



# Bankers Advisory

## COMPLIANCE MONITOR

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### **FHA Proposes FHA Loan Quality Assessment Methodology**

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September 16, 2014 the Federal Housing Administration (FHA) posted its proposed draft Loan Quality Assessment Methodology ("defect taxonomy") for feedback. The Loan Quality Assessment Methodology is one part of FHA's Blueprint for Access strategy announced earlier this year to expand access to mortgage credit for underserved borrowers.

The proposed Methodology is based on three core concepts:

1. Identifying a loan defect;
2. Capturing the sources and causes of the defect; and,
3. Assessing the severity level of the defect.

Additionally, the Methodology is comprised of nine proposed defects, their specific sources and causes, and four defect severity levels. FHA's overall Quality Assurance efforts, including the proposed Loan Quality Assessment Methodology, will provide transparency and consistency for lenders, and make it easier for stakeholders to do business with FHA.

To facilitate FHA's review and analysis of feedback, lenders and industry representatives are encouraged to use the Loan Quality Assessment Methodology Feedback Response Worksheet posted on the SF Drafting Table to record feedback. Submit your Feedback Response Worksheet to the special e-mail box for this purpose accessible from the SF Drafting Table web page by October 15, 2014.

### **FHA Blueprint for Access Strategy**

FHA's publication, Blueprint for Access, is highlighted below:

#### Qualified Borrowers Are Underserved

The economic crisis significantly constrained credit making it tough for anyone with less than perfect credit to obtain a mortgage. According to the Urban Institute, the average credit score for loans sold to the GSEs is 752. Currently, there are 13 million people with credit scores ranging from 580 to 680. Shutting these consumers out of the market hurts American families and undermines our efforts to build more stable communities, create pathways to the middle class, and increase homeownership opportunities for minority and low-wealth borrowers. A healthy mortgage market serves all qualified borrowers. FHA is committed to finding ways to responsibly increase access for underserved borrowers.

#### Principles to Responsibly Expand Access

To increase access, we must identify and implement responsible ways for creditworthy borrowers to obtain mortgage credit. This includes:

##### **Encouraging Housing Counseling**

Responsible access can be enhanced by ensuring borrowers are well-educated about the home- buying and mortgage finance process.

### **Establishing Clear Rules of the Road**

Lenders must be able to quantify the risk of making a mortgage loan. Taking steps to establish clear quality assurance policies helps ensure lenders can make loans without fear of unanticipated consequences.

### **Avoiding Unsound Lending Practices**

Facilitating access does not mean returning to the days of unsound lending practices. It means building on the reforms already

### **Loan Quality Assessment**

FHA is developing a new methodology for evaluating underwriting defects. The new criteria will be more descriptive—identifying a limited number of specific defects, their related causes, and levels of severity. Categorizing loan defect severity levels simplifies the compliance process as it allows lenders to better assess the risk posed by a specific deficiency. Additionally, assessing the quality of loans under this framework will allow lenders to more easily address the root causes of defects.

### **Loan Sampling**

Currently, FHA primarily selects higher-risk loans for review, e.g. loans evidencing payment challenges. FHA recognizes that this risk-based approach does not accurately reflect a lender's overall underwriting quality as it is primarily focused on non-performing loans. Going forward, we plan to expand our evaluation of loans to include random sampling of performing loans closer to the time of endorsement. This approach provides a more balanced view of underwriting quality.

### **Lender Performance Management**

FHA currently calculates a Lender Compare Ratio for all lenders. This ratio is geographically based, comparing the rate of early defaults and claims for single family loans in a geographic area to other mortgagees in the same area. FHA plans to introduce an additional national lender performance metric. This new Supplemental Performance Metric will assess lender performance based on the lender's default rate within three credit score bands and compare it to an FHA target rate, rather than to the lender's peers. Like the Compare Ratio, the new metric will be reported in Neighborhood Watch.

Introduction of the new performance metric, along with existing metrics and standards, will provide a more comprehensive assessment of lender performance. The draft Supplemental Performance Metric will be posted for review and feedback at Single Family Housing's Policy "Drafting Table" on HUD's website before being more formally implemented.

## **Proposed Quality Assessment Methodology**

The proposed methodology centers on three core concepts:

### **Identifying a defect**

There are nine fundamental characteristics of loan insurability that impact a loan's insurability, credit quality, and compliance; each of these fundamental characteristics would have one defect associated with it, for a total of nine defects.

### **Assessing the severity of the defect**

Severity is assigned to the individual instance of the defect, not to each individual source and cause; severity is driven by the impact to loan insurability.

### **Capturing the sources and causes of the defect**

A "defect" may be composed of one or many sources and causes found in the loan or in the input of loan file data into TOTAL; potential sources and causes of a defect vary by defect type.