriter as the focal point of the Direct Endorsement program. The underwriter must assume the following responsibilities.

1) Compliance with HUD instructions, the coordination of all phases of underwriting, and the quality of decisions made under the program.

2) The review of appraisal reports, compliance inspections and credit analyses performed by fee and staff personnel to ensure reasonable conclusions, sound reports and compliance with HUD requirements.

3) The decisions relating to the acceptability of the appraisal, the inspections, the buyers capacity to repay the mortgage and the overall acceptability of the mortgage loan for HUD insurance.

4) The monitoring and evaluation of the performance of fee and staff personnel used for the Direct Endorsement program.

5) Awareness of the warning signs that may indicate irregularities, and an ability to detect fraud, as well as the responsibility that underwriting decisions are performed with due diligence in a prudent manner.

2-5 UNDERWRITING PROCEDURES. The underwriter's role and responsibility are critical elements of the Direct Endorsement program.

The underwriter executes the Underwriter Certification which enables HUD to endorse the mortgage loan without a detailed technical underwriting review. The underwriter certifies that he has personally reviewed the application documents and finds compliance with the applicable requirements. One of the underwriter's responsibilities, as stated in the previous paragraph, is the coordination of all phases of the underwriting of the mortgage loan. This role enables the underwriter to ensure that prudent underwriting procedures are followed.

HISTORICAL REFERENCE ONLY

HUD Handbook 4000.4, Appendix 3.

APPENDIX 3

UNDERWRITER CERTIFICATION

The underwriter executing form HUD-54113 has personally reviewed the appraisal report (if applicable) and credit application, including the analysis performed on the mortgage credit analysis worksheet, and certifies, for and on behalf of the mortgagee, that the mortgage complies with HUD underwriting requirements as contained in all outstanding HUD handbooks and Mortgagee Letters, and is in compliance with the applicable regulations described below. The mortgage loan is eligible for mortgage insurance under the Direct Endorsement program. This underwriter certification is in addition to any certifications required of the mortgagee, the mortgagor, or both on form HUD-92900-A. If a requirement from 24 CFR Part 203 is incorporated in a different regulation by cross-reference (e.g., 203.40 in Certification 1 is cross-referenced in 221.1), a reference to the Part 203 requirement in a certification shall also be deemed a reference to each instance where the requirement is incorporated by cross-reference. Each of the below-listed certifications apply to the loan submitted for endorsement, except to the extent the certification itself defines the situation to which it applies.

(1) The mortgaged property is located in a community where the housing standards and location meet the requirements of 24 CFR 203.40 or 234.63 (condominiums).

(2) There is located on the mortgaged property a dwelling unit designed principally for residential use for not more than four families, as required by 24 CFR 203.38, or for eleven families if 220.20 is applicable.

(3) The mortgage is executed by a mortgagor who is to occupy the dwelling as a principal residence (as described in 24 CFR 203.18(f)(1) or 234.27(e)(1)) or, if the mortgagor is a non-occupant, the mortgagor is eligible under 24 CFR 203.18(f)(3), 234.27(e)(3), or is purchasing the dwelling from HUD.

(4) The mortgagor's monthly mortgage payments will not be in excess of his or her reasonable ability to pay, as required either under 24 CFR 203.21, 203.45(d) (GPMs), 203.47(a) (GEMs), 220.1, or 234.36 (condominiums).

(5) The mortgagor's income is and will be adequate to meet the periodic payments required to amortize the mortgage submitted for insurance, as required under 24 CFR 203.33, or 234.56 (condominiums).

(6) The mortgagor's general credit standing is satisfactory, as required under 24 CFR 203.34, or 234.57.

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(7) The buildings on the property secured by the mortgage comply with

203.17(e) and property standards issued by HUD as required by the applicable provisions of 24 CFR part 200, subpart S, for proposed construction, and 203.39, 203.50(d) (if a Section 203(k) mortgage), 220.15 (urban renewal), 234.25(d) (if a condominium unit) or the standards set forth in HUD handbook 4905.1 for existing construction as applicable.

(8) In cases where the mortgaged property is subject to a junior mortgage or lien, the applicable requirements of 24 CFR 203.32(b), (c) or (d), or 234.55(b), (c) or (d) (condominiums), are met.

(9) For a condominium unit, the mortgaged property is in a project that has been approved by HUD and all other requirements under 24 CFR 234.26 are met.

(10) In the case of proposed or new construction in a new subdivision, the property covered by the application for insurance meets the requirements of 24 CFR 203.12.

(11) The property covered by the mortgage is not located in an area that is precluded from receiving Federal financial assistance pursuant to the Coastal Barrier Resources Act (Pub. L. 97-349).

(12) If the mortgage loan is for rehabilitation under Section 203(k), the mortgage also meets the requirements of 203.50(c) (dwelling at least one year old), 203.50(d)(2) (meets energy conservation standards), and 203.50(e) (is an acceptable risk).

(13) If the property is located in an older declining urban area and is to be insured under Section 223(e) of National Housing Act, it also meets the additional requirements of 24 CFR 203.43a.

SPECIFIC CERTIFICATIONS FOR SECTION 235(r) MORTGAGES. The certifications contained in Items (1) through (13) do not apply to mortgages insured under Section 235(r). The certifications which do apply are the following:

(14) The mortgagor meets all the eligibility requirements of 24 CFR 235.1202(b)(6)(i) through (viii).

(15) The monthly payments of principal and interest at the 235(r) interest rate on the mortgage submitted for insurance are less than the monthly payments of principal and interest on the mortgage being refinanced.

(16) The computation of the amount of assistance payments which the Secretary will pay on behalf of the mortgagor was computed in accordance with the formula contained in 24 CFR 235.1210(a).

HISTORICAL REFERENCE ONLY

HUD Handbook 4060.1 Rev-1
Chapter 6

CHAPTER 6
CHANGES SUBSEQUENT TO APPROVAL

6-1 Reporting Business Changes. A mortgagee is required to notify the Department within a specified number of business days of any business change that affects its standing as an approved institution, or which changes the information on which it was originally approved. Generally, notification consists of a letter to FHA, signed by an executive officer of the mortgagee. Certain changes may require additional documentation. The notice must be sent or faxed to the Director, Lender Approval and Recertification Division. Failure to notify HUD may lead to processing delays or sanctions by the Mortgagee Review Board.

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6-2 Change of Home Office Location or Telephone Number. The Department maintains the following addresses for the home office of a mortgagee:

* Geographic Address, Address where the office is physically located;
* Mailing Address, Address to which HUD correspondence is sent;
* Premium Address, Address of the office to which premiums are to be billed;
* Payee Address, Address is used to mail Advice of Payment letters;
* Conditional and Firm Commitment (CHUMS) Address, Address HUD will use to conduct business relating to applications for insurance; and
* Endorsement Address, Address to which the confirmation will be sent of payment of the ôone-timeö mortgage insurance premium.

A. Address Changes. Mortgagees update all of their addresses via their FHA Connection account. However, they may not change the ôStateö part of the Geographic Address of the home office. If an office has relocated to a different State, the mortgagee must submit a request to the Lender Approval and Recertification Division to update the address. A mortgagee whose address in incorrect for delivery of its FHA Connection CoordinatorÆs registration information, should submit a request for correction to the Lender Approval and Recertification Division.

B. Telephone and Fax Numbers and Email Address. Because FHA often has a need to contact mortgagees by telephone or fax or by email, a mortgagee must update this information through the Lender Approval functions of the FHA Connection. The numbers are also displayed on searchable lists of FHA approved mortgagees on HUDÆs web site.

6-3 Change of Branch Office Location or Telephone Number.

A. Within the Same State. The mortgagee must update the addresses for each branch through the Lender Approval functions under the FHA Connection.

B. To Another State. A mortgagee cannot change the ôStateö part of the Geographic Address of a branch office. If an office has relocated to a different State, the mortgagee must submit a request to the Lender Approval and Recertification Division to update the address.

6-4 Termination of Principal-Authorized Agent Relationship. If a Principal/Authorized Agent relationship is terminated by either party, then either party must also terminate the relationship in FHAÆs systems via the Lender Approval functions under the FHA Connection.

6-5 Termination of Loan Correspondent-Sponsor Relationship. If a loan correspondent/sponsor relationship is terminated by either party, then either party must also terminate the relationship in FHAÆs systems via the Lender Approval functions under the FHA Connection. Because a loan correspondent must have at least one sponsor, loss of all sponsors is grounds for FHA to withdraw the loan correspondent's approval. In such cases, the loan correspondent has 30 days to establish a relationship with at least one new sponsor. If the loan correspondent fails to establish a new Sponsor relationship, then its FHA approval will be withdrawn.

6-6 Permission for Supervised Loan Correspondent to Service. Upon application to the Department, a supervised loan correspondent may be granted permission to service its own FHA-insured mortgages. The ôapplicationö consists of a letter to the Lender Approval and Recertification Division. Generally, permission is granted only when the mortgagee has converted from a supervised mortgagee and has an outstanding portfolio of FHA-insured mortgages.

6-7 Change of Fiscal Year. A mortgagee is allowed to change its fiscal year. The mortgagee must submit a written request to the Lender Approval and Recertification Division. HUD may, at its discretion, require the mortgagee to submit financial statements and a computation of adjusted net worth certified by its management. This requirement depends on the length of time since the mortgagee last submitted audited financial statements to the Department. Every period must eventually be audited. In no case may more than 18 months elapse between the dates of audited financial statements.

6-8 Change of Legal Name. For a change of name, a mortgagee must submit the following to the Lender Approval and Recertification Division

A. Acceptable documentation showing the name change, such as:

* The amendment to its articles of incorporation;
* Resolution by the mortgagee's Board of Directors; and
* Charter amendment for a supervised institution.

B. When required by the State, evidence that the name change has been accepted by the State in which the home office is located.

6-9 Changes to ôDoing Business Asö (dba) Name. A mortgagees makes changes to its ôdoing business asö through the FHA Connection and certify it has the appropriate approval to use the dba name. Although a mortgagee may have more than one ôdba,ö each home or branch office is limited to one ôdbaö name in the FHA Connection. See paragraph 2-4, regarding names including restricted words such as ônationalö or ôFederal.ö

6-10 Loss of Direct Endorsement Underwriter. If a mortgagee with Direct Endorsement (DE) authority loses its only DE underwriter, it must immediately obtain and register a qualified replacement. Without a registered DE underwriter, the mortgagee will be unable to underwrite FHA mortgages. If it is unable to obtain and register a replacement, then the mortgagee must either enter into a Principal-Authorized Agent relationship or convert to loan correspondent status. For Principal-Authorized Agents, see chapter 5 Part B. For conversion, see paragraph 6 16.

6-11 Change of Senior Officer. If a mortgagee has an addition or substitution of a principal, including but not limited to chairman of the board, president, vice president, director, or LLC member, the mortgagee must notify HUD of the change. A Residential Mortgage Credit Report must be submitted on the new individual. A supervised mortgagee or supervised loan correspondent does not have to comply with the credit report requirement.

6-12 Change in a Partnership. If a managing general partner withdraws or is removed from the partnership, a new managing general partner must be substituted and the Department must be immediately notified of the change. The mortgagee must immediately notify the Department of any amendments to the partnership agreement that would affect the partnership's actions under any of the mortgage insurance programs. Newly admitted partners must agree to the management of the partnership by the designated managing general partner. Before a partnership is terminated, all FHA insured mortgages held by the partnership must be transferred to an approved mortgagee.

6-13 Change of Shareholder, Ownership, or Control. Whenever an individual or entity, that previously owned less than 25 percent of voting stock of a mortgagee, acquires voting stock resulting in ownership of 25 percent or more, the mortgagee must notify HUD. A resume and Residential Mortgage Credit Report must be submitted on any such individual; for a business entity, a commercial credit report, or a Dun & Bradstreet report, must be submitted. If a mortgagee's controlling ownership changes, a new application and fee may be necessary. The mortgagee should contact the Lender Approval and Recertification Division in advance to determine what will be required. A change of ownership or control resulting from a merger or consolidation is covered in paragraph 6 17; a change of ownership or control resulting from acquisition of the mortgagee is covered in paragraph 6 18.

6-14 Change in Charter or Federal Taxpayer Identifying Number.

A. Change Resulting in New Federal Taxpayer Identifying Number. If a mortgagee reincorporates the approved institution, changes the institution's charter, changes the State where the company is incorporated or otherwise chartered, or completes any other change that results in the company receiving a different Federal Taxpayer Identifying Number, the mortgagee is required to submit a new application for mortgagee approval and pay the fee for a new mortgagee approval as specified in paragraph 2 7. If a new mortgagee identification number is issued, HUD will leave the old mortgagee identification number active for approximately 45 days to allow completion of processing of loans in process under that identification number. When a new mortgagee identification number is issued, the mortgagee must cease originating cases under the old number.

B. Change Not Resulting in Change of Federal Taxpayer Identifying Number. If the change does not result in a new Federal Taxpayer Identifying Number, then the mortgagee must submit the following to the Lender Approval and Recertification Division:

1. Certification as to the nature of the conversion and that there has been no change in the Federal Taxpayer Identifying Number or depositor insurance (in the case of a supervised mortgagee).

2. Certification that the institution will continue to comply with the approval requirements of this Handbook.

3. Certification that the newly chartered entity will continue to be responsible for the assets and liabilities of the former institution. This would include any problems found subsequently by the Department in the origination or servicing of any Title II mortgages originated or serviced by the institution prior to the adoption of the new charter.

4. Copy of the new charter and a complete description of the changes. In lieu of the above, the mortgagee must submit a new application for mortgagee approval and pay the fee for a new mortgagee approval as specified in paragraph 2 7.

C. Special Cases. There may be instances where the Federal Taxpayer Identifying Number may not change, but the change in the business entity is such that HUD may require a new application.

6-15 Change in Character of Business (Principal Activity). If there is a change in the character of an approved non-supervised mortgagee's business such that it may no longer qualify under the ôprincipal activityö rule (see paragraph 2 27(D) or 2 29(C), as applicable and 24áCFRá202.7(a) or 202.8(a)(2), as applicable.), and this change in character is permanent, it must withdraw from the program. If the change is temporary, it must notify the Department and provide to the Department a Corrective Action Plan detailing how it will reestablish mortgage lending as its principal activity.

6-16 Conversion of Mortgagee Type. A mortgagee that converts its status from one type to another during its fiscal year must continue to comply with all annual recertification requirements. To convert its mortgagee type, a mortgagee must complete a new HUD form 11701, Application for Approval, FHA Lender and/or Ginnie Mae Mortgage Backed Securities Issuer, and pay a non-refundable $300 conversion fee. A mortgagee or loan correspondent must demonstrate that it has adequate net worth to meet the requirements of the type of mortgagee to which it is converting. The conversion application and its supporting documentation must be sent the Director, Lender Approval and Recertification Division. The non refundable $300 conversion fee must be mailed to HUD's lock box address shown in paragraph 2 7, together with its transmittal form. The mortgagee's 10 digit FHA identification number for its home office must be inserted in the memo section of the check and the transmittal form.

A. Supervised Mortgagee to Supervised Loan Correspondent. In this type of conversion, the mortgagee must submit:

* Transmittal letter, showing the mortgageeÆs ID number, name, address and nature of request;
* Copy of the check for the conversion fee and the transmittal form;
* Sponsor Letter, in which the sponsor agrees to sponsor the supervised loan correspondent and purchase all FHA mortgages originated by the supervised loan correspondent and underwritten by the Sponsor; and
* Certification that all FHA-insured mortgages held or serviced has been transferred to another FHA mortgagee that is approved to service FHA-insured mortgages; or a request for permission to hold or service FHA-insured mortgages.

B. Supervised Loan Correspondent to Supervised Mortgagee. In this type of conversion, the mortgagee must submit:

* Transmittal letter, showing the mortgageeÆs ID number, name, address and nature of request;
* Copy of the check for the conversion fee and the transmittal form;
* Evidence of errors and omissions insurance for a minimum of $300,000; and
* Evidence of a fidelity bond for a minimum of $300,000.

C. Supervised Entity to Non-supervised Entity. In this type of conversion, the mortgagee must submit:

* Transmittal letter, showing the mortgageeÆs ID number, name, address and nature of request;
* Copy of the check for the conversion fee and the transmittal form;
* A new HUD form 11701, Application for Approval, FHA Lender and/or Ginnie Mae Mortgage-Backed Securities Issuer; and
* The same documentation as for a new application for approval with all the required documentation for that type of mortgagee.

D. Non-supervised Mortgagee to Non-supervised Loan Correspondent. In this type of conversion the mortgagee must submit:

* Transmittal letter, showing the mortgageeÆs ID number, name, address and nature of request;

* Copy of the check for the conversion fee and the transmittal form;
* Sponsor letter showing evidence of an acceptable funding agreement; and
* Certification that all FHA-insured mortgages held or serviced has been transferred to another FHA mortgagee that is approved to hold and service FHA-insured mortgages.

E. Non-supervised Loan Correspondent to Non-supervised Mortgagee. In this type of conversion, the mortgagee must submit:

* Transmittal letter, showing the mortgageeÆs ID number, name, address and nature of request;
* Copy of the check for the conversion fee and the transmittal form;
* Copy of its most recent audited financial statements and, if these are more than six months old, management certified financial statements and computation of adjusted net worth. (see paragraph 3 2(A)(6);
* Evidence of an acceptable funding program. (see paragraph 2 27.C);
* Evidence of errors and omissions insurance for a minimum of $300,000; and
* Evidence of a fidelity bond for a minimum of $300,000.

Once this conversion is approved, the mortgagee will no longer have any sponsors and needs to contact the appropriate Homeownership Center for obtaining approval as a DE mortgagee if they wish to underwrite single family loans.

F. Conversion to Investing Mortgagee. In this type of conversion, the mortgagee must submit:

* Transmittal letter, showing the mortgageeÆs ID number, name, address and nature of request;
* Copy of the check for the conversion fee and the transmittal form;
* A new HUD form 11701, Application for Approval, FHA Lender and/or Ginnie Mae Mortgage-Backed Securities Issuer;
* Evidence that it meets the requirements specified in paragraph 2 30(B), regarding legal authority to purchase insured mortgages and availability of funding; and
* Certification that all servicing of FHA-insured mortgages has been transferred to another approved FHA mortgagee that is approved to service FHA-insured mortgages.

G. Conversion from Investing Mortgagee. In this type of conversion, the mortgagee must submit:

* Transmittal letter, showing the mortgageeÆs ID number, name, address and nature of request;
* Copy of the check for the conversion fee and the transmittal form;
* Submit the same documentation as for a new application for approval with all the required documentation for that type of mortgagee; and
* If conversion is to a loan correspondent, certify that all FHA-insured mortgages held or serviced have been transferred to another FHA mortgagee that is approved to hold and service FHA-insured mortgages.

6-17 Merger or Consolidation. Mergers can take a variety of forms.

A. Two or More HUD/FHA-Approved Mortgagees Merge.

1. Non-surviving Entity. The non-surviving entity must:

a. Submit a letter signed by an executive officer informing the Department that it is merging with another entity. The letter must:

* Indicate which mortgagee will survive;
* Provide the mortgagee identification numbers for each mortgagee involved;
* Provide the date the merger occurred or will occur; and
* Request termination of its approval.

b. If the non-surviving mortgagee was a Sponsor of FHA-approved loan correspondents, it must notify its loan correspondents of its request for termination.

c. Once the non-surviving entity ceases to exist or its approval is terminated, whichever comes first:

* It may not accept any new applications for Title II mortgages;
* It may no longer purchase Title II mortgages;
* It may no longer service Title II mortgages; and
* It may no longer submit claims to the Department.

d. When the non-surviving mortgagee holds a portfolio of Title II mortgages, it must arrange to transfer the loans to the surviving mortgagee or some other approved FHA mortgagee approved to service FHA mortgages. See paragraphs 6-17(A)(2)(e) and (f). There is a continued obligation to pay insurance premiums due and to meet all other obligations associated with the insured mortgages.

2. Surviving Entity. The surviving entity must:

a. Submit a letter describing the merger and certifying that 1) any loan correspondents not continuing with sponsorship have been notified, 2) all loan correspondents of the non-surviving mortgagee will be sponsored by the surviving mortgagee or 3) the non-surviving mortgagee was not the sponsor of any loan correspondents.

b. Submit a copy of the document which evidences the merger. A supervised mortgagee, must submit a copy of the letter from the supervisory authority which approved the merger.

c. Submit a list identifying each of the non-surviving entity's branch offices which will remain open under the auspices of the surviving entity, and pay the branch office registration fee specified in paragraph 2 7.

d. Register each of the non-surviving entity's loan correspondents, if any, that the surviving entity will continue to sponsor in the FHA Connection. Sponsorship is not automatically transferred. Each of the non-surviving entity's loan correspondents, for which the surviving entity will not continue sponsorship, must be given 30 days written notice by the Sponsor.

e. If the surviving mortgagee acquires only a portion of the non-surviving mortgagee's Title II mortgages, one of the parties must submit a Mortgage Record Change transaction for each mortgage that will not be acquired by the surviving mortgagee.

f. If the surviving mortgagee acquires all of the non-surviving mortgagee's outstanding Title II mortgages, it is not necessary to submit Mortgage Record Changes. All loans will be transferred to the surviving entity by HUD when the merger is processed.

B. An Approved Mortgagee Merges with a Non-approved Mortgagee.

1. Non-approved Mortgagee Survives.

a. The non-surviving mortgagee must comply with the provisions of paragraph 6 17(A)(1).

b. If the surviving mortgagee wishes to originate or hold Title II mortgages or submit claims for mortgages previously held by the non-surviving mortgagee, it must become FHA-approved. To become approved, it must follow the approval procedures of this Handbook. The mortgagee should include with its application a letter describing the merger, and, if applicable, its intentions regarding the non-surviving mortgageeÆs outstanding Title II mortgages and sponsored loan correspondents. Immediately after becoming approved, the mortgagee should register each of the non-surviving entityÆs branch offices which will remain open under the auspices of the surviving entity, and pay the branch registration fee specified in paragraph 2-7. The mortgagee must register each of the loan correspondents it is sponsoring in the FHA Connection.

2. Approved Mortgagee Survives. The surviving mortgagee must:

a. submit a letter describing the merger.

b. Submit a copy of the document which evidences the merger. A supervised mortgagee, must submit a copy of the letter from the supervisory authority which approved the merger.

6-18 Sale or Acquisition. The sale or acquisition of a FHA-approved mortgagee may take the form of stock, assets or operations being acquired or some combination of these. The mortgagee may cease to exist, becoming part of the acquiring company, it may continue as a subsidiary or affiliate of the acquiring company, or may become an independent company. Each of these is handled differently.

A. An Approved Mortgagee Acquired by Another Approved Mortgagee. The necessary action depends upon whether the acquired mortgagee will cease to exist or will continue as a subsidiary or affiliate of the acquiring mortgagee.

1. Continuation as Subsidiary or Affiliate. If the mortgagee being acquired will continue to operate as a subsidiary or affiliate of the acquiring mortgagee, the acquiring mortgagee must submit a letter describing the transaction including the names of all parties, their FHA mortgagee identification numbers, and the date of the acquisition. The letter must also explain that the acquired entity will continue as a subsidiary or affiliate of the acquiring entity. The acquired mortgagee must notify the Department by letter that it has been acquired and will continue to operate as a subsidiary or affiliate of the acquiring mortgagee. The acquired mortgagee may continue to operate under its existing Title II mortgagee Identification Number.

2. Dissolution of Mortgagee. If the mortgagee being acquired will be dissolved,

a. The non-surviving entity must submit a letter signed by an executive officer informing the Department of details regarding its acquisition and requesting termination of its approval. The mortgagee must comply with the provisions of paragraphs 6 17(A)(1).

b. The surviving entity must submit to HUD a copy of the articles of dissolution and a letter describing the acquisition and, if applicable, its intended disposition or sale of FHA insured loans held or serviced by the non-surviving mortgagee. The letter must also certify that 1) any loan correspondents not continuing with sponsorship have been notified, 2) all loan correspondents of the non-surviving mortgagee will be sponsored by the surviving mortgagee or 3)áthe non-surviving mortgagee was not the sponsor of any loan correspondents. The surviving mortgagee must comply with paragraphs 6 17(A)(2)(c) through (f).

B. An Approved Mortgagee Acquired by an Entity that is Not Approved.

1. Acquiring Entity Requires Approval to Participate in Program. If the acquiring entity wishes to be able to originate, hold, or service Title II mortgages, it must apply for approval under the applicable provisions of this Handbook.

If the acquired mortgagee will not be continuing as a subsidiary or affiliate, the acquiring entity should include with its application a letter describing the acquisition and, if applicable, its intentions regarding the non-surviving mortgageeÆs outstanding Title II mortgages and sponsored loan correspondents. Immediately after becoming approved, the mortgagee should register each of the non-surviving entityÆs branch offices which will remain open under the auspices of the surviving entity, and pay the branch registration fee specified in paragraph 2-7(A). The mortgagee may electronically register each of the loan correspondents it is sponsoring or follow the alternate procedures described in paragraph 5-12.

2. Acquired Mortgagee to Continue as Subsidiary or Affiliate. If the acquired entity will continue to operate as a subsidiary or affiliate of the acquiring mortgagee, it may continue to operate as a Title II mortgagee under its own name, whether or not the acquiring entity becomes FHA-approved. The mortgagee must submit a letter describing the acquisition and its future operating status.

3. Acquired Mortgagee Ceases to Exist. If the acquired entity will cease to exist, it must comply with the provisions of paragraph 6 18(A)(2)(a).

C. The Approved Mortgagee Becomes Independent. When an approved mortgagee, which has been a subsidiary or part of a larger entity, becomes independent, it must notify HUD and provide details of the change. Based on this, HUD may require additional information. For changes in senior officers, directors, or ownership, the mortgagee must submit documentation as specified in paragraphs 6 11 and 6 13.

D. The Approved Mortgagee Acquires an Entity that is Not Approved.

If the acquired entity will operate as a subsidiary or affiliate of the acquiring mortgagee and wishes to be able to originate, hold or service Title II mortgage, it must apply for approval under the applicable provisions of this Handbook.

6-19 Termination of Supervision. A supervised mortgagee is required to notify the Department in writing within 10 business days after the termination of supervision by its supervising agency. If the mortgagee qualifies for approval as another type of mortgagee, it must submit a new application, with the appropriate non-refundable fee, for approval to participate in the Department's mortgage insurance programs.

6-20 Termination of Fidelity Bond or Errors and Omissions Insurance. If a mortgagee's fidelity bond or errors and omissions insurance is terminated and the mortgagee is unable to obtain a new policy within ten business days, to continue as a FHA approved mortgagee, it must convert to a loan correspondent (see paragraph 6 16).

6-21 Net Worth Deficiency. An approved mortgagee must maintain at least the minimum required adjusted net worth at all times. If at any time it falls below the required minimum, the mortgagee must notify the Lender Approval and Recertification Division and submit a Corrective Action Plan. Failure to comply is grounds for an administrative action by the Mortgagee Review Board.

6-22 Liquid Assets Deficiency. An approved mortgagee must maintain at least the minimum required liquid assets at all times. If at any time it falls below the required minimum, the mortgagee must notify the Lender Approval and Recertification Division and submit a Corrective Action Plan. Failure to comply is grounds for an administrative action by the Mortgagee Review Board.

6-23 Operating Loss. A mortgagee must submit financial statements within 30 days of the end of each fiscal quarter in which the mortgagee experiences an operating loss of 20 percent or greater of its net worth. The interim financial statements may be either audited or un-audited, and the mortgagee must continue to submit them until it shows an operating profit for two consecutive quarters, or until its next annual recertification by FHA, whichever is later.

6-24 Bankruptcy or Liquidation.

A. Business. A mortgagee must submit a statement of Adjusted Net Worth within 30 days of commencement of voluntary or involuntary bankruptcy, conservator ship, receivership or any transfer of control to a Federal or State supervisory agency. A current original Dun and Bradstreet or business credit report must be submitted. HUD must be notified of each change of status in the bankruptcy proceedings. HUD reserves the right to require the mortgagee to submit court documents.

B. Personal. If an officer or principal of the mortgagee commences voluntary or involuntary bankruptcy, within 30 days the mortgagee must notify HUD. A current original credit report for that officer or principal must be submitted. HUD must be notified of each change of status in the bankruptcy proceedings.

6-25 Voluntary Withdrawal of HUD/FHA Approval. A mortgagee may request a voluntary withdrawal of its FHA approval by submitting written notification, signed by a senior officer, to the Lender Approval and Recertification Division. The request will not be honored while there is an administrative action or Mortgagee Review Board action pending against the mortgagee. Any mortgagee whose approval is voluntarily withdrawn may reapply for FHA approval at any time after its withdrawal.

6-26 All Other Business Changes. Any other business change that affects a mortgagee's approval status or its conduct of business with the Department must be reported in writing to the Lender Approval and Recertification Division within 10 days.

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A. ***Requirement.*** A supervised or non-supervised mortgagee or loan correspondent must maintain liquid assets of 20 percent of its adjusted net worth or $100,000 whichever is lesser. Supervised applicants are not required to verify liquid assets in their application, but may be asked to verify compliance during application processing.

B. ***Acceptable.*** Cash and cash equivalents constitute liquid assets. Cash includes cash on hand, checking accounts, savings accounts, and certificates of deposit. Cash equivalents are readily marketable investments, e.g. securities readily convertible into cash. To be considered a liquid asset, the cash or cash equivalent must not be restricted or otherwise reserved for any purpose other than the payment of a current liability.

C. ***Unacceptable.*** FHA does not consider a line of credit or loans or mortgages held for resale by the mortgagee to be liquid assets.

2.7 Application Fees. All fees are nonrefundable (TOP)

A.. ***Fee Amount.***

1. ***Mortgagee Approval****.* The fee is $1,000 except for those entities already approved as a Title I lender, governmental institutions or non-depository not-for profit entities.

2. ***Branch Office Registration.*** The fee is $300, except for governmental institutions or non-depository not-for profit entities.

B. ***Fee Payment.*** The application fee must be mailed to HUD's lockbox together with the HUD form, *Application Fee for Title II Mortgagee Approval* to the following address:

U.S. Department of HUD
P.O. Box 198619
Atlanta, GA 30384

Copies of the check and application fee form must accompany the FHA lender application form. If not, a copy of the front and back of the cancelled check will be requested.

2-8 Operating Expenses. (TOP)

A mortgagee must pay all its own operating expenses. This includes expenses of its main and branch offices involved in originating or servicing any FHA insured mortgages. Operating expenses include, but are not limited to, equipment, furniture, office rent, overhead, employee compensation, and similar expenses.

2-9 Employees and Officers. (TOP)

An approved mortgagee must employ trained personnel that are competent to perform their assigned responsibilities.

A. ***Employees.*** Employees are those individuals who are under the direct supervision and control of an FHA approved mortgagee and where the individuals are exclusively employed by the FHA approved mortgagee in the mortgage lending and real estate fields. The mortgagee must demonstrate the essential characteristics of the employer-employee relationship upon inquiry by the Department. [See also paragraphs 2-9(D) and 2-9(G)]

Compensation of employees may be on a salary, salary plus commission, or commission only basis and includes bonuses. All compensation must be reported on Form W-2. Employees who perform underwriting and loan servicing activities may *not* receive commissions.

B. ***Officers.*** Individuals are officers for the purposes of FHA requirements if they bear the corporate title of Vice President or higher and also include Branch Managers. A mortgagee must have one or more officers with authority over the mortgagee's loan origination and servicing operations. An officer is either a corporate officer, or a principal of a non-corporate entity, who has authority to legally bind the corporation or entity. In the case of a government institution, this role would be filled by a designated staff person(s). At least one officer must spend full time managing and directing the mortgagee's operations. That officer must have a minimum of three years acceptable experience in the mortgage activities for which the mortgagee is seeking approval. Relevant training may be substituted for some of the required experience. An applicant must submit, with its application, current resumes documenting this experience. In determining the acceptability of an officer's experience, the Department will consider:

- Experience in originating single family and multifamily mortgages;
- Experience in servicing single family and multifamily mortgages;
- Experience in investing funds in real estate mortgages;
- Experience in managing other individuals performing these services; and

- Experience in real estate sales or brokerage does *not* qualify.

A Branch Manager's compensation may be based upon the "net" profit of the branch. For example, the FHA approved mortgagee may collect the revenue from the branch, pay the branch expenses, and then pay the branch manager the remaining revenues, if any, as a commission. Such an arrangement is, essentially, an alternative compensation program for the branch manager and is an acceptable arrangement if all other branch requirements are met.

C. ***Companies with Joint Officers.*** If a mortgagee has any of the same officers, stockholders, partners, or members as another entity, the officers may represent more than one entity if:

1. There is a clear and effective separation of the two entities, and mortgagors know at all times exactly with which entity they are doing business.

2. There is a duly appointed or elected senior officer, with the required minimum three years of acceptable experience, designated to conduct exclusively the affairs of the mortgagee during normal business hours.

D. ***Control and Supervision of Staff.*** (TOP) A mortgagee must exercise control and responsible management supervision over its home office and branch employees. Control and supervision must include, at a minimum, regular and ongoing reviews of employee performance and of work performed.

E. ***Signatory Authority.*** (TOP) Any employee who signs applications for mortgage insurance on behalf of the mortgagee must be a Vice President, or be authorized to bind the mortgagee in matters involving the origination and servicing of insured mortgages.

F. ***Conducting Mortgagee Business.*** (TOP) During his/her normal duty hours, employees, who are involved with FHA transactions, may conduct only the business of the mortgagee.

G. ***Full Time, Part Time and Outside Employment.*** (TOP) A mortgagee may employ staff full time or part-time (less than the normal 40 hour work week). They may have other employment including self-employment. However, such outside employment may not be in mortgage lending, real estate, or a related field. Direct endorsement underwriters are included in this provision. An underwriter may not work on a part-time basis for any other mortgagee, even underwriting conventional mortgage loans. An underwriter may not underwrite loans for a parent or subsidiary of the underwriter's approved employer. A direct endorsement underwriter's authority is through the employer and does not extend under any corporate "umbrella."

2-10 Ineligible Participants. (TOP)
An applicant is ineligible for approval if the mortgagee or any officer, partner, director, principal, or employee of the applicant mortgagee is:

A. Suspended, debarred, under a limited denial of participation (LDP), or otherwise restricted under 24 CFR Part 24 or 25 or under similar provisions of any other Federal agency;

B. Under indictment for, or has been convicted of, an offense that reflects adversely upon the applicant's integrity, competence or fitness to meet the responsibilities of an approved mortgagee;

C. Subject to unresolved findings contained in a HUD or other governmental audit, investigation, or review;

2-23 Quality Control. (TOP)

A mortgagee must maintain a written Quality Control Plan for the origination and servicing of FHA insured mortgages. The Quality Control Plan and its implementation must meet the requirements set forth in chapter 7. Mortgagees are required to report to HUD any fraud, illegal acts, irregularities or unethical practices.

2-24 Requirement to Notify HUD of Changes Subsequent to Approval. (TOP)

A mortgagee must notify the Department in writing within a specific number of days of any business change that affects its standing as an approved institution, or which changes the information on which it was originally approved, including: corporation conversion, merger, consolidation, succession, liquidation, termination; or a change in its charter provisions, name, bylaws, location, ownership, character of business, or senior officers; or a significant reduction in its revenues, assets or net worth. See chapter 6 for details.

Part B. Additional Requirements for Specific Mortgagee Types (TOP)

2-25 Introduction. (TOP)

A mortgagee may be approved to participate in the Department's mortgage insurance programs as one of the following designated types of mortgagee. In addition to the general approval requirements of Part A of this chapter, it must meet specific requirements for its particular mortgagee type.

2-26 Supervised Mortgagees. (TOP)

A supervised mortgagee is a financial institution that is a member of the Federal Reserve System or an institution whose accounts are insured by the FDIC or the NCUA. Such a mortgagee is not required to have mortgage lending as a principal activity as described in paragraph 2-29(C). A subsidiary or an affiliate of a supervised financial institution is ***not*** considered to be supervised for approval as an FHA mortgagee. Examples of supervised mortgagees are banks, savings associations, and credit unions.

A. ***Permissible Mortgage Lending Activities.*** A supervised mortgagee may originate, underwrite, purchase, hold, service, and sell FHA insured mortgages and submit applications for mortgage insurance.

B. ***Branch Offices.*** A supervised mortgagee may maintain FHA registered branch offices that originate insured mortgages. Specific approval requirements are in chapter 5. The mortgagee is fully responsible to HUD for the actions of its offices.

C. ***Fiduciary Relationships.*** Approval of a financial institution as a supervised mortgagee constitutes approval for it to act in a fiduciary capacity in investing fiduciary funds, which are under its individual or joint control. When such a fiduciary relationship is ended, any insured mortgages held in the fiduciary estate must be transferred to an approved supervised mortgagee; the fiduciary relationship must permit the transfer.

Chapter 7 Quality Control Plan

7-1 General. (TOP)

All FHA approved mortgagees, including loan correspondents, must implement and continuously have in place a Quality Control Plan for the origination and/or servicing of insured mortgages as a condition of receiving and maintaining FHA approval. This applies to both the Single Family and the Multifamily Housing programs. A copy of the plan must be submitted when applying for mortgagee approval.

Quality Control must be a prescribed and routine function of each mortgagee's operations whether performed by a mortgagee's staff or an outside source. Mortgagees applying for approval to originate only or service only may submit a plan that pertains only to the function they will perform. A mortgagee that will perform both origination and servicing must submit a plan that covers both functions.

This Chapter sets forth basic requirements that all mortgagees must meet, along with a degree of flexibility, so that each mortgagee may develop a program that fits its circumstances while conforming to FHA's requirements. Mortgagees should consider that some of the requirements might not be applicable to their operation. It is necessary to perform Quality Control only on those activities in which a mortgagee is engaged.

Part A. Overall Requirements

7-2 Goals of Quality Control. (TOP)

The following are the overriding goals of Quality Control. Mortgagees must design programs that meet these basic goals:

- Assure compliance with FHA's and the mortgagee's own origination or servicing requirements throughout its operations;
- Protect the mortgagee and FHA from unacceptable risk;
- Guard against errors, omissions and fraud; and
- Assure swift and appropriate corrective action.

Failure to comply with specific Quality Control requirements may result in sanctions and the imposition of Civil Money Penalties by the Mortgagee Review Board (MRB).

7-3 Basic Elements of Quality Control. (TOP)

There are several basic elements that are required in all Quality Control Programs that apply to both origination and servicing.

A. ***Plan Form and Execution.*** All Quality Control Programs must be in writing. Mortgagees must have fully functioning Quality Control Programs from the date of their initial FHA approval until final surrender or termination of their approval.

B. ***Independence.*** The Quality Control function must be independent of the origination and servicing functions. This independence may be accomplished in a variety of ways. Depending on a mortgagee's operations, loan volume, staff size or other factors, a mortgagee may prefer one method over another. Quality Control functions may be performed using:

1. ***In-House Staff.*** Mortgagees may establish a unit that is dedicated solely to Quality Control. Staff performing Quality Control reviews must not be involved in the day-to-day processes that they are reviewing. (TOP)

2. ***Outside Firms.*** Mortgagees may engage outside sources to perform the Quality Control function. The FHA approved sponsors of loan correspondents are acceptable as such outside sources. A mortgagee contracting out any part of its Quality Control function is responsible for ensuring that the outside source is meeting HUD's requirements. Any agreement with the outside source must be in writing, state the roles and responsibilities of each party, and be available for review by HUD staff. (TOP)

C. ***Qualified Staff.*** Mortgagees must properly train staff involved in Quality Control and provide them access to current guidelines relating to the operations that they review. It is not necessary for mortgagees to maintain these guidelines in hard copy format if they are accessible in an electronic format. Many of the statutes, regulations, HUD Handbooks and Mortgagee Letters which establish the requirements for FHA programs are available on the web page for HUDCLIPS at: **http://www.hudclips.org/cgi/index.cgi**.

D. ***Timeliness.*** Mortgagees must ensure that quality control reviews are performed on a regular and timely basis. Depending on a mortgagee's production volume, origination reviews may be performed weekly, monthly, or quarterly. The review of a specific mortgage should be completed within 90 days of closing. Reviews of different aspects of servicing will vary in frequency; however, delinquent servicing and loss mitigation activities should be reviewed monthly. Timeliness is discussed further in the Origination and Servicing sections of this Chapter.

E. ***System of Loan File Review.*** The Quality Control Program must provide for the review of a representative sample of a mortgagee's loans. This review must evaluate the accuracy and adequacy of the information and documentation used in reaching decisions in either the origination or servicing processes. Specific elements for items to review are discussed in the Origination and Servicing sections of this Chapter. (TOP)

F. ***Adequate Scope and Sampling.*** The Quality Control reviews must thoroughly evaluate the mortgagee's origination and/or servicing functions to determine the root cause of deficiencies. The mortgagee must expand the scope of the Quality Control review when fraud or patterns of deficiencies are uncovered; scope means both an increased number of files as well as more in-depth review. All aspects of the mortgagee's operation, including but not limited to all branch offices or sites, FHA approved loan correspondents, authorized agents, loan officers or originators, processors, underwriters, appraisers, closing personnel, all FHA loan programs, servicing personnel, loss mitigation procedures, escrow analysis, and assumptions, must be subject to the mortgagee's Quality Control reviews. Sample Size is discussed in the Origination and Servicing sections of this Chapter. (TOP)

G. ***Site Review.*** A mortgagee's offices, including traditional, nontraditional branch and direct lending offices engaged in origination or servicing of FHA-insured loans, must be reviewed to determine that they are in compliance with the Department's requirements.

1. ***Review Items.*** The review must include, but not necessarily be limited to, confirmation of the following items:

- The office is properly registered with FHA and the address is current;
- Operations are conducted in a professional, business-like environment;
- If located in commercial space, the office is properly and clearly identified for any walk-in customers; has adequate office space and equipment; is in a location conducive to mortgage lending; and is separated from any other entity by walls or partitions (entrances and reception areas may be shared);
- If located in non-commercial space, the office has adequate office space and equipment; displays a fair housing poster if the public is received; if it is open to receive the public, it must be accessible to persons with disabilities, including those with mobility impairments; if it is not open to the public, but used occasionally to meet with members of the public, alternate means of accommodation may be used to serve persons with disabilities;
- The servicing office provides toll-free lines or accepts collect calls from mortgagors;
- The office is sufficiently staffed with trained personnel;
- Office personnel have access to relevant statutes, regulations, HUD issuances and Handbooks, either in hard copy or electronically;
- Procedures are revised to reflect changes in HUD requirements and personnel are informed of the changes;
- Personnel at the office are all employees of the mortgagee or contract employees performing functions that FHA allows to be outsourced; and
- The office does not employ or have a contract with anyone currently under debarment or suspension, or a Limited Denial of Participation. (TOP)

2. ***Frequency.*** Technology enables mortgagees to conduct effective Quality Control remotely. Annual visits are mandatory for offices meeting certain higher risk criteria such as high early default rates, new branches or new key personnel, sudden increases in volume, and past problems. Other sites must be reviewed to assure compliance with FHA's requirements at a frequency and in a manner determined appropriate by the mortgagee. The criteria used by the mortgagee to determine the frequency of on-site reviews must be in writing and available for review by HUD at the corporate office and any branch office that is not being reviewed annually.

3. ***Staffing.*** When it is not feasible for Quality Control staff to visit each branch, qualified personnel from another office of the mortgagee, not involved in the day-to-day processes they are reviewing, or an outside firm may perform the review. (TOP)

H. ***Affiliate Review.*** The Department requires mortgagees to ensure that their contractors, agents, and loan correspondents are acceptable to FHA and operate in compliance with FHA requirements. (TOP)

1. ***Sponsors.*** A sponsor's Quality Control Program must provide for a review of loans originated and sold to it by each of its loan correspondents. sponsors should determine the appropriate percentage to review based on volume, past experience and other factors. Sponsors must document the methodologies and results.

2. ***Loan Correspondents.*** Loan correspondents may arrange with their sponsor(s) to perform Quality Control provided:

- The arrangement with the sponsor(s) is detailed in writing;
- The aggregate number and scope of reviews meet FHA requirements;
- Loans are reviewed within 90 days of closing;
- Findings are clear as to source and cause; and
- Results are available in a timely manner to both mortgagees and HUD.

3. ***Whole Loan and Servicing Purchasers.*** Mortgagees acquiring loans must confirm that mortgage insurance premiums have been paid, insurance is in force, security instruments have been recorded, and that the files and records are complete and as expected. (TOP)

I. ***Reporting and Corrective Action.*** Review findings must be reported to the mortgagee's senior management within one month of completion of the initial report. Management must take prompt action to deal appropriately with any material findings. The final report or an addendum must identify actions being taken, the timetable for their completion, and any planned follow-up activities. (TOP)

J. ***Notification to HUD.*** Findings of fraud or other serious violations must be immediately referred, in writing (along with any available supporting documentation) to the Director of the Quality Assurance Division in the HUD Homeownership Center (HOC) having jurisdiction (determined by the State where the property is located). In lieu of submitting a paper report, mortgagees must use the Lender Reporting feature in the Neighborhood Watch Early Warning System. If HUD staff is suspected of involvement, refer to the Office of Inspector General at 451 7th Street, SW, Room 8256, Washington, DC 20410.

A mortgagee's Quality Control Program must ensure that findings discovered by employees during the normal course of business and by quality control staff during reviews/audits of FHA loans are reported to HUD within 60 days of the initial discovery. (TOP)

K. ***File Retention.*** The Quality Control review report and follow-up, including review findings and actions taken, plus procedural information (such as the percentage of loans reviewed, basis for selecting loans, and who performed the review) must be retained by the mortgagee for a period of two years. These records must be made available to HUD on request. (TOP)

L. ***Restricted Participation.*** Determine that no one is employed for HUD origination, processing, underwriting or servicing who is debarred, suspended, subject to a Limited Denial of Participation (LDP) or otherwise restricted from participation in HUD/FHA programs. Mortgagees must periodically check employee list, at least semi-annually. (TOP)

7-4 Quality Control as a Risk Assessment Tool.

The Department recommends that Quality Control reports to mortgagee management include an assessment of risks. Mortgagees may develop a system of evaluating each Quality Control sample on the basis of the severity of the violations found during the review. The system should enable a mortgagee to compare one month's sample to previous samples so the mortgagee may conduct trend analysis.

Management can also use this tool to respond quickly to a sudden decline in the quality of its loans and help identify and correct the problem. Mortgagees may consider a ratings system such as the following for each loan reviewed, then aggregate these into an overall rating for the sample.

A. ***Low Risk.*** No, or a minor, problem was identified with the origination or servicing of the loan. (TOP)

B. ***Acceptable Risk.*** A variety of issues were identified pertaining to processing, documentation or decisions made but none were material to creditworthiness, collateral security or insurability of the loan. (TOP)

C. ***Moderate Risk.*** The records contained significant unresolved questions or missing documentation. Failure to resolve these issues has created a moderate risk to the mortgagee and FHA. (TOP)

D. ***Material Risk.*** The issues identified during the review were material violations of FHA or mortgagee requirements and represent an unacceptable level of risk. For example, a significant miscalculation of the insurable mortgage amount or the applicant's capacity to repay, failure to underwrite an assumption or protect abandoned property from damage, or fraud. Mortgagees must report these loans, in writing, to the Quality Assurance Division in the FHA Homeownership Center having jurisdiction.

Part B. Quality Control for Single Family Origination

7-5 Quality Control from Beginning to End. (TOP)

Quality Control for origination has historically been performed only at the end of the process, that is, after a loan has closed. In order to make it more useful, mortgagees are encouraged to implement Quality Control throughout the loan origination process. The following recommendations will help mortgagees accomplish these ends:

A. ***Monitor Application Process.*** Mortgagees should monitor the intake of mortgagor information to ensure sufficient questions are asked to elicit a complete picture of the mortgagor's financial situation, the source of funds for the transaction, the intended use of the property, and that employees working with the mortgage applicant are knowledgeable of the origination process to fully describe the mortgagor's responsibilities in obtaining a FHA-insured mortgage. This may involve periodically monitoring calls and following up with applicants regarding their treatment and understanding of the process and their obligations (e.g., to avoid misrepresentation and falsification). Mortgagees must also verify the identity of the loan applicant.

B. ***Conduct Pre-funding Reviews.*** Mortgagees may want to sample cases prior to closing to evaluate the quality of processing and underwriting. Using such reviews, mortgagees may detect problems prior to closing while problems can still be corrected. This would be especially beneficial in cases involving loans with higher risk characteristics. An important part of pre-funding reviews is reverification (by telephone or in writing) of the applicant's employment, source of funds and residency history. If a written reverification received during a pre-funding Quality Control review is satisfactory, another written reverification is not required if the loan is selected for post-closing review. (TOP)

C. ***Identify Patterns.*** Mortgagees must identify patterns of early defaults by location, program, loan characteristic, loan correspondent or sponsor. Mortgagees may use HUD's *Neighborhood Watch - Early Warning System* to identify patterns. Mortgagees must identify commonalities among participants in the mortgage origination process to learn the extent of their involvement in problem cases. Loans involving appraisers, loan officers, processors, underwriters, etc. who have been associated with problems must be included in the review sample.

7-6 Basic Requirements for Quality Control of Single Family Production. In order for a Quality Control Program to be useful and acceptable to FHA, there are several requirements that must be met. Mortgagees must adhere to each of the requirements below when conducting reviews. (TOP)

A. ***Timeliness.*** Loans must be reviewed within 90 days from the end of the month in which the loan closed. This requirement is intended to ensure that problems left undetected prior to closing are identified as early after closing as possible. (TOP)

B. ***Frequency.*** For mortgagees closing more than 15 loans monthly, quality control reviews must be conducted at least monthly and must address one month's activity. Mortgagees closing 15 or fewer loans monthly may perform quality control reviews on a quarterly basis.

C. ***Sample Size and Loan Selection.*** Because it is not feasible to review all loans originated during a period, the Program must require that an appropriately sized sample is selected and evaluated during each review. A mortgagee who originates and/or underwrites 3,500 or fewer FHA loans per year must review 10 % of the FHA loans it originates. A mortgagee who originates and/or underwrites more than 3,500 FHA loans per year may review 10 % of its loans or a statistical random sampling that provides a 95 % confidence level with 2 % precision. Each review must document how the sample size and selections were determined. (TOP)

Regardless of the percentage of loans being reviewed, the mortgagee must comply with the following:

1. ***Targeting Loans for Review.*** The Quality Control Program must contain provisions to select loans meeting the conditions stated below. It may not be feasible to select loans from each category every month, but an effort must be made to select loans from each category as often as possible. An emphasis should be placed on any participants that have large volumes of loans, show sudden increases in loan volumes or loan default rates, have recently begun a relationship with the mortgagee, or concentrate in soft market areas.

   a. Loans must be reviewed from all branch offices and all sources including authorized agents and loan correspondents; (TOP)

   b. Mortgagees must review the work of each of the loan processors, loan officers, and underwriters based on the sample selected. In addition, mortgagees must review the work of roster appraisers, real estate companies, and builders with whom they do a significant amount of business; and (TOP)

c. The sample must include all FHA programs in which the mortgagee participates including, but not limited to, 203(b), 203(k), 234(c), and Home Equity Conversion Mortgages.

2. ***Recommendations for Selecting Individual Loans.*** The Department's experience in reviewing loans that went into early default has shown that many have one or more of the characteristics listed below. It is recommended that mortgagees consider these characteristics, or any additional ones they find useful, in identifying loans to be reviewed. (TOP)

- 2-4 unit properties;
- New construction or rehab loans;
- Properties transferred within the past year;
- Substantial seller concessions;
- Non-occupying co-mortgagors or multiple mortgagors;
- Housing expenses increasing by 1.5 times or more;
- Large or multiple earnest money deposits (money orders);
- Large increase in bank account balance;
- Sale of personal property for funds to close;
- Gifts or loans of funds to close;
- Self-employed; and
- Loans risk assessed as "refers" by automated underwriting systems.

D. ***Early Payment Defaults.*** In addition to the loans selected for routine quality control reviews, mortgagees must review all loans going into default within the first six payments. As defined here, early payment defaults are loans that become 60 days past due. (TOP)

E. ***Documentation Review and Verification.*** The Quality Control Program must provide for the review and confirmation of information on all loans selected for review. (TOP)

1. ***Credit Report.*** A new credit report must be obtained for each borrower whose loan is included in a Quality Control review, unless the loan was a streamline refinance or was processed using a FHA approved automated underwriting system exempted from this requirement. A credit report obtained for a Quality Control review may be a Residential Mortgage Credit Report, a three repository merged in-file report or, when appropriate, a business credit report. The report must comply with the credit report standards described in **HUD Handbook 4155.1** (as revised). A full Residential Mortgage Credit Report must be obtained from a different credit source on cases in

which the in-file report reveals discrepancies with the original credit report. (TOP)

2. ***Credit Document Re-verification.*** Documents contained in the loan file should be checked for sufficiency and subjected to written re-verification. Examples of items that must be re-verified include, but are not limited to, the mortgagor's employment or other income, deposits, gift letters, alternate credit sources, and other sources of funds. Sources of funds must be acceptable as well as verified. Other items that may be re-verified include mortgage or rent payments. If the written re-verification is not returned to the mortgagee, a documented attempt must be made to conduct a telephone re-verification. If the original information was obtained electronically or involved alternative documents, a written re-verification must still be attempted. Any discrepancies must be explored to ensure that the original documents (except blanket verification releases) were completed before being signed, were as represented, were not handled by interested third parties and that all corrections were proper and initialed. All conflicting information in the original documentation should have been resolved before the complete file was submitted to the underwriter.

3. ***Appraisals.*** A desk review of the property appraisal must be performed on all loans chosen for a Quality Control review except streamline refinances and HUD Real Estate Owned (REO) sales. The desk review must include a review of the appraisal data, the validity of the comparables, the value conclusion ("as repaired" to meet safety and soundness requirements in HUD Handbook 4905.1 (as revised)), any changes made by the underwriter and the overall quality of the appraisal. (TOP)

   Mortgagees are expected to perform field reviews on 10 % of the loans selected during the sampling process outlined previously in paragraph 7-6 C and D. Field reviews must be performed by licensed appraisers listed on FHA's Roster of Appraisers. Mortgagees should select loans for field reviews based on factors such as those listed previously in paragraph 7-6(C)(2) and the following:

   - Property complaints received from mortgagors;
   - Discrepancies found during desk reviews;
   - Large adjustments to value;
   - Comparable sales more than six months old;
   - Excessive distances from comparables to the subject property;
   - Repetitive sales activity for the subject property;
   - Investor-sold properties;
   - Identity of interest between buyer and seller;
   - Seller identity differs from owner of record; and

- Vacant properties.

In addition, a field review should be completed on loans selected in accordance with paragraphs 7-6(C) and (D) where the desk review revealed significant problems/deficiencies with the appraisal report. If serious deficiencies or patterns are uncovered, mortgagees must report these items, in writing, to the Quality Assurance Division in the HUD Homeownership Center having jurisdiction. (TOP)

4. ***Occupancy Reverification.*** In cases where the occupancy of the subject property is suspect, mortgagees must attempt to determine whether the mortgagor is occupying the property. The failure of the mortgagor to occupy the property may be an indication that the loan contains other problems. If it is found that the mortgagor is not occupying a property mortgaged as owner-occupied, mortgagees must report this, in writing, to the Quality Assurance Division in the HUD Homeownership Center having jurisdiction. It also would be advisable to review other similar loans for occupancy. (TOP)

F. ***Underwriting Decisions.*** Each Direct Endorsement loan selected for a quality control review must be reviewed for compliance with HUD underwriting requirements, sufficiency of documentation and the soundness of underwriting judgments. (TOP)

G. ***Condition Clearance and Closing.*** Each loan selected for a quality control review must be reviewed to determine whether:

- Conditions which were required to be satisfied prior to closing were in fact met prior to closing;
- The seller was the owner of record, or was exempt from the owner of record requirement in accordance with HUD regulations;
- The loan was closed and funds disbursed in accordance with the mortgagee's underwriting and subsequent closing instructions; and
- The closing and legal documents are accurate and complete.

7-7 Specific Elements for the Production Portion of the Quality Control Program. (TOP)

A mortgagee's Quality Control Program must provide for a review of mortgage loan files to evaluate the loan origination and underwriting functions. The Department has found that the items listed below are typically found in a good Quality Control Program. Minimally, the Quality Control Program must address these elements as well as any others that might be useful in the evaluation.

A. Determine whether the information in the preliminary loan application, final application and all credit documents is consistent or reconciled.

HUD Handbook 4155.1 Rev-5
Chapters 2, 3-1

CHAPTER 2

MORTGAGE CREDIT ANALYSIS

HISTORICAL REFERENCE ONLY

2-1 **OVERVIEW.** The purpose of underwriting is to determine a borrower's ability and willingness to repay the mortgage debt, thus limiting the probability of default and collection difficulties, and to examine the property offered as security for the loan to determine if it is sufficient collateral. The "Four C's of Credit" (Credit history, Capacity to repay, Cash to close, and the Collateral) are evaluated during the underwriting process.

This chapter on mortgage credit analysis describes procedures for evaluating the credit history, the borrower's capacity to make payments, and whether sufficient cash assets are available to close the mortgage. It provides the requirements on the types of income that may be considered in qualifying the borrower, the liabilities that must be included in the determining creditworthiness, and the debt-to-income ratios and compensating factors used in the underwriting process. These underwriting instructions are FHA's "base-line" credit policies. For those lenders using FHA-approved automated underwriting systems (AUS) or those employing FHA's TOTAL mortgage scorecard, there will be a considerable number of revisions to these policies, including documentation requirements, as described in other FHA issuances.

2-2 **MORTGAGE ELIGIBILITY (BORROWERS).** Generally, we will insure mortgages made to individuals only. Under the conditions described in Chapter 1, we will also insure mortgages made to state and local government agencies and approved nonprofit organizations.

A. **Borrowers, Co-Borrowers and Co-Signers.** Borrowers and Co-borrowers take title to the property and are obligated on the mortgage note and must also sign the security instrument. The co-borrower's income, assets, liabilities, and credit history are considered in determining creditworthiness.

Co-signers do not hold ownership interest in a property, but are liable for repaying the obligation and must sign all documents with the exception of the security instruments. The co-signer's income, assets, liabilities, and credit history are considered in determining creditworthiness for the mortgage and the co-signer must complete and sign the loan application.

We do not permit an individual to take an ownership interest in the property at settlement without signing the mortgage note and all security instruments.

The following conditions also apply to co-borrower and co-signer eligibility:

1. A co-borrower or a co-signer may not be a party that has a financial interest in the transaction, such as the seller, builder, real estate agent, etc. Exceptions may be granted if the seller and co-borrower/co-signer is related to the owner by blood, marriage or law.

2. An individual signing the loan application must not be otherwise ineligible for participation. (See paragraph 2-5).

3. Unless otherwise exempted (e.g., military service with overseas assignments, U.S. citizens living abroad), any non-occupying co-borrowers or co-signers must have a principal residence in the United States.

All references to co-borrowers – including the 75 percent LTV limits (paragraph 1-8(B)), etc. – apply equally to co-signers (except co-signers do not take title to the property or sign the security instruments).

B. **Citizenship and Immigration Status.** Citizenship of the United States is not required for eligibility. When a mortgage loan applicant indicates on the loan application that he or she holds something other than U.S. citizenship, the lender must determine residency status from the documentation provided by the borrower.

*Lawful Permanent Resident Alien*s: For those borrowers with *lawful permanent resident alien* status, FHA will insure the mortgage under the same terms and conditions as U.S. citizens. The lender must document the mortgage file with evidence of permanent residency and indicate on the Uniform Residential Loan Application (URLA) that the borrower is a lawful permanent resident alien. Evidence of lawful permanent residency is issued by the Bureau of Citizenship and Immigration Services (BCIS) (formerly the Immigration and Naturalization Service) within the Department of Homeland Security.

Non-Permanent Resident Aliens: FHA will also insure a mortgage made to a *non-permanent resident alien* provided that the property will be the borrower's principal residence, the borrower has a valid SSN, and the borrower is eligible to work in the U.S. as evidenced by an Employment Authorization Document (EAD) issued by BCIS. If the authorization for temporary residency status will expire within one year and a prior history of residency status renewals exists, the lender may assume continuation will be granted. If there are no prior renewals, the lender must determine the likelihood of renewal, based on information from the BCIS.

Although social security cards may indicate work status, such as "not valid for work purposes," an individual's work status may change without the

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change being reflected on the actual social security card. Therefore, the social security card is not to be used as evidence of work status for non-permanent resident aliens; the BCIS employment authorization document is to be used instead.

Non-U.S. Citizens with no lawful residency in the U.S. are not eligible for FHA-insured mortgages.

C. **Borrower's Age.** There is no *maximum* age limit for a borrower. The minimum age is the age at which the mortgage note can be enforced legally in the state or other jurisdiction in which the property is located.

D. **Non-Purchasing Spouses.** If required by state law in order to perfect a valid and enforceable first lien, the non-purchasing spouse may be required to sign either the security instrument or documentation evidencing that he or she is relinquishing all rights to the property. If the non-purchasing spouse executes the security instrument for such reasons, he or she is not considered a borrower for our purposes and need not sign the loan application. In all other cases, the non-purchasing spouse is not to appear on the security instrument or otherwise take title to the property at loan settlement.

Where there are non-purchasing spouses who sign security instruments relinquishing their rights to the property pursuant to applicable state laws, these non-purchasing spouses do not have to sign the mortgage note. Signing the security instrument for such purposes does not make the non-purchasing spouse a co-borrower.

Except for the obligations specifically excluded by state law, the debts of the non-purchasing spouse must be included in the borrower's qualifying ratios if the borrower resides in a community property state or the property to be insured is located in a community property state. Although the non-purchasing spouse's credit history is not to be considered a reason for credit denial, a credit report that complies with the requirements of paragraph 2-4 must be obtained for the non-purchasing spouse in order to determine the debt-to-income ratio.

E. **Military Personnel.** Military personnel are considered occupant-owners and are eligible for maximum financing if a member of the immediate family will occupy the property as a principal residence, even if the service person is stationed elsewhere.

F. **Living Trusts.** Property held in a *living trust* is eligible for FHA mortgage insurance for owner-occupied property, as long as an individual borrower remains the beneficiary and occupies the property as a principal residence. The lender must be satisfied that the trust provides reasonable

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means to assure that the lender will be notified of any subsequent change of occupancy (for owner-occupant loans only) or transfer of beneficial interest. The trust must appear on the security instrument (i.e., mortgage, deed of trust, security deed). The individual borrower must appear on the security instrument when required to create a valid lien under state law; otherwise, the individual borrower is not required to appear. The owner-occupant, if any, and other borrower(s), if any, must appear on the note with the trust. The individual borrower(s) is not required to appear on the property deed or title.

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SECTION 1: CREDIT HISTORY

2-3 **ANALYZING THE BORROWER'S CREDIT.** Past credit performance serves as the most useful guide in determining a borrower's attitude toward credit obligations and predicting a borrower's future actions. A borrower who has made payments on previous and current obligations in a timely manner represents reduced risk. Conversely, if the credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, strong compensating factors will be necessary to approve the loan.

When analyzing a borrower's credit history, examine the overall pattern of credit behavior, rather than isolated occurrences of unsatisfactory or slow payments. A period of financial difficulty in the past does not necessarily make the risk unacceptable if the borrower has maintained a good payment record for a considerable time period since the difficulty. When delinquent accounts are revealed, the lender must document their analysis as to whether the late payments were based on a disregard for financial obligations, an inability to manage debt, or factors beyond the control of the borrower, including delayed mail delivery or disputes with creditors.

While *minor* derogatory information occurring two or more years in the past does not require explanation, *major* indications of derogatory credit–including judgments, collections, and any other recent credit problems–require sufficient written explanation from the borrower. The borrower's explanation must make sense and be consistent with other credit information in the file.

Neither the lack of credit history nor the borrower's decision not to use credit may be used as a basis for rejecting the loan application. We also recognize that some prospective borrowers may not have an established credit history. For those borrowers, and for those who do not use traditional credit, the lender must develop a credit history from utility payment records, rental payments, automobile insurance payments, or other means of direct access from the credit provider. The lender must document that the providers of non-traditional credit do, in fact, exist and verify the credit information. Documents confirming the existence of a non-traditional credit provider may include a public record from the state, county, or city records, or other means providing a similar level of objective confirmation. To verify the credit information, lenders must use a published address or telephone number for that creditor.

As an alternative, the lender may elect to use a non-traditional mortgage credit report developed by a credit-reporting agency, provided that the credit reporting agency has verified the existence of the credit providers and the lender verifies that the non-traditional credit was extended to the applicant. The lender must verify the credit using a published address or telephone number to make that verification.

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The basic hierarchy of credit evaluation is the manner of payments made on previous housing expenses, including utilities, followed by the payment history of installment debts, and then revolving accounts. Generally, an individual with no late housing or installment debt payments should be considered as having an acceptable credit history, unless there is major derogatory credit on his or her revolving accounts.

When reviewing the borrower's credit and credit report, the lender must pay particular attention to the following:

A. **Previous Rental or Mortgage Payment History.** The payment history of the borrower's housing obligations holds significant importance in evaluating credit. The lender must determine the borrower's payment history of housing obligations through either the credit report, verification of rent directly from the landlord (with no identity-of-interest with the borrower) or verification of mortgage directly from the mortgage servicer, or through canceled checks covering the most recent 12-month period.

B. **Recent and/or Undisclosed Debts.** The lender must ascertain the purpose of any recent debts, as the indebtedness may have been incurred to obtain part of the required cash investment on the property being purchased. Similarly, the borrower must provide a satisfactory explanation for any significant debt that is shown on the credit report but not listed on the loan application. The borrower must explain in writing all inquiries shown on the credit report in the last 90 days.

C. **Collections and Judgments.** Court-ordered judgments must be paid off before the mortgage loan is eligible for FHA insurance endorsement. (An exception may be made if the borrower has agreed with the creditor to make regular and timely payments on the judgment and documentation is provided that the payments have been made in accordance with the agreement.) FHA does not require that collection accounts be paid off as a condition of mortgage approval. Collections and judgments indicate a borrower’s regard for credit obligations and must be considered in the analysis of creditworthiness with the lender documenting its reasons for approving a mortgage where the borrower has collection accounts or judgments. The borrower must explain in writing all collections and judgments.

D. **Previous Mortgage Foreclosure.** A borrower whose previous principal residence or other real property was foreclosed or has given a deed-in-lieu of foreclosure within the previous three years is generally not eligible for a new FHA-insured mortgage. However, if the foreclosure was the result of documented extenuating circumstances that were beyond the control of the borrower and the borrower has re-established good credit since the foreclosure, the lender may grant an exception to the three-year

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requirement. Extenuating circumstances include serious illness or death of a wage earner, but do not include the inability to sell the house because of a job transfer or relocation to another area.

E. **Bankruptcy.** A Chapter 7 bankruptcy (liquidation) does not disqualify a borrower from obtaining an FHA-insured mortgage if at least two years have elapsed since the date of the discharge of the bankruptcy. Additionally, the borrower must have re-established good credit or chosen not to incur new credit obligations. The borrower also must have demonstrated a documented ability to responsibly manage his or her financial affairs. An elapsed period of less than two years, but not less than 12 months, may be acceptable if the borrower can show that the bankruptcy was caused by extenuating circumstances beyond his or her control and has since exhibited a documented ability to manage his or her financial affairs in a responsible manner. Additionally, the lender must document that the borrower's current situation indicates that the events that led to the bankruptcy are not likely to recur.

A Chapter 13 bankruptcy does not disqualify a borrower from obtaining an FHA-insured mortgage provided the lender documents that one year of the payout period under the bankruptcy has elapsed and the borrower's payment performance has been satisfactory (i.e., all required payments made on time). In addition, the borrower must receive permission from the court to enter into the mortgage transaction.

F. **Consumer Credit Counseling Payment Plans.** Participation in a consumer credit counseling payment program does not disqualify a borrower from obtaining an FHA-insured mortgage provided the lender documents that one year of the pay-out period has elapsed under the plan and the borrower's payment performance has been satisfactory (i.e., all required payments made on time). In addition, the borrower must receive written permission from the counseling agency to enter into the mortgage transaction.

2-4 CREDIT REPORT REQUIREMENTS.

A. **Traditional Credit Reports.** Credit reports submitted with each loan must contain all credit available in the accessed repositories. They also must provide an account of all credit, residence history, and public records information available in the credit repositories of each borrower responsible for the mortgage debt. The minimum credit report required by FHA is a "three repository merged" credit report (TRMCR). A Residential Mortgage Credit Report (RMCR) from an independent consumer-reporting agency also may be used. One report is required for each borrower, or a joint report may be obtained for a married couple.

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The following are requirements for traditional credit reports:

1. The TRMCR submitted must be an original received electronically and printed on the lender's printer or delivered by the credit-reporting agency. The report must not have whiteouts, erasures, or alterations. It must indicate the name, address, and telephone number of the consumer-reporting agency; and each account listed must show the primary repository from which the particular information was pulled. The name of the company ordering the report must be shown.

2. The credit report must include all credit and legal information not considered obsolete under the Fair Credit Reporting Act, including bankruptcies, judgments, law suits, foreclosures, and tax liens that have occurred within the last seven years. All inquiries made within the last 90 days must also be included on the report. Credit reports that fail to show bankruptcies, judgments, lawsuits, foreclosures and tax liens must be supplemented with a corrected report. Lenders must retain all copies of all credit reports and document in writing an analysis of the reasons for any discrepancies between the credit reports. If a lender receives any information inconsistent with the information on the credit report, the lender must reconcile the inconsistency.

3. The credit report must identify each borrower's name and social security number. For each debt listed, the report also must show the date the account was opened, the high credit amount, the required payment, the unpaid balance, and the payment history, as contained in the credit repositories. The report must be in an easy-to-read and understandable format, and it should not require code translations.

4. The lender must also develop credit information separately for any open debt that is listed on the loan application but not referenced on the credit report. Accounts listed as "rate by mail only" or "need written authorization" require separate written verification.

5. While the TRMCR should prove sufficient for processing most loan applications, the following circumstances require an RMCR:

   a. The borrower(s) disputes the ownership of accounts on the TRMCR; or
   b. The borrower(s) claims that collections, judgments, or liens listed as open on the TRMCR have been paid and cannot provide separate documentation supporting this claim; or

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c. The borrower claims that certain debts shown on the TRMCR have different balances and/or payments and cannot provide current statements (less than 30 days old) attesting to this claim; or

d. The lender's underwriter determines that it would be prudent to use an RMCR in lieu of a TRMCR to underwrite the loan properly.

6. RMCRs must access at least two named repositories and meet all the requirements for the TRMCR, plus the following:

a. Provide a detailed account of the borrower's employment history.

b. Verify each borrower's current employment and income (if obtainable). It also must include a statement attesting to certification of employment and date verified. If this information is not obtained through an interview with the employer, the credit reporting agency must state why this action was not taken.

c. Each account with a balance must have been checked with the creditor within 90 days of the credit report.

B. <u>Credit Report Requirements (Non-Traditional).</u> A Non-Traditional Mortgage Credit Report (NTMCR) is designed to assess the credit history of a borrower without the types of trade references normally appearing on a traditional credit report. It can be used either as a substitute for a TRMCR or an RMCR for a borrower without a credit history with traditional credit grantors or as a supplement to a traditional credit report having an insufficient number of trade items reported. A NTMCR may not, however, be used to enhance the credit history of a borrower with a poor payment record or to manufacture a credit report for a borrower without a verifiable credit history. It also may not be used to offset derogatory references found in the borrower's traditional credit, such as collections and judgments.

The following conditions apply when using non-traditional credit reporting:

1. If the information obtained through the standard credit report is not sufficient for the lender to make a prudent underwriting decision, the lenders may use a NTMCR developed by a credit-reporting agency that documents all non-traditional credit references. Otherwise, the lender must develop its own non-traditional credit history that is consistent with the requirements for credit reporting agencies described in paragraph 2-4.

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2. The credit-reporting agency should consider only the types of credit that require the mortgage applicant to make periodic payments on a regular basis. These types of credit include rental housing; utilities (if not included in the rental payment); telephone service; cable television service; insurance payments (excluding those paid through payroll deductions), such as medical, automobile, life, household, and renter's insurance; payments to child care providers; school tuition; payments to local stores; payments for the uninsured portion of any medical bills; etc.

2-5 ELIGIBILITY FOR FEDERALLY-RELATED CREDIT. A borrower must be rejected if any of the following conditions apply:

A. HUD Limited Denial of Participation (LDP) and the U.S. General Services Administration's "List of Parties Excluded from Federal Procurement and Non-Procurement Programs" (GSA List) A person suspended, debarred, or otherwise excluded from participation in the Department's programs is not eligible to participate in FHA-insured mortgage transactions. The lender must examine HUD's LDP list and the government-wide General Services Administration's (GSA) "List of Parties Excluded from Federal Procurement or Nonprocurement Programs" and document this review on the HUD 92900-WS/92900-PUR. If the name of the borrower, seller, listing or selling real estate agents, or loan officer appears on either list, the application is not eligible for mortgage insurance. A lender may check HUD's LDP list by going to www.hud.gov and the Federal government's list of excluded parties by going to http://epls.arnet.gov. (An exception shall be made for a seller on the GSA list when the property being sold is the seller's principal residence.)

B. Delinquent Federal Debts. If the borrower, as revealed by public records, credit information, or HUD's Credit Alert Interactive Voice Response System (CAIVRS), is presently delinquent on any Federal debt (e.g., VA-guaranteed mortgage, Title I loan, Federal student loan, Small Business Administration loan, delinquent Federal taxes) or has a lien, including taxes, placed against his or her property for a debt owed to the U.S., the borrower is *not* eligible until the delinquent account is brought current, paid, otherwise satisfied, or a satisfactory repayment plan is made between the borrower and the Federal agency owed and is verified in writing. Tax liens may remain unpaid provided the lien holder subordinates the tax lien to the FHA-insured mortgage. If any regular payments are to be made, they must be included in the qualifying ratios.

Since the IRS routinely takes a second lien position without the necessity of independent documentation, eligibility for FHA mortgage insurance will not be jeopardized by outstanding IRS tax liens remaining on the

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property unless the lender has information that the IRS has demanded a first-lien position.

Although eligibility for an FHA-insured mortgage may be established by performing the actions described above, the overall analysis of the creditworthiness must include consideration of a borrower's previous failure to make payments to the Federal agency in the agreed-to manner and must document its analysis of how the previous failure does not represent a risk of mortgage default.

C. **CAIVRS.** HUD's CAIVRS is a Federal government-wide repository of information on those individuals with delinquent or defaulted Federal debt and on those for whom a payment of an insurance claim has occurred. Lenders must screen all borrowers, including nonprofit agencies acting as a borrower, using CAIVRS (except on streamline refinances). If CAIVRS indicates the borrower is presently delinquent or has had a claim paid within the previous three years on a loan made or insured by HUD on his or her behalf, the borrower is not eligible except as described below. Lenders access CAIVRS either through the FHA Connection or functional equivalent or by calling 301-344-4000 on a touch-tone telephone. Lenders must write the CAIVRS authorization code for each borrower on the HUD-92900-WS/92900-PUR. Exceptions to this rule may be granted under the following situations:

1. **Assumptions.** If the borrower sold the property, with or without a release of liability, to an individual who subsequently defaulted, the borrower is eligible, provided he or she can prove the loan was not in default at the time of assumption.

2. **Divorce.** A borrower may be eligible if the divorce decree or legal separation agreement awarded the property and responsibility for payment to the former spouse. However, if a claim was paid on a mortgage in default prior to the divorce, the borrower is not eligible.

3. **Bankruptcy.** When the property was included in a bankruptcy that was caused by circumstances beyond the borrower's control (such as the death of the principal wage earner or serious long-term uninsured illness), the borrower may be eligible if the borrower meets the requirements in Paragraph 2-3 E.

While FHA may delete erroneous information regarding a borrower falsely indicated as having defaulted on a FHA mortgage, such as incorrect social security number reporting, it will not remove correct CAIVRS information even if the borrower is judged eligible under the conditions described above.

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Lenders may not rely upon a clear CAIVRS approval when in possession of independent evidence of delinquent federal obligations and must document the resolution of any conflicting information. If the lender has reason to believe the CAIVRS message is erroneous or needs to establish the date of claim payment, the lender must contact the appropriate HOC for instructions or documentation to support the borrower's eligibility. The appropriate HOC can provide information when the three-year waiting period will elapse or if the social security number in CAIVRS is erroneous. The HOC will also provide instructions to lenders regarding processing requirements for other HUD-related defaults and claims (e.g., Title I loans).

We cannot alter or delete CAIVRS information reported from other Federal agencies, such as the Department of Education, Veterans Affairs, etc. The borrower and/or the lender must contact those agencies to correct or remove erroneous or outdated information. We do not require a "clear" CAIVRS authorization number as a condition for mortgage endorsement, but the lender must document and justify its approval based on the exceptions described above.

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SECTION 2: EFFECTIVE INCOME

The anticipated amount of income, and the likelihood of its continuance, must be established to determine a borrower's *capacity* to repay mortgage debt. Income may not be used in calculating the borrower's income ratios if it comes from any source that cannot be verified, is not stable, or will not continue. This section describes acceptable types of income, procedures for calculating effective income, and requirements for establishing income stability.

2-6 STABILITY OF INCOME. We do not impose a minimum length of time a borrower must have held a position of employment to be eligible. However, the lender must verify the borrower's employment for the most recent two full years. If a borrower indicates he or she was in school or in the military during any of this time, the borrower must provide evidence supporting this claim, such as college transcripts or discharge papers. The borrower also must explain any gaps in employment spanning one month or more. Allowances for seasonal employment, such as is typical in the building trades, etc., may be made if documented by the lender.

To analyze and document the probability of continued employment, lenders must examine the borrower's past employment record, qualifications for the position, previous training and education, and the employer's confirmation of continued employment. A borrower who changes jobs frequently within the same line of work, but continues to advance in income or benefits, should be considered favorably. In this analysis, *income* stability takes precedence over *job* stability.

In some cases, a borrower may have recently returned to the work force after an extended absence. In these circumstances, the borrower's income may be considered effective and stable provided the following conditions apply:

A. The borrower has been employed in the current job for six months or more, and

B. The borrower can document a two-year work history prior to the absence from the work force. Acceptable documentation includes traditional employment verifications, copies of W-2's or paystubs.

An example of an acceptable employment situation includes a person that took several years off of work to raise children and then returned to the workforce. Situations not meeting the criteria listed above may be considered as compensating factors only.

2-7 SALARIES, WAGES, AND OTHER FORMS OF EFFECTIVE INCOME. The income of each borrower to be obligated for the mortgage debt must be analyzed to determine whether it can reasonably be expected to continue through at least the *first three years* of the mortgage loan. If the borrower intends to retire

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during this period, the effective income must be the amount of documented retirement benefits, social security payments, or other payments expected to be received in retirement. No inquiry may be made regarding possible future maternity leave.

In most cases, the borrower's income will be limited to salaries or wages. Income from other sources can be included as effective income with proper verification by the lender. Procedures for analyzing other acceptable income sources besides salaries and wages are described below:

A. **Overtime and Bonus Income.** Both overtime and bonus income may be used to qualify if the borrower has received such income for the past two years and it is likely to continue. The lender must develop an average of bonus or overtime income for the past two years, and the employment verification must not state that such income is unlikely to continue. Periods of less than two years may be acceptable provided the lender justifies and documents in writing the reason for using the income for qualifying purposes.

An earnings trend also must be established and documented for overtime and bonus income. If either type shows a continual decline, the lender must provide a sound rationalization in writing for including the income for borrower qualifying. If bonus income varies significantly from year to year, a period of more than two years must be used in calculating the average income.

B. **Part-Time Income.** Part-time/second job income, including employment in seasonal work, may be used in qualifying if the lender documents that the borrower has worked the part-time job uninterrupted for the past two years and will continue to do so. Seasonal employment (e.g., umpiring baseball games in summer, working at a department store during the holiday shopping season) is considered uninterrupted and may be used in qualifying if the lender documents that the borrower has worked the same type of job for the past two years and expects to be rehired during the next season. Income from a part-time position that has been received for less than two years may be included as effective income, provided the lender justifies and documents that the income's continuance is likely. Income from part-time positions not meeting these requirements may be considered as a compensating factor only.

For qualification purposes, *part-time income refers to jobs taken to supplement the borrower's income from regular employment* (i.e., a second job – not meaning primary jobs of less than 40 hours per week.) If a borrower's regular employment involves less than a typical 40-hour workweek, the stability of that income should be evaluated as any other regular, on-going primary employment. For example, a registered nurse

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may have worked 24 hours per week for the last year. Although this job requires less than 40 hours of work per week, it is the borrower's primary employment and is to be considered effective income.

We recognize that many low- and moderate-income families rely on part-time and seasonal income for day-to-day needs. Lenders must not restrict the consideration of such income sources in qualifying these borrowers.

C. **Military Income.** In addition to base pay, military personnel may be entitled to additional forms of pay. Income from variable housing allowances, clothing allowances, flight or hazard pay, rations, and proficiency pay is acceptable, provided its probability of continuance is verified in writing. An additional consideration may be the tax-exempt nature of some of these payments (see paragraph Q for additional information.)

D. **Commission Income.** Commission income must be averaged over the previous two years. The borrower must provide copies of signed tax returns for the last two years, along with the most recent pay stub. (Unreimbursed business expenses must be subtracted from gross income.) Individuals whose commission income shows a decrease from one year to the next require significant compensating factors to allow for loan approval. Borrowers with commission income received for more than one but less than two years may be considered favorably provided the underwriter is able to make a sound rationalization for acceptance and can document the likelihood of continuance.

Commissions earned for less than one year are not considered effective income. Exceptions may be made for situations in which the borrower's compensation was changed from a salary to commission within a similar position with the same employer. A borrower also may qualify when the portion of earnings *not* attributed to commissions would be sufficient to qualify the borrower for the mortgage.

E. **Retirement and Social Security Income.** Retirement and social security income require verification from the source (former employer, Social Security Administration) or federal tax returns. If any benefits expire within the first full three years, the income source may be considered only as a compensating factor.

F. **Alimony, Child Support, or Maintenance Income.** Income in this category may be considered as effective if such payments are likely to be consistently received for the first three years of the mortgage. The borrower must provide a copy of the final divorce decree, legal separation agreement, or voluntary payment agreement, *as well as* evidence that payments have been received during the last twelve months. Acceptable

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evidence of payment regularity includes cancelled checks, deposit slips, tax returns, and court records. Periods less than twelve months may be acceptable, provided the payer's ability and willingness to make timely payments is adequately documented by the lender.

G. **Notes Receivable.** A copy of the note must be presented to establish the amount and length of payment. The borrower also must provide evidence that these payments have been received consistently for the last twelve months, which may include deposit slips, cancelled checks, or tax returns. If the borrower is not the original payee on the note, the lender must also establish that the borrower is now a holder in due course and able to enforce the note.

H. **Interest and Dividends.** Interest and dividend income may be used, provided that documentation (tax returns or account statements) supports a two-year history of receipt. This income must be averaged over the two years. Any funds derived from these sources and required for the cash investment must be subtracted before the projected interest or dividend income is calculated.

I. **Mortgage Credit Certificates.** If a government entity subsidizes the mortgage payments, either through direct payments or through tax rebates, these payments can be considered as acceptable income if verified in writing. Either type of subsidy may be added to gross income or may be used to directly offset the mortgage payment before calculating the qualifying ratios.

J. **Employer Differential Payments.** If the employer subsidizes the mortgage payments through direct payments, the amount of the payments is considered gross income; it may not be used to offset the mortgage payment directly, even if the employer pays the servicing lender directly.

K. **VA Benefits.** Direct compensation, such as for a service-related disability, is acceptable, subject to documentation from the VA. Education benefits, used to offset education expenses, are not acceptable.

L. **Government Assistance Programs.** Income received from government assistance programs is acceptable, subject to documentation from the paying agency, provided the income is expected to continue at least three years. If the income is not expected to be received for at least three years, such income may be considered as a compensating factor. (Unemployment income must be documented for two years. Reasonable assurance of its continuance is also required. This requirement may apply to individuals employed on a seasonal basis, such as farm workers, resort employees, etc.)

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M. **Rental Income.** Rent received for properties owned by the borrower is acceptable if the lender can document that the rental income is stable. Examples of stability may include a current lease, an agreement to lease, or a rental history over the previous 24 months that is free of unexplained gaps greater than three months. (Student, seasonal, or military renters, or property rehabilitation would provide such an explanation). A separate schedule of real estate is not required for rental properties, provided all properties are shown on the URLA.

If the borrower resides in one or more units of a multiple-unit property and charges rent to tenants of other units, that rent may be used for qualifying purposes. However, projected rent of additional units only and not the owner-occupied unit(s) may be considered gross income only after deducting the HOC's vacancy and maintenance factor. They may not be used as a direct offset to the mortgage payments.

Income from roommates in a single-family property to be occupied as the borrower's primary residence is not acceptable. Rental income from boarders is acceptable if the boarders are related by blood, marriage, or law. The rental income may be considered effective income if shown on the borrower's tax returns. Otherwise, the income only may be considered a compensating factor and must be documented adequately by the lender.

The following is required to verify all rental income:

1. **Schedule E of IRS Form 1040.** Depreciation may be added back to the net income or loss shown on Schedule E. Positive rental income is considered gross income for qualifying purposes; negative rental income must be treated as a recurring liability. The lender must be certain that the borrower still owns each property listed, by comparing the Schedule E with the real estate owned section of the residential loan application. (If the borrower in the same general area owns six or more units, a map disclosing the locations must be submitted evidencing compliance with FHA's seven-unit limitation. See paragraph 4-8 for additional information.)

2. **Current Leases.** If a property was acquired since the last income tax filing and is not shown on Schedule E, a current signed lease or other rental agreement must be provided. The gross rental amount must be reduced for vacancies and maintenance by 25 percent (or the percentage developed by the jurisdictional HOC), before subtracting PITI and any homeowners' association dues, etc., and applying the remainder to income (or recurring debts, if negative).

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N. **Eligible Investment Properties.** If the property to be insured is an eligible investment property or sold through FHA's REO program, the following calculations of qualifying ratios apply:

1. Subtract the monthly payment (PITI) from the monthly net rental income of the subject property (gross rents, minus the 25 percent reduction or HOC's percentage reduction for vacancies and repairs). If this calculation yields a positive number, add the number to the borrower's monthly gross income. If the calculation results in a negative number, consider it a recurring monthly obligation; then
2. Calculate the mortgage payment-to-income ratio (top or front-end ratio) by dividing the borrower's current housing expense (principal residence) by the monthly gross income. (The monthly gross income will include any positive cash flow from the subject investment property.); and
3. Calculate the total fixed payment-to-income ratio (bottom or back-end ratio) by dividing the borrower's total monthly obligations, including any net loss from the subject investment property, by the borrower's total monthly gross income.

O. **Automobile Allowances and Expense Account Payments.** Only the amount by which the borrower's automobile allowance or expense account payments exceed actual expenditures may be considered income. The borrower must provide IRS Form 2106, Employee Business Expenses, for the previous two years to establish the amount of income that may be added to gross income. The borrower also must provide verification from the employer that these payments will continue. (If these calculations show a loss, that amount must be treated as a recurring debt. If the borrower uses the standard per-mile rate in calculating automobile expenses, as opposed to the actual cost method, the portion that the IRS considers depreciation may be added back to income.) Additionally, the borrower's monthly car payment must be treated as a recurring debt; it may not be offset by the car allowance.

P. **Trust Income.** Income from trusts may be used if guaranteed, constant payments will continue for at least the first three years of the mortgage term. Documentation is required and includes a copy of the Trust Agreement, or other trustee's statement, confirming amount, frequency of distribution, and duration of payments. Funds from the trust account also may be used for the required cash investment with adequate documentation.

Q. **Non-Taxable Income.** If a particular source of regular income is not subject to federal taxes (e.g., certain types of disability and public assistance payments, military allowances), the amount of continuing tax

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savings attributable to the non-taxable income source may be added to the borrower's gross income. The percentage of income that may be added may not exceed the appropriate tax rate for that income amount, and no additional allowances for dependents are acceptable. The lender must document and support the adjustments (the amount the income is "grossed up") made for any non-taxable income source. Child support income cannot be grossed up. The lender should use the tax rate used to calculate last year's income tax for the borrower. If the borrower is not required to file a federal income tax return, the tax rate to use is 25 percent.

R. **Projected Income.** Projected or hypothetical income is not acceptable for qualifying purposes. However, exceptions are permitted to this rule for income from cost-of-living adjustments, performance raises, bonuses, etc., which are both verified by the employer in writing and scheduled to begin within 60 days of loan closing.

If a borrower is about to start a new job and has a guaranteed, non-revocable contract for employment that will begin within 60 days of loan closing, the income is acceptable for qualifying purposes. The lender also *must* verify that the borrower will have sufficient income or cash reserves to support the mortgage payments and any other obligations during the interim between loan closing and the start of employment. (This condition may be appropriate for situations such as teachers whose contracts will begin with the new school year, or physicians who will begin residency after the loan is scheduled to close.) However, if the loan will close more than 60 days before the borrower’s employment begins, the loan is *not eligible for endorsement* until the lender provides a pay stub or other acceptable evidence that the borrower has begun the new job.

2-8 **EMPLOYMENT BY FAMILY-OWNED BUSINESSES.** Borrowers employed at businesses owned by their family member(s) are required to provide additional income documentation. These borrowers must provide the normal verification of employment, pay stubs, and evidence that they are not an owner of the business. This evidence may include copies of the borrower's signed personal tax returns or a signed copy of the corporate tax return showing ownership percentages.

2-9 **SELF-EMPLOYED BORROWERS.** A borrower with a 25 percent or greater ownership interest in a business is considered self-employed for FHA mortgage loan underwriting purposes.

The following conditions apply to underwriting self-employed borrowers:

A. **Minimum Length of Self-Employment.** Income from self-employment is considered stable and effective if the borrower has been self-employed for two or more years. The high probability of failure during the first few

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years of a business makes the following requirements necessary for individuals who have been self-employed less than two years:

1. **Between One and Two Years.** An individual self-employed between one and two years must have at least two years of documented previous successful employment (or a combination of one year of employment and formal education or training) in the line of work in which the borrower is self-employed or in a related occupation to be eligible.

2. **Less than One Year.** The income from a borrower self-employed less than one year may not be considered effective income.

B. **Documentation Requirements.** The following documents are required from self-employed borrowers:

1. Signed and dated individual tax returns, plus all applicable schedules, for the most recent two years.

2. Signed copies of federal business income tax returns for the last two years, with all applicable schedules, if the business is a corporation, an "S" corporation, or a partnership.

3. A year-to-date profit-and-loss (P&L) statement and balance sheet.

4. A business credit report on corporations and "S" corporations.

C. **Analyzing Income.** The lender must establish the borrower's earnings trend over the previous two years but may average the income over three years, if all three years' tax returns are provided. If the borrower provides quarterly tax returns, the analysis can include income through the period covered by the tax filings. If the borrower is not subject to quarterly tax filings or does not file quarterly returns (Form IRS 1040 ES), the income shown on the P&L statement may be included in the analysis, *provided the income stream based on the P&L statement is consistent with the previous years' earnings*. If the P&L statements submitted for the current year show an income stream considerably greater than what is supported by the previous years' tax returns, the analysis of income must be predicated solely on the income verified through the tax returns.

To determine if the business can be expected to continue to generate sufficient income for the borrower's needs, lenders must analyze carefully the business's financial strength, the source of its income, and the general economic outlook for similar businesses in the area. Annual earnings that are stable or increasing are acceptable. Conversely, a borrower whose

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business shows a significant decline in income over the period analyzed is not acceptable, even if current income and debt ratios meet our guidelines.

There are four basic types of business structures: sole proprietorships, corporations; limited liability ("S" corporations); and partnerships. Each type requires slightly different forms of analysis.

The following provides additional information on analyzing tax returns:

1. **Individual Tax Returns (IRS Form 1040).** The amount shown on the IRS Form 1040 as "adjusted gross income" either must be increased or decreased, based on the lender's analysis of the individual tax returns and any related tax schedules. Particular attention must be paid to the following:

   a. Wages, Salaries, and Tips. An amount shown under this heading may indicate that the individual is a salaried employee of a corporation or has other sources of income. It also may indicate that the spouse is employed, in which case the income must be subtracted from the adjusted gross income in the analysis.

   b. Business Income or Loss (from Schedule C). The sole proprietorship income calculated on Schedule C is business income. Depreciation or depletion may be added back to adjusted gross income.

   c. Rents, Royalties, Partnerships, Etc. (from Schedule E). Any income received from rental properties or royalties may be used as income after adding back any depreciation shown on Schedule E.

   d. Capital Gain or Loss (from Schedule D). This transaction generally occurs only one time, and it should not be considered in determining effective income. However, if the business has a constant turnover of assets resulting in gains or losses, the capital gain or loss may be considered in determining the income, provided the borrower has at least three years' tax returns evidencing capital gains. An example includes an individual who purchases old houses, remodels them, and sells them for a profit.

   e. Interest and Dividend Income (from Schedule B). This income, which is taxable and tax-exempt, may be added back to the adjusted gross income only if it has been received for the past two years and is expected to continue.

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(If the interest-bearing asset will be liquidated as a source of the cash investment, the lender must adjust accordingly.)

f. Farm Income or Loss (from Schedule F). Any depreciation shown on Schedule F may be added back to the adjusted gross income.

g. IRA Distributions, Pensions, Annuities, and Social Security Benefits. The non-taxable portion of these items may be added back to the adjusted gross income, if the income is expected to continue for the first three years of the mortgage.

h. Adjustments to Income. Certain adjustments to income shown on the IRS Form 1040 may be added back to the adjusted gross income. Among these adjustments are IRA and Keogh retirement deductions, penalties on early withdrawal of savings, health insurance deductions, and alimony payments.

i. Employee Business Expenses. These expenses are actual cash expenses that must be deducted from the borrower's adjusted gross income.

2. **Corporate Tax Returns (IRS Form 1120).** Corporations are state-chartered businesses owned by their stockholders. Compensation to its officers, generally in proportion to the percentage of ownership, is shown on the corporate tax returns and will appear on individual tax returns. If the borrower's percentage of ownership is not shown, it must be obtained separately from the corporation's accountant, with evidence that the borrower has the right to those funds. Once the adjusted business income is determined, it should be multiplied by the borrower's percentage of ownership in the business.

In analyzing the corporate tax returns, lenders must adjust for the following:

a. Depreciation and Depletion. The corporation's depreciation and depletion must be added back to after-tax income.

b. Taxable Income. Taxable income is the corporation's net income before federal taxes. It must be reduced by the tax liability.

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c. Fiscal Year vs. Calendar Year. If the corporation operates on a fiscal year that is different from the calendar year, an adjustment must be made by the lender to relate corporate income to the individual tax return.

d. Cash Withdrawals. The borrower's withdrawal of cash from the corporation may have a severe negative impact on the corporation's ability to continue operating.

3. **"S" Corporation Tax Returns.** An "S" corporation is generally a small, start-up business, with gains and losses passed on to stockholders in proportion to each stockholder's percentage of business ownership. The income for the owners comes from W-2 wages and is taxed at the individual rate.

The "compensation of officers" line on the IRS Form 1120S is transferred to the borrower's IRS Form 1040. Both depreciation and depletion may be added back to income in proportion to the borrower's share of income. However, income also must be deducted proportionately by the total obligations payable by the corporation in less than one year. The borrower's withdrawal of cash from the corporation may have a severe negative impact on the corporation's ability to continue operating and must be considered in the analysis.

4. **Partnership Tax Returns.** A partnership is formed when two or more individuals form a business and share in profits, losses, and responsibility for running the company. Each partner pays taxes on his or her proportionate share of the partnership's net income.

Both general and limited partnerships report income on the IRS Form 1065; this form must be reviewed by the lender to assess the viability of the business. The partner's share of income is carried over to Schedule E of IRS Form 1040. Both depreciation and depletion may be added back to income in proportion to the borrower's share of income. However, income also must be deducted proportionately by the total obligations payable by the partnership in less than one year. The borrower's withdrawal of cash from the partnership may have a severe negative impact on the partnership's ability to continue operating and must be considered in the analysis.

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SECTION 3: BORROWER'S CASH INVESTMENT IN THE PROPERTY

2-10 FUNDS TO CLOSE. The cash investment in the property must equal the difference between the amount of the insured mortgage, excluding any upfront MIP, and the total cost to acquire the property including prepaid expenses and closing costs as described in paragraph 1-9.

All funds for the borrower's investment in the property must be verified and documented. Acceptable sources of these funds include the following:

A. **Earnest Money Deposit.** If the amount of the earnest money deposit exceeds 2 percent of the sales price *or* appears excessive based on the borrower's history of accumulating savings, the lender must verify with documentation the deposit amount and the source of funds. Satisfactory documentation includes a copy of the borrower's cancelled check. A certification from the deposit-holder acknowledging receipt of funds and separate evidence of the source of funds is also acceptable. Evidence of source of funds includes a verification of deposit or bank statement showing that at the time the deposit was made the average balance was sufficient to cover the amount of the earnest money deposit.

B. **Savings and Checking Accounts.** A verification of deposit (VOD), along with the most recent bank statement, may be used to verify savings and checking accounts. If there is a large increase in an account, or the account was opened recently, the lender must obtain a credible explanation of the source of those funds.

C. **Gift Funds.** An outright gift of the cash investment is acceptable if the donor is the borrower’s relative, the borrower's employer or labor union, a charitable organization, a governmental agency or public entity that has a program to provide homeownership assistance to low- and moderate-income families or first-time homebuyers, or a close friend with a clearly defined and documented interest in the borrower. The gift donor may not be a person or entity with an interest in the sale of the property, such as the seller, real estate agent or broker, builder, or any entity associated with them. Gifts from these sources are considered inducements to purchase and must be subtracted from the sales price. No repayment of the gift may be expected or implied. (As a rule, we are not concerned with how the donor obtains the gift funds provided they are not derived in any manner from a party to the sales transaction. Donors may borrow gift funds from any other acceptable source provided the mortgage borrowers are not obligors to any note to secure money borrowed to give the gift.) This rule also applies to properties of which the seller is a government agency selling foreclosed properties, such as the Veterans Administration or Rural Housing Services. Only family members may provide equity credit as a gift on a property being sold to other family members. These restrictions

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on gifts and equity credit may be waived by the jurisdictional HOC provided that the seller is contributing to or operating an acceptable affordable housing program.

FHA deems the payment of consumer debt by third parties to be an inducement to purchase. While FHA permits sellers and other parties to make contributions of up to six percent of the sales price of a property toward a buyer's actual closing costs and financing concessions, this policy applies exclusively to the provision of mortgage financing. Other expenses paid on behalf of the borrower must result in a dollar-for-dollar reduction to the sales price. The dollar-for-dollar reduction to the sales price also applies to gift funds not meeting the requirement that the gift be for downpayment assistance and is provided by an acceptable source. When someone other than a family member has paid off debts, the funds used to pay off the debt must be treated as an inducement to purchase and the sales price must be reduced by a dollar-for-dollar amount in calculating the maximum insurable mortgage.

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Documentation Requirements. The lender must document the gift funds by obtaining a gift letter, signed by the donor and borrower, that specifies the dollar amount of the gift, states that no repayment is required, shows the donor’s name, address, telephone number and states the nature of the donor’s relationship to the borrower. In addition, the lender must document the transfer of funds from the donor to the borrower, as follows:

1. If the gift funds are in the homebuyer's bank account, the lender must document the transfer of the funds from the donor to the homebuyer by obtaining a copy of the canceled check or other withdrawal document showing that the withdrawal is from the donor's account. The homebuyer's deposit slip and bank statement that shows the deposit is also required.

2. If the gift funds are to be provided at closing:

   a. If the transfer of the gift funds is by certified check made on the donor's account, the lender must obtain a bank statement showing the withdrawal from the donor's account, as well as a copy of the certified check.

   b. If the donor purchased a cashier's check, money order, official check, or any other type of bank check as a means of transferring the gift funds, the donor must provide a withdrawal document or canceled check for the amount of the gift, showing that the funds came from the donor's personal account. If the donor borrowed the gift funds and cannot provide documentation from the bank or other savings account, the donor must provide written evidence that those funds were borrowed from an acceptable source, i.e., not from a party to the transaction, including the lender. "Cash on hand" is not an acceptable source of the donor's gift funds.

Regardless of when the gift funds are made available to the homebuyer, the lender must be able to determine that the gift funds ultimately were not provided from an unacceptable source and were indeed the donor's own funds. When the transfer occurs at closing, the lender remains responsible for obtaining verification that the closing agent received funds from the donor for the amount of the purported gift and that those funds came from an acceptable source.

NOTE: FHA does not "approve" down payment assistance programs in the form of gifts administered by charitable organizations (i.e., nonprofits). Mortgage lenders are responsible for assuring that the gift to the homebuyer from the charitable organization meets the appropriate FHA requirements and the transfer of funds is properly documented. In addition, FHA does not allow nonprofit entities to provide gifts to homebuyers for the purpose of paying off installment loans, credit cards, collections, judgments, and similar debts.

D. **Collateralized Loans.** Funds can be borrowed for the total required investment as long as satisfactory evidence is provided that the funds are fully secured by investment accounts or real property. Such assets may include stocks, bonds, real estate (other than the property being purchased), etc.

In addition, certain types of loans secured against deposited funds, such as signature loans, the cash value of life insurance policies, loans secured by 401(k)s, etc., in which repayment may be obtained through extinguishing the asset; do not require consideration of a repayment for qualifying purposes. However, in such circumstances, the asset securing the loan may not be included as assets to close or otherwise considered as available to the borrower.

An independent third party must provide the borrowed funds. The seller, real estate agent or broker, lender, or other interested third party may not provide such funds. Unacceptable borrowed funds include signature loans, cash advances on credit cards, borrowing against household goods and furniture and other similar unsecured financing.

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E. **Sales Proceeds.** The net proceeds from an arms-length sale of a currently owned property may be used for the cash investment on a new house. A fully executed HUD-1 Settlement Statement must be provided as satisfactory evidence of the cash sales proceeds accruing to the borrower. If the property has not sold by the time of underwriting, loan approval must be conditioned upon verifying the actual proceeds received by the borrower. The lender must document both the actual sale and the sufficiency of the net proceeds required for settlement.

F. **Trade Equity.** The borrower may agree to trade his or her real property to the seller as part of the cash investment. The amount of the borrower's equity contribution is determined by subtracting all liens against the property being traded (along with any real estate commission) from the lesser of that property's appraised value or sales/trade price.

Value must be determined by a residential appraisal no more than six months old. Evidence of ownership also is required. Additionally, if the property being traded has an FHA-insured mortgage, assumption processing requirements and restrictions apply (see Chapter 4 for additional information).

G. **Sale of Personal Property.** If the borrower intends to sell personal property items (cars, recreational vehicles, stamps, coins, baseball card collections, etc.) to obtain funds required for closing, the borrower must provide a satisfactory estimate of their worth, in addition to conclusive evidence the items have been sold. The estimated worth of the items being sold may be in the form of published value estimates, such as those issued by automobile dealers, philatelic or numismatic associations, or a separate written appraisal by a qualified appraiser with no financial interest in the loan transaction. Only the lesser of this estimate of value or the actual sales price is considered as assets to close.

H. **Employer's Guarantee Plans.** If the borrower's employer guarantees to purchase the borrower's previous residence as the result of relocation, the borrower must submit evidence of the agreement and the net proceeds must be guaranteed.

I. **Employer Assistance Plans.** If the employer, to attract or retain valuable employees, pays the employee's closing costs, mortgage insurance premium, or any portion of the cash investment, this payment is considered employee compensation and no adjustment to the maximum mortgage amount is required. If the employer provides this benefit after loan settlement, the borrower must provide evidence of sufficient cash for closing. *A salary advance, however, cannot be considered as assets to close since it represents an unsecured loan.*

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J. **Savings Bonds, Etc.** Government issued bonds are counted at original purchase price, unless eligibility for redemption and redemption value are confirmed. Actual receipt of funds at redemption must be verified.

K. **IRAs, Thrift Savings Plans, 401(k)s & Keogh Accounts.** Assets such as IRAs, thrift savings plans, and 401(k)s, etc., may be included in the underwriting analysis up to only *60 percent* of value unless the borrower provides conclusive evidence that a higher percentage may be withdrawn after subtracting any federal income tax and any withdrawal penalties. Evidence of redemption is required.

L. **Stocks and Bonds.** The monthly or quarterly statement provided by the stockbroker or financial institution managing the portfolio may be used to verify the value of these securities. Actual receipt of funds must be verified and documented.

M. **Cash Saved At Home.** Borrowers who have saved cash at home and are able to demonstrate adequately the ability to do so are permitted to have this money included as an acceptable source of funds to close the mortgage. To include such funds in assessing the homebuyer's cash assets for closing, the money must be verified–whether deposited in a financial institution or held by the escrow/title company–and the borrower must provide satisfactory evidence of the ability to accumulate such savings.

The asset verification process requires the borrower to explain in writing how such funds were accumulated and the amount of time taken to do so. The lender must determine the reasonableness of the accumulation of the funds based on the borrower's income stream, the time period during which the funds were saved, the borrower's spending habits, documented expenses and the borrower's history of using financial institutions. (All other factors being equal, individuals with checking and/or savings accounts are less likely to save money at home than an individual with no history of such accounts.)

N. **Rent Credit.** The cumulative amount of the rental payments that exceed the appraiser's estimate of fair market rent may be considered accumulation of the borrower's cash investment. Both the rent-with-option-to-purchase agreement and the appraiser's estimate of market rent must be included in the endorsement package.

Conversely, if the sales agreement reveals that the renter has been living in the property (or one owned by the seller) rent-free, or that an agreement was made allowing the renter to occupy at a rental amount considerably below fair market value in anticipation of eventual purchase of the property, this situation must be treated as an inducement to purchase with an appropriate reduction to the mortgage. Exceptions may be granted in

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situations, such as when a builder fails to deliver a property at an agreed-to time and then permits the borrower to occupy that or another unit for less-than-market rent temporarily until construction is complete.

O. **Sweat Equity.** Labor performed or materials furnished by the borrower before closing, on the property being purchased, may be considered as the equivalent of a cash investment, to the extent of the estimated cost of the work or materials. (Sweat equity may be "gifted" subject to the gift requirements and additional requirements shown below.) Additionally, the following apply to sweat equity:

1. On existing construction, only the repairs or improvements listed on the appraisal are eligible for sweat equity. Any work completed or materials provided *before* the appraisal is made are not eligible. On proposed construction, the sales contract must indicate the tasks to be performed by the homebuyer during construction.

2. The borrower's labor may be considered as the equivalent of cash, if the borrower can demonstrate his or her ability to complete the work in a satisfactory manner. The lender must document the contributory value of the labor through either the appraiser's estimate or a cost estimating service.

3. Delayed work (on-site escrow), clean up, debris removal, and other general maintenance cannot be included as sweat equity.

4. There can be no cash back to the borrower in these transactions.

5. Sweat equity on a property other than the property being purchased is not acceptable. Compensation for work performed on other properties must be in cash and be properly documented.

6. Evidence of the source of funds used to purchase and the market value of the materials must be provided if the borrower furnishes these.

P. **Commission from Sale.** If the borrower is a licensed real estate agent entitled to a real estate commission from the sale of the property being purchased, that amount may be used for the cash investment with no adjustment to the maximum mortgage required. A family member entitled to the commission also may provide gift funds to the homebuyer.

Q. **Disaster Relief Grants and Loans.** Grants or loans from state and federal agencies [e.g., Federal Emergency Management Agency (FEMA)] that provide immediate housing assistance to individuals displaced due to natural disaster may be used for the borrower's cash investment. Secured

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or unsecured disaster relief loans administered by the Small Business Administration (SBA) also may be used. However, if the SBA loan will be secured against the property being purchased, it must be clearly subordinate to the FHA-insured mortgage. Any monthly payment arising from such a loan must be included in the qualifying ratios.

R. **Cash Accumulated with Private Savings Clubs.** Some borrowers may choose to use non-traditional methods of saving money by making deposits into private savings club. Often, these private savings clubs pool resources for use among the membership.

If a homebuyer claims that the cash to close an FHA-insured mortgage is from savings held with a private savings club, the borrower must be able to adequately document the accumulation of those assets with the club. While such clubs are not supervised banking institutions, the clubs must – at a minimum– have account ledgers, receipts from the club, verification from the club treasurer, and identification of the club so that the lender can reverify the information provided. The underwriter must be able to determine that it was reasonable for the borrower to have saved the money claimed and that there is no evidence these funds were borrowed with an expectation of repayment.

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SECTION 4: LIABILITIES

2-11 TYPES OF LIABILITIES. The following are types of liabilities that must be considered in qualifying borrowers:

A. Recurring Obligations. The borrower's liabilities include all installment loans, revolving charge accounts, real estate loans, alimony, child support, and all other continuing obligations. In computing the debt-to-income ratios, the lender must include the monthly housing expense and all other additional recurring charges *extending ten months or more*, including payments on installment accounts, child support or separate maintenance payments, revolving accounts and alimony, etc. Debts lasting less than ten months must be counted if the amount of the debt affects the borrower's ability to make the mortgage payment during the months immediately after loan closing; this is especially true if the borrower will have limited or no cash assets after loan closing.

The following additional information deals with revolving accounts and alimony payments:

1. Revolving Accounts. If the account shown on the credit report has an outstanding balance, monthly payments for qualifying purposes must be calculated at the greater of 5 percent of the balance or $10 (unless the account shows a specific minimum monthly payment).

2. Alimony. Because of the tax consequences of alimony payments, the lender may choose to treat the monthly alimony obligation as a reduction from the borrower's gross income in calculating qualifying ratios, rather than as a monthly obligation.

B. Contingent Liabilities. A contingent liability exists when an individual will be held responsible for payment of a debt, should another party, jointly or severally obligated, default on that payment. Unless the borrower can provide conclusive evidence from the debt holder that there is no possibility the debt holder will pursue debt collection against him or her should the other party default, the following rules apply to contingent liabilities:

1. Mortgage Assumptions. When a borrower remains obligated on an outstanding FHA-insured, VA-guaranteed, or conventional mortgage secured by a property that has been sold or traded within the last twelve months without a release of liability, or is to be sold on assumption *without* a release of liability being obtained, contingent liability must be considered unless:

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a. The originating lender of the mortgage being underwritten obtains from the servicer of the assumed loan a payment history showing that mortgage has been current during the previous 12 months; or

b. An appraisal or closing statement from the sale of the property supports a value that results in a 75 percent LTV ratio [i.e., the outstanding balance on the mortgage loan (minus any UFMIP, if applicable) cannot exceed 75 percent of the appraised value or sales price].

2. Co-Signed Obligations. If the individual applying for an FHA-insured mortgage is a co-signer–or is otherwise co-obligated on a car loan, student loan, mortgage, or any other obligation – contingent liability applies unless the lender obtains documented proof that the primary obligor has been making payments during the previous 12 months on a regular basis and does not have a history of delinquent payments on the loan.

C. Projected Obligations. If a debt payment, such as a student loan, is scheduled to begin within twelve months of the mortgage loan closing, the lender must include the anticipated monthly obligation in the underwriting analysis, unless the borrower provides written evidence that the debt will be deferred to a period outside this timeframe. Similarly, balloon notes that come due within one year of loan closing must be considered in the underwriting analysis.

D. Obligations Not Considered Debt. Obligations not to be considered debt (or subtracted from gross income) include federal, state, and local taxes; FICA or other retirement contributions such as 401(k) accounts (including repayment of debt secured by these funds); commuting costs; union dues; open accounts with zero balances; automatic deductions to savings accounts; child care; and voluntary deductions.

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SECTION 5: BORROWER QUALIFYING

The paragraphs below discuss debt-to-income ratios and the compensating factors that may be used to exceed the qualifying ratios. As evidenced by the description of compensating factors, ratios can be exceeded when significant compensating factors exist. We also do not set an arbitrary percentage that ratios may never exceed; however, the underwriter should judge the overall merits of the loan application and determine what compensating factors apply and the extent to which ratios may be exceeded.

Underwriting requires careful analysis of the many aspects of the mortgage. Each loan is a separate and unique transaction, and there may be other factors that demonstrate the borrowers' ability and willingness to make timely mortgage payments. There is a danger of "layering flexibilities" in assessing mortgage insurance risk, and simply establishing that a loan transaction meets minimal standards does not necessarily constitute prudent underwriting. The lender is responsible for adequately analyzing the probability that the borrower will be able to repay the mortgage obligation in accordance with the terms of the loan.

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2-12 **DEBT-TO-INCOME RATIOS.** Ratios are used to determine whether the borrower can reasonably be expected to meet the expenses involved in homeownership, and otherwise provide for the family. The lender must compute two ratios:

A. **Mortgage Payment Expense to Effective Income.** If the total mortgage payment (principal and interest; escrow deposits for real estate taxes, hazard insurance, the mortgage insurance premium, homeowners' association dues, ground rent, special assessments, and payments for any acceptable secondary financing) does not exceed *29 percent of the gross effective income*, the relationship of the mortgage payment to income is considered acceptable. A ratio exceeding 29 percent may be acceptable only if significant compensating factors as discussed in paragraph 2-13 are documented and are recorded on the mortgage credit analysis worksheet. Typically, for borrowers with limited recurring expense, greater latitude is permissible on this ratio than on the total fixed payment ratio described below.

B. **Total Fixed Payment to Effective Income.** If the total of the mortgage payment and all recurring charges does not exceed *41 percent of the gross effective income*, the relationship of total obligations to income is considered acceptable. A ratio exceeding 41 percent may be acceptable only if significant compensating factors as discussed in paragraph 2-13 are documented and are recorded on the mortgage credit analysis worksheet.

2-13 **COMPENSATING FACTORS.** Compensating factors that may be used to justify approval of mortgage loans with ratios exceeding our benchmark guidelines are those listed below. Underwriters must record on the "remarks" section of the HUD 92900-WS/HUD 92900-PUR the compensating factor(s) used to support loan approval. Any compensating factor used to justify mortgage approval must be supported by documentation.

A. The borrower has successfully demonstrated the ability to pay housing expenses equal to or greater than the proposed monthly housing expense for the new mortgage over the past 12-24 months.

B. The borrower makes a large downpayment (ten percent or more) toward the purchase of the property.

C. The borrower has demonstrated an ability to accumulate savings and a conservative attitude toward the use of credit.

D. Previous credit history shows that the borrower has the ability to devote a greater portion of income to housing expenses.

E. The borrower receives documented compensation or income not reflected in effective income, but directly affecting the ability to pay the mortgage, including food stamps and similar public benefits.

F. There is only a minimal increase in the borrower's housing expense.

G. The borrower has substantial documented cash reserves (at least three months' worth) after closing. In determining if an asset can be included as cash reserves or cash to close, the lender must judge whether or not the asset is liquid or readily convertible to cash and can be done so absent retirement or job termination. Also see paragraph 2-10K.

Funds borrowed against these accounts may be used for loan closing, but are not to be considered as cash reserves. "Assets" such as equity in other properties and the proceeds from a cash-out refinance are not to be considered as cash reserves. Similarly, funds from gifts from any source are not to be included as cash reserves.

H. The borrower has substantial non-taxable income (if no adjustment was made previously in the ratio computations).

I. The borrower has a potential for increased earnings, as indicated by job training or education in the borrower's profession.

J. The home is being purchased as a result of relocation of the primary wage-earner, and the secondary wage-earner has an established history of employment, is expected to return to work, and reasonable prospects exist for securing employment in a similar occupation in the new area. The underwriter must document the availability of such possible employment.

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SECTION 6: SPECIAL UNDERWRITING INSTRUCTIONS

2-14 Temporary Interest Rate Buydowns. Interest rate buydowns are designed to reduce the borrower's monthly payment during the early years of the mortgage and are permitted only on purchase transactions. Buydowns may only be used on fixed-rate mortgages.

Buydown funds may come from the seller, lender, borrower or other party. Funds from the seller or any other interested third party are considered seller contributions and must be included in the six percent limit on seller contributions (see paragraph 1-7A). Lenders must ensure that the funds described in the escrow agreement have been placed in escrow before or at closing and that the agreement meets the requirements described below.

Buydowns on eligible loans not meeting all the criteria described in paragraph A, below, may be considered only as compensating factors. However, all buydowns must comply with the escrow agreement requirements in paragraph B, below.

A. Underwriting Requirements for Qualifying Borrowers at the Buydown Interest Rate.

1. The mortgage must be a fixed rate loan on an owner occupied principal residence.

2. The buydown must not result in a reduction of more than two percentage points below the interest rate on the note.

3. The buydown must not result in more than a one-percentage point annual decrease in the interest rate. The borrower's payment may change only once a year.

B. Additional Interest Rate Buydown Instructions.

1. Lender-funded buydowns on fixed-rate purchase money mortgages through premium pricing are acceptable provided that the funds generated do not result in a reduction of more than 2 percentage points below the note rate.

2. The lender must establish that the eventual increase in mortgage payments will not affect the borrower adversely and likely lead to default. The underwriter must document that the borrower meets one of the following criteria:

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a. The borrower has a potential for increased income that would offset the scheduled payment increases, as indicated by job training or education in the borrower's profession or by a history of advancement in the borrower's career with attendant increases in earnings.

b. The borrower has a demonstrated ability to manage financial obligations in such a way that a greater portion of income may be devoted to housing expenses. This criterion also may include borrowers whose long-term debt, if any, will not extend beyond the term of the buydown agreement.

c. The borrower has substantial assets available to cushion the effect of the increased payments.

d. The cash investment made by the borrower substantially exceeds the minimum required.

3. <u>Escrow Agreement Requirements.</u> A copy of the escrow agreement, signed by the borrower and the provider of funds, must accompany the loan application. (The underwriter may condition the loan approval for an executed buydown agreement at closing.)

The following are requirements for the escrow agreement:

a. The agreement must provide that any escrow funds not distributed at the time the mortgage loan is prepaid be applied to the outstanding balance due on the mortgage. However, in the event of foreclosure, the claim for mortgage insurance benefits must be reduced by the amount remaining in the buydown escrow account.

b. The agreement must not permit reversion of undistributed escrow funds to the provider if the property is sold or the mortgage is prepaid in full. The agreement may provide that assistance payments continue to buyers who assume the mortgage. Unless the borrower establishes the escrow account, unexpended escrow funds may not be provided to the borrower in cash.

c. The escrow funds must be held in an escrow account by a financial institution supervised by a federal or state agency. Payments must be made by the escrow agent to the lender or its servicing agent. However, if the escrow payments are not received for any reason, it is the borrower's responsibility to make the total payment set forth in the

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mortgage note. FHA has no objection to the lender holding and administering the escrow funds for up to 60 days when there is an outstanding forward commitment to sell the mortgage.

2-15 ADJUSTABLE RATE MORTGAGES (ARMs). Borrowers must qualify for one-year ARMs using the mortgage payments based upon the contract or initial interest rate plus 1 percentage point (i.e., the anticipated maximum second-year interest rate) if the loan-to-value ratio is 95 percent or greater.

2-16 CONDOMINIUM UNITS–UTILITY EXPENSES. With proper documentation, such as that which is available from the utility company, the portion of a condominium fee that is clearly attributable to utilities may be subtracted from the Homeowners Association (HOA) dues before computing ratios.

2-17 CONSTRUCTION–PERMANENT MORTGAGE PROGRAM. A construction-permanent mortgage combines the features of a construction loan, a short-term interim loan for financing the cost of construction, and the traditional long-term permanent residential mortgage. For mortgage insurance and LTV purposes, we consider it to be a purchase transaction. The mortgage lender makes the loan directly to an approved borrower/homebuyer. There is one closing that occurs prior to the start of construction. At closing, funds are disbursed to cover purchase of the land, with the balance of the mortgage proceeds placed in an escrow account to be disbursed as construction progresses. *The loan is insured after construction is complete.*

Program Information.

A. **Disbursement of Funds.** It is the lender's responsibility to obtain written approval from the borrower before each draw payment is provided to the builder.

B. **Construction Period Fees.** Unless a separate agreement has been made specifying responsibility, construction loan interest, commitment fees, inspection fees, title update charges, real estate taxes, hazard insurance, and other financing charges incurred during the construction period are to be paid by the builder.

C. **Interest Rate.** The permanent mortgage loan interest is established at closing. However, a lender may offer a "ceiling/floor," whereby the borrower may "float" the interest rate during construction. The agreement must provide that, at the point of interest rate lock-in, the permanent mortgage will not exceed a specific maximum interest rate based on market fluctuations, as well as permit the borrower to lock-in at a lower rate depending on the market. The borrower must qualify for the

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mortgage at the maximum rate at which the permanent mortgage may be set.

D. **Disclosure.** The lender must provide a disclosure to the borrower explaining that the loan is not eligible for FHA mortgage insurance until after either a final inspection or issuance of a certificate of occupancy by the local governmental jurisdiction (whichever is later), and that FHA has no obligation until the mortgage is endorsed for insurance.

E. **Amortization.** Amortization must begin no later than the first of the month following 60 days from the date of either the final inspection or issuance of certificate of occupancy, whichever is later.

F. **Endorsement.** The lender must submit a request for endorsement after final inspection or issuance of certificate of occupancy (but within 60 days of the date the latter of these events occur). During construction, the loan is not FHA-insured.

G. **Remitting UFMIP.** FHA must receive the UFMIP within 15 days of closing or other time period as may be prescribed by FHA.

H. **Maximum Mortgage Amount.** The maximum mortgage amount is determined by applying LTV limits to the lesser of the appraised value or the acquisition cost. The acquisition cost includes the contractor's price to build, cost of the land, and allowable closing costs. (If the land has been owned more than six months or was received as an acceptable gift, the *value* of the land may be used instead of its cost.)

I. **Equity in the Land.** Equity in the land may be used for the borrower's cash investment. However, if the advancement of the permanent loan results in the borrower receiving cash out in excess of $250, the maximum LTV is limited to 85 percent. *If the contractor of the improvements is also the seller of the land, the total acquisition cost for maximum mortgage purposes is the purchase price to the borrower.*

J. **Other Underwriting Considerations.** The following criteria must be met for a loan to be considered a construction/permanent loan and to be eligible for FHA mortgage insurance:

The borrower must own or be purchasing the lot (or, if owned by the contractor, the lot must be included in the total contract price).

(1) The borrower must have secured or will secure the loan in his or her own name.

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(2) The borrower has contracted with a builder to construct the improvement. (This program is not available to a borrower acting as his or her own general contractor, unless the borrower is a licensed builder by profession. In this case, the acquisition cost must be determined by the actual documented cost to construct the improvements.)

(3) The balance on the loan, when it is fully drawn, must be verified. The construction escrow account, if one was established, must be fully extinguished; any remaining funds must be applied to the outstanding balance of the permanent loan.

(4) If the borrower purchased the lot within the past 6 months, he or she must provide a copy of the HUD-1 or other settlement statement showing the acquisition cost. If the borrower owns the lot free-and-clear, the borrower must provide a copy of the Warranty Deed showing no vendor's lien, a copy of the release of lien, or a copy of the HUD-1 or other settlement statement showing ownership.

(5) If the initial draw on the loan was for the purpose of paying off the lot, a statement verifying the amount must be provided.

(6) The borrower must provide a copy of the fully executed sales agreement, which includes the contractor's price to build. (A Mechanic's and Material man’s lien is not sufficient.)

(7) If the borrower is including extras over and above the contract specification and/or is paying out-of-pocket costs over and above the interim loan, the borrower must provide a breakdown of the extras and the cost of each and canceled checks and paid receipts for all out-of-pocket construction costs.

K. **Documentation Requirements.** The loan is to be closed using standard FHA documentation, with the addition of a Construction Rider to the Note and a Construction Loan Agreement. These construction documents may be in any form acceptable to the lender, but they must provide that all special construction terms end when the construction loan converts to a permanent loan. After conversion, only the permanent loan terms (using standard documents) continue to be effective, thus making the permanent loan eligible for FHA mortgage insurance.

Prior to endorsement, the DE underwriter must be provided with the following:

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1. Certification, signed by the borrower after conversion to the permanent loan, that the mortgaged property is free-and-clear of all liens other than the mortgage.

2. Verification that the construction loan has been fully drawn down.

3. Copies of canceled checks and paid receipts for all the borrower's out-of-pocket construction costs.

2-18 MORTGAGE INSURANCE FOR DISASTER VICTIMS [Section 203(h)]. FHA provides mortgage insurance to assist victims of Presidentially-declared disasters. Under this program, individuals or families whose residences were destroyed or damaged to such an extent that reconstruction or repair is necessary are eligible for 100 percent financing for the purchase of a home. The Federal Emergency Management Agency (FEMA) provides listings of the specific affected counties and cities and corresponding declaration dates. This information can be found on the Internet at http://www.fema.gov/disasters.

The procedures described are in effect whenever a disaster is declared by the President and remain in effect for one year from the date of the President's declaration.

A. Program and Underwriting Requirements.

The borrower's previous residence must have been in the disaster area and must have been destroyed or damaged to such an extent that reconstruction or replacement is necessary. The borrower must provide conclusive evidence of this fact. Documentation showing a permanent residence in the affected area before the disaster includes a valid driver's license, a voter registration card, utility bills, etc. Documentation regarding destruction of the residence includes an insurance report, an inspection report by an independent fee inspector or government agency, or conclusive photographic evidence showing the destruction or damage. The borrower may have been the owner of the property or a renter of the property affected.

The borrower is eligible for 100 percent financing of the sales price and no down payment is required. (However, closing costs and prepaid expenses not paid by the seller must be paid by the borrower in cash or paid through premium pricing.)
Maximum mortgage amounts are the same as for Section 203(b)/203(h). A list can be accessed from the lender Web page on HUD's Website at www.hud.gov or on FHA Connection at https://entp.hud.gov/clas/.

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The program is limited to one-unit detached homes or units in an approved condominium project. "Spot units" in condominiums are eligible also. Two-, three-, and four-unit properties may not be purchased under the Section 203(h) program.

The borrower's mortgage loan application must be submitted to the lender within one year of the President's declaration of the disaster.

ARMS may be used with the Section 203(h) program.

B. **Using Section 203(k) with 203(h) for Rehabilitation Mortgages.** The requirement for a dwelling to be completed more than one year preceding the date of the application for mortgage insurance under Section 203(k) does not apply to properties in the disaster area. Damaged residences are eligible for Section 203(k) mortgage insurance regardless of the age of the property. The residence needs only to have been completed and ready for occupancy for eligibility under Section 203(k). The percentage of financing is determined by the type of mortgage being made (i.e., normal LTV ratios apply to Section 203(k) mortgages made in these areas).

Homes that have been demolished, or will be razed as part of the rehabilitation work, are eligible provided the existing foundation system is not affected and still will be used. The complete foundation system must remain in place.

2-19 ENERGY-EFFICIENT HOMES (EEH). The benchmark qualifying ratios may both be exceeded by up to 2 percentage points when the borrower is purchasing or refinancing an EEH. These higher housing expense- and obligations-to-income ratios are justified due to the anticipated energy costs savings and become 31 percent and 43 percent, respectively. The appropriate HOC determines if a property qualifies for EEH designation. The original documentation attesting to energy efficiency is required on resales.

All properties meeting the Council of American Building Officials (CABO) 1992 Model Energy Code (MEC) are considered energy efficient and eligible for the two percentage points increase in the qualifying ratios.

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2-20 ENERGY EFFICIENT MORTGAGE (EEM) PROGRAM. The FHA EEM Program is for *existing* properties. An EEM recognizes the energy savings of a home that has "cost effective" energy saving improvements, which increase the energy efficiency of a home. Because the home is energy efficient, the occupant(s) will save on utility costs and, thus, be able to devote more income to the monthly mortgage payment. Energy efficiency improvements can include energy saving equipment and active and passive solar technologies.

Under the FHA EEM Program, a borrower can finance into the mortgage 100 percent of the cost of eligible energy efficient improvements, subject to certain dollar limitations, without an appraisal of the energy efficient improvements. To be eligible for inclusion into the mortgage, the energy efficient improvements must be "cost effective" (i.e., the total cost of the improvements, including maintenance costs, must be less than the total present value of the energy saved over the useful life of the improvements). The mortgage includes the cost of the energy efficient improvements, in addition to the usual mortgage amount normally permitted.

A. Basic Program Requirements.

1. Existing *one- and two-unit* properties are eligible. Three- and four- unit existing properties are not eligible.

2. The cost of any improvement to the property that will increase the property's energy efficiency and that is determined to be "cost effective" is eligible for financing into the mortgage. Its cost may be added to the mortgage amount up to the greater of:

   a. 5 percent of the property's value (not to exceed $8,000); or
   b. $4,000.

   "Cost effective" means that the total cost of the improvements, including any maintenance costs, is less than the total present value of the energy saved over the useful life of the energy improvement. The FHA maximum loan limit for the area may be exceeded by the cost of the energy efficient improvements.

3. The cost of the energy improvements, including maintenance costs, and the estimate of the energy savings must be determined based upon a physical inspection of the property by a home energy ratings system (HERS) representative or energy consultant.

   The HERS representative or energy consultant must be an independent entity; it cannot be related, directly or indirectly, to the seller of the property or the prospective borrower. The contractor selected by the borrower to install the energy efficient

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improvements may not be related, directly or indirectly, to the HERS representative or energy consultant. The HERS representative or energy consultant may be a utility company; a local, state, or federal government agent; an entity approved by a local, state, or federal government agency specifically for the purpose of providing home energy ratings on residential properties; or a nonprofit organization experienced in conducting home energy ratings of residential properties.

4. The home energy rating report prepared by the HERS representative or energy consultant must be in writing and provided to the prospective borrower and lender. The report must contain the following information:

   a. Address of the property.
   b. Name of the current owner(s) of the property.
   c. Date of the property inspection.
   d. Description of the energy features currently in the property. This description must include, at a minimum, a description of the insulation R values in ceilings, walls and floors; infiltration levels and barriers (caulking, weatherstripping and sealing); a description of the windows (storm windows, double pane, triple pane etc.) and doors; and a description of the heating (including water heating) and cooling systems.
   e. Description of the modifications recommended to improve the energy efficiency of the property.
   f. Estimated costs of the energy improvements, their useful life, and the costs of any maintenance over the useful life.
   g. Present estimated annual utility costs *before* installation of the energy efficient improvements.
   h. Estimated annual utility costs *after* installation of the energy efficient improvements.
   i. Estimated annual savings in utility costs after installation of the energy efficient improvements.
   j. Printed name(s) and signature(s) of the person(s) that inspected the property and prepared the report, as well as the date of preparation of the report.
   k. The following certification statement, signed by the person(s) who inspected the property and prepared the report, must accompany the report:

      "I certify, that to the best of my knowledge and belief, the information contained in this report is true and accurate and I understand that the information in this report may be used in connection with an application for an energy efficient

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mortgage to be insured by the Federal Housing Administration of the United States Department of Housing and Urban Development."

For streamline refinance transactions, the borrower's monthly payment for principal and interest for the refinance mortgage (which will include the cost for the energy efficient improvements) *must be lower than the monthly principal and interest on the current mortgage*.

B. **Escrow Account Specifications.** An escrow account may be established for no more than three months after loan closing to allow for installation of the energy efficient improvements. The lender, a utility company, a nonprofit organization, or a government agency may administer the escrow account. The escrow account must be insured and be established at a financial institution supervised by a federal agency.

C. **Processing and Underwriting Requirements.**

1. The lender will process the mortgage loan application and qualify the borrower using our standard underwriting requirements and qualifying ratios. If the borrower elects to have an EEM and add the cost of the energy efficient improvements to the mortgage, the lender must take the following additional steps:

   a. Obtain a report prepared by a HERS representative or energy consultant showing the estimated costs of installing the energy efficient improvements, including any maintenance costs, and the estimated annual savings in utility costs that will result from the installation of the energy efficient improvements.

   b. Using the HERS or energy consultant's report, the lender must determine that the energy efficient improvements are "cost effective" by calculating the *present cost* of the energy improvements, including maintenance costs (if any) over the useful life of the improvements and the *present value of the energy savings* over the useful life of the energy improvements. If the energy efficient improvements meet the "cost effective" test (i.e., present cost of improvements is less than the present value of the energy savings), the lender may add 100 percent of the cost of the energy efficient improvements (subject to the dollar limits described above in B. 4.) to the otherwise allowable maximum mortgage amount. No appraisal of the energy efficient improvements is necessary, and the borrower need not meet any further credit standards. If the energy

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efficient improvements meet the "cost effective" test, the full cost of the improvements can be added to the borrower's base loan amount, *without* a determination of value and *without* further credit qualification.

c. The lender calculates the UFMIP on the full mortgage amount, which will include the cost of the energy improvements.

D. **Escrow Account.** We will insure the mortgage before the energy efficient improvements are installed provided the lender establishes an escrow account and deposits into it the funds to pay for the energy efficient improvements. The escrow account shall be for a period of no more than 90 days. If the improvements are not installed within 90 days, the lender must apply the funds held in escrow to a prepayment of the principal balance of the mortgage. The escrow account may be established by the lender and administered by the lender, a utility company, a nonprofit organization, or a government agency. However, the lender is responsible for assuring FHA that the escrow has been cleared. Lenders shall execute Form HUD 92300 Mortgagee Assurance of Completion to indicate that the escrow for the energy efficient improvements has been established. Subsequently, the lender is responsible for notifying FHA that the improvements have been made and that the escrow has been cleared. The installation of the improvements may be inspected by the lender, the HERS, or an FHA fee inspector. The borrower may be charged an inspection fee in accordance with the appropriate HOC fee schedule.

F. **Home Energy Rating Report.** The lender must include a copy of the home energy rating report, performed by the HERS representative or energy consultant, in the closing package, when requesting insurance endorsement.

2-21 **ADVANCE MORTGAGE PAYMENTS PROHIBITED.** We do not permit, as a condition for making a FHA insured mortgage, a lender to collect from the borrower advance payment(s) of the mortgage. Borrowers are not to be required to write post-dated checks, give cash, or otherwise make mortgage payments to the lender in advance of the borrowers mortgage payment requirements under the security instruments.

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CHAPTER 3

DOCUMENTATION AND OTHER PROCESSING REQUIREMENTS

- This chapter describes the documentation requirements for each loan submitted for mortgage insurance and the specific requirements lenders must observe in processing and underwriting FHA-insured mortgages. The lender is responsible for asking sufficient questions to elicit a complete picture of the borrower's financial situation, source of funds for the transaction, and the intended use of the property. All information must be verified and docuemtned. The lender must also verify and document the identity of the loan applicant(s).

SECTION 1: UNDERWRITING DOCUMENTATION

3-1 **APPLICATION PACKAGE.** The application package must contain all documentation supporting the lender's decision to approve the mortgage loan. *When standard documentation does not provide enough information to support this decision, the lender must provide additional explanatory statements, consistent with other information in the application, to clarify or to supplement the documentation submitted by the borrower.*

- All documents may be up to *120 days old* at the time the loan closes (*180 days* for new construction) unless this or other applicable HUD instructions specify a different timeframe, or the nature of the document is such that its validity for underwriting purposes is not affected by being older than the number of prescribed days (e.g., divorce decrees, tax returns). Updated, written verifications must be obtained when the age of the documents exceed these limits. Verification forms or documents used as an alternate to these verifications must pass directly between the lender and the provider without being handled or transmitted by any third party or using any third party’s equipment. No document used in the processing or underwriting of a loan may be handled or transmitted by or through an interested third party to the transaction.

- The Verification of Deposit (VOD) and Verification of Employment (VOE) may be faxed documents or printed pages from the Internet if they clearly identify their sources (e.g., contain the names of the borrower’s employer or depository/investment firm). The lender is accountable for ascertaining the authenticity of the document by examining information included in a document’s headers and footers. The lender should verify the authenticity of printed Web pages by examining the pages for similar information. A printed Web page also must show its uniform resource locator (URL) address, as well as the date and time the document was printed.

- Lenders may not accept or use documents relating to the credit, employment or income of borrowers that are handled by or transmitted from or through

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interested third parties (e.g., real estate agents, builders, sellers) or by using their equipment.

- The following documents are generally required for mortgage credit analysis in all transactions except for certain streamline refinances:

A. **Loan Application.** Uniform Residential Loan Application (URLA), signed and dated by all borrowers and the lender, and the Addendum to the URLA (form HUD-92900-A).

B. **Mortgage Credit Analysis Worksheet.** Form HUD 92900-WS or HUD-92900-PUR, as appropriate.

C. **Social Security Number Evidence.** For all borrowers, including US citizens, the lender is required to document a valid SSN for each borrower, co-borrower, and co-signer on the mortgage. All individuals eligible for legal employment in the US must have a SSN. Each borrower must provide the lender with evidence of his or her own valid SSN as issued by the Social Security Administration (SSA). This applies to purchase money loans and all refinances, including streamline refinances. While the actual social security card is not required, the lender is required to validate the SSN. Lenders may use various means for validating the SSN including examining the borrower's pay stubs, passport, valid tax returns, and may use service providers including those with direct access to the SSA. The lender is also required to resolve any inconsistencies or multiple SSNs for individual borrowers that are revealed during loan processing and underwriting. (Also see paragraph 2-2 B).

D. **Credit Report.** The lender must obtain a credit report on all borrowers who will be obligated on the mortgage note (except for streamline refinance transactions).

E. **Verification of Employment (VOE).** VOE and the borrower's most recent pay stub are to be provided. "Most recent" means at the time the initial loan application is made. If the document is not more than 120 days old when the loan closes (180 days old on new construction), it does not have to be updated.

Alternative Documentation. *As an alternative to obtaining a VOE, the lender may obtain the borrower's original pay stub(s) covering the most recent 30-day period, along with original IRS W-2 Forms from the previous two years. The pay stub(s) must show the borrower's name, social security number, and year-to- date earnings. Any copies of the W-2 Form not submitted with the borrower's income tax returns are considered "original" W-2's. (These original documents may be photocopied and returned to the borrower.) The lender also must verify by telephone all current employers. The loan file must include a certification from the*

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lender that original documents were examined and the name, title, and telephone number of the person with whom employment was verified. For all loans processed in this manner, the lender also must obtain a signed copy of Form IRS 4506 Request for Copy of Tax Form, Form IRS 8821, or a document that is appropriate for obtaining tax returns directly from the IRS. The lender also may use an electronic retrieval service for obtaining W-2 and tax return information.

If the employer will not give telephone confirmation of employment or if the W-2 indicates inconsistencies (e.g., FICA payments not reflecting earnings), standard employment documentation must be used.

F. **VOD.** VOD and most recent bank statements are to be provided. "Most recent" means at the time the initial loan application is made. Provided the document is not more than 120 days old when the loan closes (180 days old on new construction), it does not have to be updated.

Alternative Documentation. *As an alternative to obtaining a VOD, the lender may obtain from the borrower original bank statement(s) covering the most recent three-month period. Provided the bank statement shows the previous month's balance, this requirement is met by obtaining the two most recent, consecutive statements.*

G. **Federal Income Tax Returns.** Federal income tax returns (both individual returns and business returns) for the past two years, including all applicable schedules, for self-employed borrowers, are required. Commissioned individuals must provide individual federal income tax returns for the past two years. The lender must obtain signed Forms IRS 4506, IRS 8821, or whatever form or electronic retrieval service is appropriate for obtaining tax returns directly from the IRS for any loan for which the borrower's tax returns are required.

H. **Sales Contract.** The sales contract and any amendments or other agreements and certifications are to be included in the case binder. Either an original or a certified true copy of the sales contract received by the lender is required.

I. **Real Estate Certification.** Real estate certification, signed by the buyer, seller, and selling real estate agent or broker (if not contained within the purchase agreement) are required. Also see paragraph 3-3, below.

J. **Verification of Rent or Payment History of Present/Previous Mortgages.** This document must be in the form of a direct verification from the landlord or mortgage servicer or through information shown on the credit report.

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K. **Uniform Residential Appraisal Report (URAR).** The URAR and Valuation package must be included in the endorsement binder except for streamline refinances made without appraisals.

L. **Explanatory Statements.** Explanatory statements or additional documentation necessary to make a sound underwriting decision are to be included in the case binder.

3-2 DOCUMENTATION STANDARDS.

A. **Application Forms.** Application forms must be signed and dated by all borrowers applying for the mortgage and assuming responsibility for the mortgage debt.

B. **Verifications.** Rather than requiring borrowers to sign multiple verification forms, the lender may ask the borrower to sign a general authorization form that gives the lender blanket authority to verify information needed to process the mortgage loan application, such as past and present employment records, bank accounts, stock holdings, etc. If the lender uses such an authorization, he or she must attach a copy of the authorization to each verification sent. Additionally, lenders may use self-adhesive signature labels for laser printed verifications. Each label must completely and clearly indicate its use and must contain the Privacy Act notification.

C. **Documents Signed in Blank.** Lenders may not have borrowers sign documents in blank, or on blank sheets of paper.

3-3 REAL ESTATE CERTIFICATION. The borrower, seller, and the selling real estate agent or broker involved in the sales transaction must certify that the terms and conditions of the sales contract are true to the best of their knowledge and belief and that any other agreement entered into by any of the parties in connection with the real estate transaction is part of, or attached to, the sales agreement.

- If the sales contract contains a provision that there are no other agreements between parties and that the terms of the sales contract constitute the entire agreement between the parties, the certification specified in the above paragraph is not needed if all parties are signatories to the sales contract submitted at the time of underwriting.

3-4 AMENDATORY CLAUSE. An amendatory clause must be included in the sales contract when the borrower has not been informed of the appraised value by receiving a copy of Form HUD-92800.5B, Conditional Commitment/DE Statement of Appraised Value or VA-CRV *before* signing the sales contract. The amendatory clause must contain the following language:

HISTORICAL REFERENCE ONLY

HUD Handbook 4155.2
Chapter 2.A.4.B

4. Underwriter Qualification Criteria and Responsibilities, Continued

4155.2 2.A.4.b Underwriter Responsibilities

The table below outlines the responsibilities assumed by the underwriter.

Responsibility	Description
Familiarity with Underwriting Procedures	The lender is responsible for ensuring the underwriter's familiarity with • the underwriting procedures discussed in principal underwriting handbooks – HUD 4155.1, *Mortgage Credit Analysis for Mortgage Insurance on One-to-Four Family Properties*, and – HUD 4155.2, *Lender's Guide to the Single Family Mortgage Insurance Process* • the appraisal procedures discussed in valuation handbooks – HUD 4145.1, *Architectural Processing and Inspections for Home Mortgage Insurance* – HUD 4150.1, *Valuation Analysis for Home Mortgage Insurance*, and – HUD 4150.2, *Valuation Analysis for Single Family One- to Four-Unit Dwellings* – HUD 4905.1, *Requirements for Existing Housing, One-to-Four-Family Living Units*, and – HUD 4910.1, *Minimum Property Standards for Housing*, and • all applicable FHA Mortgagee Letters that affect appraisals and credit underwriting.
Coordination and Compliance	The underwriter is responsible for • coordinating all phases of the loan underwriting process, and • ensuring compliance with all FHA requirements and prudent underwriting procedures.

Continued on next page

4. Underwriter Qualification Criteria and Responsibilities, Continued

4155.2 2.A.4.b Underwriter Responsibilities (continued)

Responsibility	Description
Verification of Information	The underwriter must ensure that information is obtained and verified with at least the same care that would be exercised if originating a mortgage in which the lender would be entirely dependent on the property as security to protect its investment.
Appraisal Review and Credit Analysis	The underwriter must ensure reasonable conclusions, sound reports, and compliance with FHA requirements by • reviewing appraisal reports and compliance inspections, and • documenting all credit analyses performed and/or obtained by fee and staff personnel.
Loan Acceptability	The underwriter is responsible for making decisions with due diligence and in a prudent manner, regarding the • acceptability of the – appraisal – inspections, and – borrower's capacity to repay the mortgage, and • overall acceptability of the mortgage loan for FHA insurance.
Personnel Performance	The underwriter must monitor and evaluate the performance of fee and staff personnel used for the Direct Endorsement (DE) Program.

Continued on next page

4. Underwriter Qualification Criteria and Responsibilities, Continued

4155.2 2.A.4.b Underwriter Responsibilities (continued)

Responsibility	Description
Detection of Warning Signs	The underwriter must be • attuned to the warning signs that may indicate any irregularities, and • alert and able to detect fraud.
Certification Page 3, *Form HUD-92900-A*	By executing page 3 of Form HUD-92900-A, *HUD/VA Addendum to Uniform Residential Loan Application*, the underwriter certifies that he/she • has personally reviewed all application documents • finds compliance with the applicable requirements, and • is approving the loan for closing.

Closing Review and Certification	The underwriter (or the lender or lender's closing department) must
	
	• review all
	  – closing documents
	  – certifications on the closing statements, and
	  – legal instruments and other documents executed at closing, and
	• certify on page 4 of form HUD-92900-A, *HUD/VA Addendum to Uniform Residential Loan Application,* that the
	  – transaction and loan meet statutory and regulatory requirements of the FHA and National Housing Act, and
	  – loan has been closed in accordance with the terms and sales price specified in the sales contract.

HUD Handbook 4700.2 Rev-1
Chapter 6

CHAPTER 6. QUALITY CONTROL PLAN

6-1 GENERAL REQUIREMENT. As a condition of HUD Title I approval, all lenders, including Loan Correspondents, shall prepare and implement a Quality Control Plan (QCP) The Department considers a QCP to be an important part of a lender's origination and servicing operations in order to ensure that the lender maintains compliance with HUD requirements and its own policies and procedures. The QCP must be sufficient in scope to enable the lender to evaluate the accuracy, validity and completeness of its loan origination and servicing operations.

A. POLICY AND OBJECTIVES. All Nonsupervised and Supervised Lenders and Loan Correspondents shall prepare and implement a QCP which utilizes an independent program of internal or external audit performed by personnel who are knowledgeable and have no direct loan processing, underwriting or servicing responsibilities. The quality control function may be performed by either company personnel or an outside firm. The QCP shall provide for periodic reports to be provided to senior management. The reports will identify for senior management any areas of the loan origination or servicing functions that are deficient.

B. SCOPE. The QCP must provide for a monthly review of not less than ten percent of all Title I loans originated by the lender on a monthly basis, including its branches and Loan Correspondents. For loan servicing, lenders must perform a quarterly review of a representative sample of loans that is sufficient in number to provide reasonable evidence that HUD loan servicing policies and requirements have been met. For each branch office that originates or services HUD insured Title I loans, an on-site branch office review must take place at least once every year. The QCP must also provide for a review of the lender's files and records to determine compliance with HUD's Fair Housing Act as amended in 1988.

C. LOAN CORRESPONDENTS. While it is important for Sponsors to include each of their Loan Correspondents in their review samples, each Loan Correspondent must have its own QCP. It is not acceptable for a Sponsor to perform its routine review of Loan Correspondents

and use this as a replacement for the Loan Correspondent's own review, unless a full 10 percent sample is reviewed.

As discussed below, Loan Correspondents may choose to use an outside source to perform their quality control reviews. However, if a Sponsor is used, the review must cover the full 10 percent sample.

D. QUALITY CONTROL REVIEWS MUST INCLUDE:

1. A selection of loans on a random basis including loans from all branch offices, loan correspondents and servicing agents.

2. Assurance that all loan officers, underwriters and servicers will have loans subjected to reviews.

3. Analysis of all loans which go into default within six payments after closing.

4. Procedures for expanding the scope of the review where a pattern of deficiencies or fraudulent activity is disclosed.

E. CONTRACTING OUT. Lenders are permitted to use an outside source to perform their quality control reviews. This procedure may be useful for smaller lenders who do not have sufficient staff to devote to quality control, for example. The outside source is expected to use the lender's QCP or develop one that meets the Department's requirements. Lenders are still required to take appropriate actions in response to findings, as discussed in this Chapter.

F. INITIATE CORRECTIVE ACTION. The QCP must require written notification to the lender's senior management, at least quarterly, of deficiencies cited as a result of the reviews. Senior management must promptly initiate action to correct all deficiencies. The actions taken by management must be formally documented by citing each deficiency, identifying the cause of the deficiency, and providing management's response or actions taken. Employees are to be provided with the results of the quality control review.

G. NOTIFICATION TO HUD OF SIGNIFICANT DISCREPANCIES. Approved lenders are required to report to HUD any violation of law or regulation, false statements or program abuses by a borrower, dealer, the lender, its Loan Correspondents, employees or any other party to the transaction (refer to 24 CFR Section 201.40(a)). These reports should be forwarded to the Monitoring Division in Washington, D.C. or the Office of Inspector General at the nearest HUD field office.

6-2 GENERAL REQUIRED ELEMENTS OF THE QUALITY CONTROL PLAN. The quality control plan shall:

A. Assure that each office of the lender including, if applicable, its approved Loan Correspondent(s) and branches maintain copies of all HUD issuances, including regulations, handbooks, and Title I letters, etc., which are relevant to the lender's Title I origination and servicing activities. These documents must be accessible to all employees, and new directives must be reviewed with appropriate staff.

B. Assure that all loans reported by the lender to HUD/FHA for insurance are processed only by employees of the lender.

C. Assure that the lender does not employ or conduct Title I business with any individual who is debarred, suspended or subject to a Limited Denial of Participation (LDP).

D. Assure that a check was made through the Department's Credit Alert Interactive Voice Response System (CAIVRS) or some other means to determine whether an applicant is in default or a claim has been paid in connection with any loan obligation owed to or insured or guaranteed by the Federal government'.

E. Assure that the originating lender is retaining a copy of the entire case file pertaining to all loan originations, either in hard copy or microfilm form, for at least two years from date of loan disbursement.

F. Assure that Home Mortgage Disclosure Act (HMDA) reporting is being done accurately, timely and is properly documented.

G. Assure that the lender does not require, as a condition of providing an insured loan, that the principal amount of the loan exceed a minimum amount established by the lender.

H. Assure that quality control reviews are performed within 90 days of loan disbursement. For loan servicing, reviews must be done at least quarterly.

I. Assure that post-disbursement inspections are conducted to determine that improvements were completed or a manufactured home was properly installed.

J. Assure that the lender keeps records of the results of quality control reviews, including findings and actions taken, for a period of one year.

6-3 REQUIREMENTS FOR LOAN ORIGINATION.

A. GENERAL. Lenders are expected to exercise prudence and diligence in determining whether the borrower is an acceptable credit risk, with a reasonable ability to make payments on the loan obligation. All documentation supporting the determination of creditworthiness must be retained in the loan file.

1. The QCP must ensure that all loans comply with the applicable provisions of 24 CFR Part 201 and requirements contained in Title I letters.

2. The QCP must provide for the reverification of the borrower's employment and deposit by telephone or in writing with the employer and depository. It must also provide for the reverification of gift letters or other sources of funds. All reverifications must be documented in the loan file.

3. A new in-file credit report must be obtained and compared to the original for discrepancies. Also, the credit report must be reconciled with the credit application to determine that all liabilities were listed or properly adjusted and documented.

B. SPECIFIC REQUIREMENTS: The QCP must provide for a review of the loan origination and underwriting functions in order to:

1. Determine whether all income and employment data is supported by written verification or other documentation, especially for self-employed applicants and those with non-employment income. Determine whether the loan file contains a financial statement or Federal income tax return if the borrower is self-employed.

2. Determine whether a complete and current consumer credit report on the borrower and any co-maker or co-signer was obtained, and any credit inquiries reported within the previous 90 days were checked. If more than one credit report was obtained, determine whether all information was considered by the underwriter and any discrepancies were resolved.

3. Determine whether a written verification of the source of funds was obtained through verifications of deposit, bank statements, gift letters or other written documentation, when the principal balance of the loan exceeds $5,000 and the initial payment exceeds five percent of the loan amount.

4. Determine whether the borrower's expense-to-income ratios are within the allowable ratios established by HUD/FHA, or that there are appropriate compensating factors that support approval of the loan.

5. Determine whether all conflicting information or discrepancies were reconciled and properly documented in writing.

6. Determine whether the lender completed a face-to-face or telephone interview with the applicant before making a final determination of creditworthiness in order to ensure the accuracy of information in the file. (Refer to 24 CFR 201.22(a) (9)).

7. Determine that proper procedures were used to determine borrower eligibility and evaluating whether the loan proceeds were intended to be used for eligible purposes. (Refer to 24 CFR 201.20 or 201.21 as appropriate.)

8. Determine whether the property improvement loan files contain all required documents, including but not limited to, completion certificates and inspections of completed improvements.

9. Determine whether each manufactured home loan file contains all required documents, including but not limited to, a placement certificate and a site-of-placement inspection.

10. Where the lender approves dealer loans, determine that the lender supervises and monitors each dealer and visits the dealer periodically.

    a. Determine that each dealer's approval is documented on a HUD-approved form signed and dated by both parties.

    b. Determine that each dealer file contains the dealer's current financial statement, including a determination that the dealer meets the minimum net worth requirements of 24 CFR 201.27(a) (1), and credit reports on the dealership and its owners, principals and officers.

    c. Determine that each file contains documentation of the lender's experience with the dealer's Title I loans, including information on borrower defaults and borrower complaints and their resolution.

    d. Determine whether the lender reviews the dealer's advertising during the time of annual re-approval and during the semi-annual on-site visits to ensure it is not inaccurate or misleading regarding the Title I Program.

6-4 REQUIREMENTS FOR LOAN SERVICING

A. GENERAL The lender shall service loans in accordance' with accepted practices of prudent lending institutions. It shall have adequate facilities for contacting the borrower in the event of default, and

shall otherwise exercise diligence in collecting the amount due. The lender shall be responsible for proper collection efforts, even though actual loan servicing and collection may be performed by an agent of the lender. The lender shall have an organized means of identifying, on a periodic basis, the payment status of delinquent loans to enable collection personnel to initiate and follow-up on collection activities, and shall document its records to reflect its collection activities on delinquent loans.

B. SPECIFIC REQUIREMENTS The QCP must provide for a review of the loan servicing function in order to:

1. Determine that loan servicing records are promptly established after loan closing or acquisition and that the servicing

records contain the information necessary to properly service the loan. Also, determine that the borrowers have been notified concerning the transfer of servicing.

2. Determine through a review of individual loan servicing records that the amount of fees and charges imposed on the borrower do not exceed those permitted by HUD regulations at 24 CFR 201.25.

3. Determine that inquiries from borrowers concerning their individual loan accounts are promptly responded to.

4. Determine that an analysis is performed on all loans that default early (less than 6 payments) to determine the cause of the default and confirm that the loans were underwritten properly.

5. Determine that borrowers are provided every reasonable opportunity to remedy a delinquency or default, including modification agreements or informal repayment plans.

6. Determine that adequate collection activities and accurate documentation of collection efforts are recorded.

7. Determine that a face-to-face meeting or telephone

interview with the borrower is attempted before the lender takes any action to accelerate the maturity of the loan to discuss the reasons for lack of payment and to determine the necessary steps to bring the loan current.

8. Determine whether the notice of default and acceleration is in compliance with the regulations (24 CFR 201.50(b) and Title I Letter TI-408).

9. Determine whether there are sufficient controls to assure that all aspects of the claims for insurance benefits are prepared accurately and on a timely basis.

10. Determine whether the borrower's default is reported to a credit reporting agency following acceleration of the loan maturity.

11. Determine whether foreclosure or repossession proceedings are initiated and completed on a timely basis and in accordance with HUD requirements. Determine that valid and enforceable deficiency judgements are taken against the borrowers where required or appropriate to establish the validity of the obligation.