RD AN No. 4366 (1980-D)
May 7, 2008

TO: All State Directors
Rural Development

ATTENTION: Rural Housing Program Directors,
Guaranteed Rural Housing Specialists,
Area Directors and Area Specialists

FROM: Russell T. Davis ***(Signed by Peter Morgan)*** for
Administrator
Housing and Community Facilities Programs

SUBJECT: Single Family Housing Guaranteed Loan Program
Approved Lender Underwriting Guidelines, Debt Ratio
Waivers, Payment Shock, and Collection Accounts

PURPOSE/INTENDED OUTCOME:

The purpose of this Administrative Notice is to clarify RD Instruction 1980-D and provide guidance on the Agency's position concerning the use of debt ratio waivers and compensating factors when approving loan guarantees, reiterate Agency methodology for evaluating "payment shock", and clarify whether non-federal collection accounts with outstanding balances are required be paid off prior to closing under the Single Family Housing Guaranteed Loan Program (SFHGLP).

COMPARISON WITH PREVIOUS AN:

This AN replaces AN 4262 dated March 30, 2007.

EXPIRATION DATE:
May 31, 2009

FILING INSTRUCTIONS:
Preceding RD Instruction 1980-D

BACKGROUND:

The National Office receives inquiries from both lenders and Agency staff regarding debt ratio waivers, compensating factors, payment shock, and treatment of open collection accounts. How does payment shock factor into loan decisions? What are strong compensating factors lenders may document in order to strengthen a loan application? How high can debt ratios be exceeded?

Rural Development guarantees underwritten loan packages submitted by participating and approved lenders. The agency recognizes that each loan applicant is unique and may require additional flexibility in underwriting when supported in order to assist them in achieving successful homeownership. SFHGLP loans are designed to accommodate the varying needs of each applicant. RD Instruction 1980-D outlines many of the underwriting issues which are addresses in further detail by the AN.

IMPLEMENTATION RESPONSIBILITIES:

State Directors will advise lenders about the need to: underwrite loans according to Agency regulations, process and approve loans in accordance with program instructions, review loan applications for accuracy and completeness, not to exceed income limits, ensure applicants have adequate loan repayment ability, verify acceptable credit histories, and regularly check Rural Development's website for new issuances related to program requirements.

DEBT RATIO WAIVERS:
Requested by the lender, approved by Rural Development

In the guaranteed loan program an applicant meets agency requirements for repayment ability if their Principal, Interest, Real Estate Taxes, and Homeowners Insurance (PITI) debt ratio is 29% or less, and the Total Debt Ratio (TD) (the PITI plus any additional monthly debt obligations combined) is 41% or less.

It is common for underwriters and Rural Development to allow exceptions to both the PITI and TD ratio requirements. There is not a maximum amount that the ratio standards may be exceeded. Strong compensating factors documented by the underwriter will assist Rural Development in approving higher ratio waivers. PITI ratios in the high 30's and TD ratios in the high 40's are not uncommon.

Requests to exceed the standard ratio thresholds must be **submitted in writing** to Rural Development, including the documentation of appropriate compensating factors for support of sound underwriting judgment.

Applicants with Fair Isaacs & Company (FICO) scores of 660 and higher do not require additional compensating factors to be identified for debt ratio waiver requests. If co-applicants included on the application have a FICO score of 659 or below, additional compensating factors should be documented to further support the ratio waiver request. There is no minimum credit score required to be eligible for a debt ratio waiver request. It is possible that a credit score is not indicative of an applicant's true credit risk.

Underwriters are encouraged to evaluate credit, capacity, and collateral when considering any applicant for a debt ratio waiver.
The National Office supports and encourages granting ratio waiver requests for applicants with legitimate compensating factors such as those listed below and in 1980.345(c)(5) which include but are not limited to:

- FICO score of 660 or higher for any applicants.

- No or low payment shock: minimal increase in housing expenses, or current rent is comparable to proposed PITI (100% increase in payment or less).

- Conservative attitude toward the use of credit and ability to accumulate savings

- Previous credit history verifies that applicant has the ability to devote a greater portion of income to housing expense. Many low income or high cost area applicants already pay a substantial amount for rent or housing and are successful.

- Employment history: Two or more years in current position is excellent, however underwriters should consider applicants who change positions frequently to better their financial position. Underwriters should give more credence to a history of continuous employment, (no gaps due to multiple terminations, etc.).

- Additional compensation/income: Public benefits, food stamps, potential commissions, bonus payouts, and additional part time employment that lacks a stable history may not be reflected in the repayment income, yet this additional income will have a direct effect on the ability to successfully repay the mortgage. obligation.

- Cash reserves available post closing.

- Potential for increased earnings and career advancement, as indicated by job training or education in the applicant's profession.

- Trailing spouse income: Home is being purchased as the result of relocation of the primary wage-earner. The secondary wage earner has an established history of employment and is currently seeking or expects to return to work and there are reasonable prospects for securing employment in a similar occupation within the new area.

- Low TD: A low TD by itself does not compensate for a high PITI ratio, however when other strong compensating factors are present a low TD ratio should be viewed as a positive mitigating factor.

If requested by a lender, Agency staff may assist lenders in determining any compensating factors associated with guaranteed loan applications to make a preliminary determination of the appropriateness of a ratio exception. However, Rural Development can not approve or deny guaranteed debt ratio waiver requests without a complete underwritten loan package. Denial of a lender's request for a ratio waiver is not appeal-able, however this adverse action may be reviewed if and when the guaranteed loan is denied for lack of repayment ability.

PAYMENT SHOCK
<u>Approved by the lender</u>

Analysis of early delinquency loans guaranteed under the SFHGLP has indicated that payment shock is a delinquency factor when additional risk factors are present (risk layering). The presence of payment shock is especially significant when the applicant's credit history contains derogatory information.

The term "payment shock" signifies the increase in housing expenses experienced by an applicant. Payment shock is defined as a percentage and calculated using the following formula:

New PITI (principal, interest, taxes and insurance) ÷ Current housing expense – 1.

The following examples illustrate payment shock as a percentage.

A. New PITI: $850 Current Rent: $550
850.00 ÷ 550.00 = 1.54 -1 = .54 or 54%
The payment shock in this example is 54 percent.
The payment shock for this example is below 100% and therefore <u>not</u> a risk factor.

B. New PITI: $1,500 Current rent: $650
1,500.00 ÷ 650.00 = 2.30 – 1 = 1.30 or 130%
The payment shock in this example is 130 percent.
The payment shock for this example is above 100% and therefore <u>is</u> a risk factor.

C. New PITI: $750 Current rent: $0 (lives with parents)
The payment shock in this example can not be measured and therefore <u>is</u> a risk factor. In cases where the applicant does not have prior experience in meeting rent or housing expense obligations, payment shock can not be measured as a percentage.

When payment shock is 100 percent or higher, <u>or</u> the applicant has no previous rent or housing expenses, <u>no</u> additional risk layering (such as adverse credit waivers approved by the lender), debt ratio waivers (approved by Rural Development), or temporary buy-downs, should be allowed without strong compensating factors such as those listed above.

COLLECTION ACCOUNTS
<u>Lender decides to pay or not pay non-federal collections</u>

Applicants are expected to demonstrate a reasonable ability and willingness to meet obligations as they come due. If the lender has established that there are mitigating circumstances concerning an applicant's credit history as described in RD Instruction 1980-D, section 1980.345(d)(3), the lender is responsible to determine what collection accounts if any, should be paid in full by the applicant prior to or at closing.

Mitigating circumstances must be documented in the lender's file if the applicant(s) credit scores are 619 and below if there are open collection accounts. In such cases, the lender must document the adverse credit was temporary in nature and beyond the applicant's control and has been removed.

We emphasize that the loan, while guaranteed by the Agency, is the lender's loan. The determination of whether the collection account represents a greater risk or must be paid off is entirely the lender's decision, regardless of credit score. In some instances payment of the collection account may cause the depletion of cash resources that could otherwise be available as reserves or closing costs.

Paying an outstanding collection is not justification, in itself, that would establish an applicant has demonstrated a willingness to meet obligations in an acceptable manner. The lender's underwriter is required to determine the prospects of the applicant repaying the loan to be guaranteed by the Agency. If the lender establishes there were mitigating circumstances in regards to adverse credit in accordance with section 1980.345(d)(3), the underwriter may determine that it is not necessary to pay a collection account in order to establish the applicant's creditworthiness.

The lender need not document mitigating circumstances for any applicants who have a credit score of 620 or higher.

ENSURING QUALITY UNDERWRITING

Although the Agency is not responsible for underwriting individual Single Family Housing Guaranteed Loans, approved lenders will be periodically monitored for SFHGLP underwriting compliance. Existing lenders that exhibit high early delinquencies or high loan losses will be subjected to quality control reviews to ensure that agency underwriting standards are followed. Newly approved lenders will have their underwriting reviewed based on the criteria outlined in RD Instruction 1980-D, section 1980.309(g)(1).

QUICK REFERENCE GUIDE

Underwriting Topic	Who issues approval	Who documents compensating factors?	Are there minimum credit score benefits?
Debt Ratio Waivers	**Rural Development** Lender should submit a written debt ratio waiver request to the Agency with documented compensating factors	**Lender**	**660 and higher:** Stand alone compensating factor when additional risk layers are not present.
Payment Shock	**Lender**	**Lender**	**660 and higher:** Stand alone compensating factor for payment shock of 100% and above
Collection Accounts	**Lender**	**Lender**	**620 and higher:** No documentation or comments required by underwriter. **619 and below:** Underwriter must document that the adverse credit was temporary in nature and beyond the applicant's control and has been removed

Questions concerning this AN should be addressed to Kristina Zehr at (309) 452-0830 ext. 111, or Joaquin Tremols at (202) 720-1465. Their respective email addresses are kristina.zehr@wdc.usda.gov and joaquin.tremols@wdc.usda.gov.