

FHA New Criteria

After the real estate crash decimated the mortgage market, a tiny government agency has assumed an outsize role in the housing recovery. In 2006, the Federal Housing Administration—which insures home loans against default—backed just 3 percent of new home-purchase mortgages. But today, the agency insures nearly 3 out of every 10 new home loans. That’s because while banks have raised their lending standards, credit requirements for FHA-backed loans have remained fairly liberal. But after a recent actuarial study concluded that the housing swoon has dragged the agency’s reserves below its congressionally mandated level, the FHA is facing mounting political pressure to increase borrower requirements as well.

Shaun Donovan, secretary of housing and urban development, recently responded to such criticism by outlining a series of steps the agency plans to take to make sure its loans are available and safe. “We want to ensure that we are able to continue to support the housing market in the short term and provide access to homeownership over the long term, while minimizing the risk to the American taxpayer,” Donovan told a congressional committee in written testimony. Here are five things you need to know about the development.

1. More money down: The FHA’s low down-payment requirement—of just 3.5 percent—is one of the main reasons that agency-guaranteed loans have become so popular. Home loans without FHA backing can come with down payments anywhere from 10 to 20 percent, depending on the market, borrower, and other factors. But the FHA’s deteriorating balance sheet has triggered calls for the agency to force borrowers to put more cash down. Rep. Scott Garrett, a Republican from New Jersey, has introduced legislation that would boost the minimum down payment to 5 percent. In his testimony, Donovan indicated that the agency was considering higher down-payment requirements. “We have made the decision to exercise our authority to increase the upfront cash that a borrower has to bring to the table in an FHA-backed loan—to make sure that FHA borrowers have more ‘skin in the game’ and a stronger equity position in their loans,” Donovan said. The size of the potential increase remains unclear, but Donovan said additional details would be released in January. Keith Gumbinger of HSH.com said he expected down payments to increase only slightly, to 3.75 percent or perhaps 4 percent.

2. Higher fees: The major downside to getting an FHA-backed loan is that borrowers must pay into an insurance pool through upfront and annual fees. The agency uses the cash to reimburse lenders in the event of default. But with its cash reserves dwindling as more loans go bad, Donovan said the agency is considering increasing the insurance premiums as well. Although the current 1.75 percent upfront insurance premium remains below its statutory cap, the annual fee is already as high as the law allows it to go. “To protect against future uncertainty in market conditions, we are requesting authority from Congress to raise annual premiums, as this is one of the most effective means of raising capital for the fund with the least impact per borrower,” Donovan said.

3. Better credit: Donovan also said the agency would—at least for now—increase the minimum credit score for new borrowers. The FHA’s current minimum credit score is 500, and the agency did not detail the new threshold. But Guy Cecala, publisher of *Inside Mortgage*

Finance, said that even a more stringent FHA credit score requirement would have little impact on borrowers. In underwriting FHA-backed loans, lenders apply their own credit score requirements, which are significantly higher than the agency's minimum. "What's happened is Bank of America, JPMorgan Chase, whoever is making the FHA loan, has already imposed their own [minimum credit scores]," Cecala says. "And generally, nobody will make one [to a borrower with a credit score of] below 650."

4. Political concessions: Cecala says the development is an acknowledgment that the FHA was going to have to beef up its credit requirements one way or another. "It's basically a trade-off," Cecala says. The FHA is "saying if we do it ourselves it is going to be better than what Congress is potentially going to ram down our throat."

5. Impact: Gumbinger says that new guidelines will prevent some marginal buyers from buying homes. "There are some borrowers who might have been able to squeak in under the existing guidelines that just aren't going to make the cut anymore," he said. "That means that home sales are probably going to slow down a little bit as a result Of course, it also means that delinquencies and foreclosures will probably slow as well." Reduced foreclosure and delinquency rates will, of course, help ease the pressure on the FHA's finances .

Note: Please be aware that the above information is believed to be accurate as of this writing, July 12, 2010, but mortgage guidelines are consistently changing and a mortgage professional should be consulted for accuracy.