BLACK | MANN & GRAHAM L.L.P.

9575 Katy Freeway, Suite 300

Houston, TX 77024

Phone: 713-871-0005

Fax: 713-871-1358

Thomas E. Black, Jr., P. C. *

Calvin C. Mann, Jr., P. C.

Gregory S. Graham, P. C.

David F. Dulock

Diane M. Gleason

Benjamin R. Idziak **

Shawn P. Black **

Margaret A. Noles

Robert J. Brewer

Regina Uhl

Ali Hedayatifar

** Also Licensed in New York, Washington, West Virginia and Iowa*

*** Also Licensed in New York*

July 15, 2010

To: Clients and Friends

From: David F. Dulock

Subject: FHA Proposed Changes to Risk Management Practices - Reduction of Seller Concessions and New Loan-to-Value and Credit Score Requirements

In today's *Federal Register* (75 FR 41217) HUD published notice that in order to enhance FHA risk management practices, FHA is proposing the following changes to its underwriting guidelines:

1. reduce "seller concessions";
2. introduce a minimum eligibility credit score;
3. reduce the maximum LTV for low credit score borrowers; and
4. tighten underwriting standards for manually underwritten loans.

HUD states in the notice that the Mutual Mortgage Insurance Fund (MMIF) capital ratio has fallen below its statutorily mandated threshold and the purpose for these proposed changes is to maintain the financial soundness of the MMIF. HUD is soliciting public comment on these proposed changes. Comments are due by August 16, 2010 and the instructions for submitting comments by the due date are set out on page 41217 of the above-cited issue of the *Federal Register*.

Below is a brief summary of these proposed changes to FHA-insured mortgage loan underwriting guidelines:

1. Reduction of Seller Concessions

The notice proposes to reduce FHA's existing policy regarding seller concessions[1] for FHA-insured single-family mortgage loans from six percent (6%) to three percent (3%) of the lesser of the sales price or appraised value. This proposed change in FHA's seller concessions policy will not prohibit seller concessions above 3%, but concessions exceeding 3% would result in a dollar-for-dollar reduction in the sales price for the purpose of calculating the maximum FHA-insured loan amount.

2. Minimum Eligibility Credit Score

The notice proposes a minimum credit score of 500 for an applicant to be eligible for an FHA-insured loan. Applicants with credit scores below 500 would not be eligible for FHA-insured loans. The credit score will be based on the middle of three National Credit Bureau scores, or the lower of two scores when all three National Credit Bureau scores are not available, for the lowest scoring applicant.

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1. As stated in the notice, "Seller concessions include any payment toward the borrower's closing costs by any third party with an interest in the transaction, including the seller, builder, developer, mortgage broker, lender, or settlement company." (*See* Handbook 4155.1, section 2.A.3 and Handbook 4155.2, section 4.8.)

3. New LTV Ratio Requirements

The notice proposes to reduce the maximum LTV to 90 percent for borrowers with credit scores between 500 and 579, based on the middle of three National Credit Bureau scores, or the lower of two scores when all three National Credit Bureau scores are not available, for the lowest scoring loan applicant.

For borrowers with credit scores at or above 580, the maximum LTV for purchase transactions and rate and term refinance transactions remains at 96.5 percent and 97.75 percent, respectively.

4. Stricter Manual Underwriting Standards[2]

For those loans that FHA requires to be manually underwritten, the notice proposes the following additional requirements that consider the borrower's credit history, LTV percentage, housing/debt ratios, and reserves:

1. A minimum cash reserve equal to one mortgage payment (principal, interest, taxes, and insurance).

2. Maximum housing and debt-to-income ratios of 31 percent and 43 percent, respectively.

3. Borrowers with credit scores at or above 620 may: (i) exceed the 31/43 percent ratios, not to exceed 35/45 percent, if they can meet one of the compensating factors listed below; or, (ii) exceed the 35/45 percent ratios, not to exceed 37/47 percent, if they can meet two of the compensating factors listed below. As stated in the notice, acceptable compensating factors are:

"• The borrower will have a documented significant decrease or a documented minimal change in housing expense AND a documented 12-month housing payment history with no more than 1X30 late payments, *e.g.,* no more than one month late on all rental or mortgage payments made within the month due.
• Documented significant additional income that is not considered effective income, *e.g.,* part-time income that does not meet the requirements in Handbook 4155.1, paragraph 4.D.2.d., and is not reasonably expected to continue for the next 2 years.
• Documented cash reserves in the amount of 3 total monthly mortgage payments (principle [sic], interest, taxes, insurance). The reserves, consisting of the borrower's own funds, must be liquid or readily accessible, and may not consist of gift funds.
• Energy Efficient Mortgages, as well as those homes that were built to the 2000 International Energy Conservation Code, formerly known as the Model Energy Code, or are being retrofitted to that standard, have "stretch ratios" up to 33/45 percent."

These proposed new guidelines are not applicable to mortgages insured under the following programs: Title I of the National Housing Act; Home Equity Conversion Mortgages (HECMs);

[2] Applicable for the following loans: purchase, FHA cash-out refinance, conventional to FHA refinance. Not applicable for the following loans: FHA-to-FHA rate and term refinance (no cash-out), FHA streamline refinance, and HECMs.

HOPE for Homeowners (H4H); Section 247 (Hawaiian Homelands); Section 248 (Indian Reservations); Section 223(e) (declining neighborhoods); and Section 238(c) (military impact areas in Georgia and New York).

The above summary is not a complete description of the notice, and for a full understanding you should read the entirety of the notice published in the July 15, 2010, issue of the *Federal Register* at: http://edocket.access.gpo.gov/2010/pdf/2010-17326.pdf.

Those clients who would be adversely affected by these proposed changes in FHA policy are urged to submit written comments to HUD on or before the August 16, 2010 deadline. See the instructions for submitting comments set out on page 41217 of the above-cited issue of the *Federal Register*.