# FHA to toughen rules for borrowers

WASHINGTON – Dec. 2, 2009 – The Federal Housing Administration is proposing to increase the up-front cash paid by borrowers as part of an effort to shore up the agency's finances, which have been staggered by rising defaults in its flagship mortgage insurance program, according to FHA officials.

The changes also include raising minimum credit scores for borrowers who receive FHA-backed mortgages and limiting the amount of money sellers can kick in, including paying closing costs or giving free upgrades.

These measures are designed to increase the amount borrowers invest in the homes they buy, thereby making it less attractive for them to default on loans and walk away from properties, as many people have done during the current housing crisis.

Housing and Urban Development Secretary Shaun Donovan is scheduled to announce the agency's policy changes when he testifies Wednesday before the House Financial Services Committee.

The FHA has played a critical role in propping up the housing market by insuring lenders against default after the mortgage market unraveled. Currently, the agency backs about 30 percent of all loans for home purchases and 20 percent of refinancings. In the past, the FHA has resisted raising down payments or insurance premiums for fear of shutting out qualified borrowers and stunting the housing market's slow but steady recovery.

But Donovan plans to tell the House committee that the exploding volume of loans the FHA is now handling requires stricter risk controls than the previous administration had in place, according to a copy of his prepared testimony. A recent audit shows that the FHA's financial cushion already has eroded below the level required by law.

"We've learned from recent history that the market is fragile, and we have to plan for the unexpected," Donovan's prepared statement says. "That uncertainty is complicated by an organization we inherited that, to be honest, was simply not properly managing or monitoring its risk."

By requiring that borrowers bring more cash to the table, the agency is seeking to ensure they have "more skin in the game and a stronger equity position in their loans," Donovan says. But he does not specify the size of the proposed increase. FHA officials said they have yet to determine how much cash will be required.

"There are several ways to accomplish this, and so we are currently analyzing various options to determine which is the most effective and consistent with our mission," Donovan says.

Up-front cash can include down payments as well as other payments. For now, FHA borrowers can put down as little as 3.5 percent, a level that many FHA critics say is too low. One lawmaker has introduced legislation that would boost the minimum down payment to 5 percent.

As for seller concessions, the agency now allows sellers to kick in 6 percent of the home's value. Donovan said he wants the maximum permissible level to be lowered to 3 percent, in line with industry norms.

Agency staff is reviewing whether to increase the monthly insurance premiums charged to borrowers, officials said. These payments come on top of insurance paid up front.

The current up-front premium is set at 1.75 percent of the value of the loan. FHA may decide that an increase in that premium is needed also, officials said.

To protect itself against the riskiest borrowers, the agency has decided "for the time being" to raise its minimum credit score requirements for new borrowers. Again, FHA staff is still analyzing what the new threshold should be, Donovan's prepared testimony says.

The minimum credit score requirement is now so low – 500 out of a possible 850 – that it's basically irrelevant. Many lenders that make FHA-insured loans impose much tougher restrictions. The concern is that if FHA does not toughen up, abusive lenders will get away with financing risky, poor credit borrowers already rejected by more reputable lenders.

Most of the new initiatives do not require congressional approval. Many have previously been suggested by critics and even supporters of the agency.

These measures are meant to build on other actions the FHA has taken to curb its risk and beef up its eroding cash reserves.

An audit released last month found that the agency's cash reserves have shrunk to a level far below what is required by law, and the agency could need taxpayer funding if worst-case scenarios play out.

The audit, designed to measure the agency's financial health, examined the excess cash the agency must set aside to deal with unexpected losses and found that those reserves were at about $3.6 billion as of Sept. 30, a drop from the $12.9 billion available a year earlier. The current total represents 0.53 percent of all outstanding single-family-home loans insured by the FHA, well below the 2 percent threshold set by law. This is the first time reserves have fallen under that level since 1994.

To stop the financial erosion, the FHA has focused in part on weeding out abusive lenders. This year, the agency has suspended business with seven lenders, including the now-defunct Taylor, Bean and Whitaker. It has withdrawn FHA-approval for 270 others, including Lend America. On its Web site Tuesday, Lend America said it has ceased its loan origination and operations, effective immediately.

The FHA is currently working on a new rule that would require banks it does business with to have up to $2.5 million in capital that they can use to repay the agency for losses if they were involved in fraud. Now, they are required to hold only $250,000.

On Wednesday, Donovan will ask Congress to grant the agency more authority to close down abusive lenders.