

K&LNGAlert

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Mortgage Banking/Consumer Finance Commentary

USER FRIENDLY FHA: HUD Modifies and Streamlines Certain FHA Requirements

Over the past several months, Kirkpatrick & Lockhart Nicholson Graham LLP has kept you informed of efforts by the U.S. Department of Housing and Urban Development (“HUD” or “Department”) to modify and streamline certain Federal Housing Administration (“FHA”) requirements related to mortgage lenders. In June 2005, we issued a Client Alert summarizing HUD’s new requirements for case binder submission and late case endorsement requests. In the same month, we also issued a Client Alert describing HUD’s increased incentive payments related to a servicer’s loss mitigation actions, new electronic enhancements in connection with a mortgagee’s recertification fee and yearly verifications, and the addition of a fraud-reporting tool on HUD’s Neighborhood Watch Early Warning System Menu. Since June, HUD has issued a series of new Mortgagee Letters to introduce new FHA lender features or to modify existing obligations. With the recent decrease in FHA lending, these efforts highlight the Department’s attempt to regain FHA market share and to make FHA lending and compliance with HUD’s rules and regulations more user friendly. This Client Alert summarizes several FHA changes that we believe are designed to make FHA lending less burdensome for mortgage lenders.

ELECTRONIC SOCIAL SECURITY NUMBER VALIDATION

Beginning June 18, 2005, the Department validates, at no cost to lenders, borrowers’ social security numbers (“SSNs”) for consistency with borrower names and dates of birth in an effort to further reduce incidents of identity theft and fraud in FHA’s single-family mortgage insurance programs. As described in Mortgagee Letter 2005-27, once a lender enters a borrower’s name, SSN, and birth date into FHA Connection, the system queries various external databases to determine the validity, consistency, and correlation of the data elements. This online verification process provides an overall confidence rating in real time and gives lenders an opportunity during loan processing to correct this information prior to case number assignment.

If the borrower’s three data elements match information contained in external databases, FHA Connection automatically issues the lender an FHA case number and allows loan processing to continue. If the system fails to match the data elements, the system performs an overnight verification with the Social Security Administration (“SSA”) through the SSA’s database. If the SSA successfully verifies the borrower’s information, a case number is typically assigned the next business day. Should the overnight verification fail, lenders may obtain conclusive documentation from the borrower that the SSA’s database is in error. Once the relevant Homeownership Center (“HOC”) reviews this documentation and determines its validity, the HOC manually issues the lender a case number.

In connection with this new procedure, please also note that HUD has revised Form 92900-A (Addendum to the Uniform Residential Loan Application) to provide disclosure to the borrower, and obtain his or her consent, to verify an SSN against computer matching services. Mortgagees must use this revised form for all new loan applications taken on or after June 18, 2005.

UNDERWRITING SECTION 8 HOMEOWNERSHIP VOUCHERS

On July 29, 2005, HUD issued Mortgagee Letter 2005-32 to announce its modification of underwriting guidelines for loan applications where the buyer receives a monthly homeownership assistance payment under the housing choice voucher homeownership program. Specifically, lenders may now reduce the monthly mortgage payment amount by the amount of the assistance payment before dividing by the monthly income to determine the payment-to-income and debt-to-income ratios. To take advantage of this rule, however, lenders must ensure that the assistance payment funds do not pass through the hands of the buyer, but, instead, are either paid directly to the servicing lender or placed into an account that only the servicing lender may access. If the assistance payment funds are made directly to the buyer, the lender may only consider the amount as income in qualifying the borrower for an FHA loan. HUD stated that "FHA believes these new underwriting guidelines will increase homeownership opportunities for those homebuyers who receive Section 8 monthly homeownership assistance payments while not increasing the risk of borrower defaults on the mortgage."

REVISED APPRAISAL REPORTING AND PROTOCOL

On September 26, 2005, HUD issued Mortgagee Letter 2005-34, announcing that FHA is eliminating two of its appraisal-related forms and updating its appraisal protocol. Specifically, in an effort to reduce duplicative paperwork, FHA is adopting four of the revised appraisal reporting forms recently released by Fannie Mae. All appraisals of FHA properties, performed on or after January 1, 2006, must be reported on one of the Fannie Mae appraisal reporting forms designated by property type. The forms are available online at <http://www.efanniemae.com/index.jsp>.

Upon implementation, HUD will eliminate the Valuation Conditions and Homebuyer Summary forms currently in use, and all valuation conditions, including repairs, alterations and/or required inspections, must be reported within the appropriate section of the new Fannie Mae appraisal form. Once the lender receives the completed appraisal form, it must note any physical deficiency or adverse condition requiring repair or further inspection on HUD's Conditional Commitment Direct Endorsement Statement of Appraised Value form and provide a copy of this form to the borrower at least five business days prior to closing. The Department also reminds mortgagees to advise borrowers of their right to request and receive a copy of the completed appraisal report.

LENDER INSURANCE PROGRAM

In an effort to simplify the FHA endorsement process, on September 26, 2005, HUD announced its new FHA Lender Insurance ("LI") program to enable high-performing lenders with acceptable default and claim rates to endorse FHA mortgage loans for insurance without a pre-endorsement review by HUD. Beginning January 1, 2006, LI-approved mortgagees will perform their own pre-endorsement reviews and provide mortgage loan level data to FHA via the FHA Connection. FHA Connection then will perform an automated verification process to check the data for accuracy and completeness and automatically endorse the loan. FHA's system will generate a mortgage insurance certificate electronically to serve as evidence that the mortgage has been insured.

In addition to providing automatic endorsement, the electronic endorsement process is designed to eliminate the submission of case binders for every FHA loan. Under the new LI program, case binders will be required only if a loan is selected by HUD for a post-endorsement technical review ("PETR") or if the loan level data entered into the system suggests that the loan application must be reviewed by HUD before endorsement. In these cases, mortgagees may continue to submit case binders in paper or lenders may take advantage of a digi-

tized format. Both the electronic case binder and hard copy case binder, depending on the method selected by the mortgagee, must be submitted within five business days of FHA's transmittal request. Failure to submit five or more requested case binders to the applicable HOC could result in a suspension of the mortgagee's eligibility to submit files under the LI program.

To be eligible to participate in the LI program, a mortgagee must be an unconditionally approved Direct Endorsement ("DE") mortgagee and have two years acceptable default and claim rate. The acceptable claim/default rate is defined as at or below 150 percent of the national average. If, however, a mortgagee operates in only one state, it may use a compare rate in that state, rather than the national average. FHA will monitor a mortgagee's default and claim rate eligibility on a yearly basis. Once approved, if the mortgagee's claim/default performance continues to be acceptable and meets all other approval criteria for LI participation, the mortgagee's approval will be renewed for another year. Lenders may monitor their own default and claim performance through HUD's Neighborhood Watch Early Warning System.

Moreover, after a DE mortgagee elects to participate and is approved as an LI mortgagee, it must process and endorse for insurance all of the loans it originates or underwrites through LI. It must also conduct a "pre-insurance" review and do so using staff that neither originated nor underwrote the mortgage loan. This review must follow certain minimum requirements outlined in Mortgagee Letter 2005-36, including specific certifications and documentation. Although the new LI program is designed to significantly reduce the paperwork required for FHA endorsement, LI-approved lenders still must maintain, as they do now, their origination binder in either hard copy or electronic format for two years from the date of endorsement.

UP-FRONT MORTGAGE INSURANCE PREMIUMS

In Mortgagee Letter 2005-38, HUD announced that it will charge an up-front mortgage insurance premium ("UFMIP") for mortgages to be insured under Sections 234(c) (condominium loans) and 203(k) (rehabilitation loans) of the National Housing Act. HUD will charge the same 1.5 percent UFMIP rate on mortgages insured under Section 234(c) and 203(k) loans as it charges on mortgages insured in the Mutual Mortgage Insurance Fund. The procedure for remittance of UFMIP on Section 234(c) and 203(k) loans is also the same as Section 203(b). Although the effective date of this rule is December 28, 2005, all Section 234(c) and 203(k) mortgages are expected to be in full compliance with the final rule by January 1, 2006.

Moreover, effective October 11, 2005, mortgagees are now required to remit UFMIPs within 10 calendar days of loan closing or disbursement, whichever is later. As all mortgagees are now required to make UFMIP payments electronically, the Department shortened the remittance period by five days. This modification applies to all FHA mortgages requiring an UFMIP, except Section 255 Home Equity Conversion Mortgages. All mortgagees are expected to be in full compliance by November 1, 2005.

FHA LENDING AREAS AND NATIONWIDE LENDING

Prior to the Department's issuance of Mortgagee Letter 2005-40 on October 20, 2005, FHA guidelines restricted the geographic lending areas for mortgagees and loan correspondents such that a lender could not originate FHA loans from a single office location. With this Mortgagee Letter, however, FHA has made major changes to FHA lending areas to "provide more flexibility in how mortgagees can operate."

First, HUD expands all lending areas where each registered office can originate to all HUD field office jurisdictions within groups of states. Currently, when a mortgagee is approved by FHA to originate FHA loans, each registered office's origination activities are restricted to properties located within that office's "Lending Area," or "Areas Approved for Business." Based on these lending areas, a lender could achieve nationwide origination by selectively placing approximately 25 branch locations across the country. With HUD's changes, however, lending areas will now be composed of all HUD field office jurisdictions within groups of states, which the Department has determined will allow a mortgagee to better utilize its state licenses and serv-

ice a larger area with each mortgagee office. Instead of placing 25 branch locations across the country, the new lending areas will require as few as 13 branch offices to permit a lender to originate FHA loans nationwide. If a lender wishes to only originate loans in the 48 continental states and the District of Columbia, the number of branches is reduced to as few as 10 offices in some instances. Please be aware that the new lending areas identified in Mortgagee Letter 2005-40 are deemed to supercede the lending areas described in Appendix VI of HUD Handbook 4000.2, REV-3, dated May 20, 2004.

Second, HUD introduces direct nationwide lending to permit a mortgagee to originate FHA loans on a nationwide basis through a single office via the internet or a call center. In order to conduct direct nationwide lending, an FHA approved Title II mortgagee or loan correspondent must request a separate FHA branch identification number to be used for the sole purpose of direct nationwide lending. Each mortgagee is limited to only one branch number and must submit a fully executed Branch Office Notification form for review and approval. The direct operation also must have a separate manager and may be co-located in an existing office or established at a new location.

Moreover, the mortgagee must submit a request for direct nationwide lending on its letterhead and include a statement agreeing to originate only internet and/or call center mortgages through the branch identification number. The letter also must include a list of states in which the mortgagee will engage in direct FHA lending. As long as the mortgagee is properly licensed and meets all other state requirements, including physical presence, if applicable, FHA will grant approval to originate direct FHA loans in the states requested, which in some cases could include all states. The lender must also certify that: (1) it has updated its quality control plan to include specific elements related to direct lending; (2) it agrees to notify HUD in writing if it no longer meets the requirements of any states; and (3) neither it nor any of its officers, directors, or principals or employees have been denied a license or otherwise been sanctioned by any federal, state, or local agency or have been suspended, debarred, or otherwise denied participation in HUD programs. Once approved, if a mortgagee notifies HUD that it does not meet certain state law requirements, that state will be removed from the mortgagee's approved direct lending areas. These direct lending areas could differ considerably from those otherwise identified in Mortgagee Letter 2005-40 for standard FHA originations.

Please be aware that any branch offices approved after October 20, 2005 will receive automatic access to the new expanded lending areas. All other registered branch locations will receive this access within 30 days.

UNDERWRITING REFINANCE TRANSACTIONS

On October 31, 2005, HUD announced, in Mortgagee Letter 2005-43, several revised underwriting instructions regarding FHA refinance transactions. These changes take effect for mortgages endorsed on or after October 31, 2005. HUD stated that "these changes are designed to provide expanded alternatives for homeowners wishing to refinance their mortgages, and offer greater flexibility to mortgagees in processing and underwriting certain refinance transactions."

For cash-out refinance loans, FHA will now insure a cash-out refinance of up to 95% of the appraiser's estimate of value, provided certain eligibility conditions are met. These eligibility conditions require:

- The subject property to have been owned by the borrower as the principal residence for at least 12 months prior to the loan application;
- The borrower to have made all mortgage payments, if applicable, within the month due for the previous 12 months;
- The property securing the refinanced mortgage to be a one- or two-unit dwelling;

- Any subordinate financing to remain subordinate to the FHA insured first mortgage, regardless of the total indebtedness or combined loan-to-value ratio, provided the homeowner qualifies for making scheduled payments on all liens; and
- Any co-borrower being added to the note to be an occupant of the property.

For “no cash out” refinance loans and streamline refinance mortgages, the current underwriting instructions remain in effect, except for the following four modifications and additions: (1) the mortgage being refinanced must be current for the month due; (2) the mortgagee may include accrued late charges and escrow shortages in determining the existing debt as part of the mortgage amount calculation; (3) the borrower may not receive cash back at closing in excess of \$500; and (4) prepaid expenses may include the per diem interest to the end of the month on the new loan, hazard insurance premium deposits, monthly mortgage insurance premiums, and any real estate tax deposits needed to establish the escrow account. This final instruction applies regardless of whether the refinancing lender is also the servicing lender for the mortgage.

Moreover, in those cases where borrowers refinance their FHA mortgage to shorten the term of the loan, previous underwriting instructions provided for an allowance of \$50 before triggering a credit review. Due to the increase in mortgage amounts over the past several years, however, HUD considers \$50 to be “an unrealistic threshold.” As a result, HUD will now permit a mortgage on a principal residence to be refinanced to a shorter-term mortgage, provided the monthly principal and interest increases no more than twenty percent.

Finally, HUD is revising its underwriting instructions to permit an FHA-Hybrid Adjustable Rate Mortgage to be streamline refinanced to a fixed rate mortgage. A lender may underwrite this refinance transaction with or without an appraisal and provided that the payment will not increase by more than twenty percent. To be eligible, a borrower must have made all mortgage payments within the month due for the prior 12 months or all months since the mortgage was incurred, if shorter.

As FHA-approved lenders appear to be relying less on FHA lending, HUD recognizes that it is losing considerable market share in the mortgage industry. As a result, although the summaries above are not meant to be comprehensive, the Department is making changes and streamlining certain processes to make FHA lending more user friendly and the FHA loan a more competitive mortgage product. Although it is unclear whether these changes will provide the needed boost to allow HUD to regain a portion of the market, the Department appears to be committed to lessening certain administrative barriers to FHA lending.

If you have any questions about HUD’s new and modified FHA requirements or should you need assistance in connection with an FHA matter, please contact Phillip L. Schulman (202.778.9027 / pschulman@kling.com) or Holly M. Spencer (202.778.9853 / hspencer@kling.com).

MORTGAGE BANKING/CONSUMER FINANCE PRACTICE

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