



Guide to Understanding Mortgage Financing for NSP-Assisted Homebuyers

About this Tool

Description:

This guide provides NSP grantees and their partnering housing providers with information and best practices on ways to help potential homebuyers successfully obtain permanent mortgage financing in their market. This guide will help you understand the basics of permanent mortgage financing and the current mortgage lending landscape; apply that understanding to the design and implementation of local efforts; and, connect prospective buyers of NSP homes to the resources needed to successfully purchase properties.

Source of Document:

This document draws on *Fitting the Pieces Together: Using Public and Private Financing Tools with HOME-Assisted Homebuyer Programs*, and *NSP Homebuyer Programs: Financing and Long Term Affordability*. Both can be found on the [NSP Resource Exchange](#). The document was also enhanced with the insights and real-life observations of participants in the HUD-sponsored NSP Mortgage Financing Roundtables led by Enterprise Community Partners and the National Community Stabilization Trust in the summer of 2011.

Disclaimer:

This document is not an official HUD document and has not been reviewed by HUD counsel. It is provided for informational purposes only. Any binding agreement should be reviewed by attorneys for the parties to the agreement and must conform to state and local laws.

Additional NSP resources may be found at www.hud.gov/nspta

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Section 1: Today's Lending Landscape

Goal: Provide an overview of how the mortgage industry has changed, examine the key players, and explain how lenders evaluate borrower creditworthiness.

Due to the unprecedented upheaval in the housing market over the last several years, obtaining a permanent mortgage for homebuyers, particularly in markets experiencing economic and physical distress, has become a daunting challenge for NSP grantees. In response to the housing crisis, there has been a shift toward more conservative lending practices and a return to loan underwriting basics.

As a result of the many changes, today's mortgage industry is characterized by:

- Fewer and larger mortgage originators
- More responsible mortgage products and fewer exotic offerings
- A resurgence of FHA as a preferred and predictable product option
- Renewed reliance on Fannie Mae and Freddie Mac secondary market guidelines
- A return to underwriting fundamentals and tighter credit standards

But the mortgage industry today cannot be characterized as simply a return to the basics. The reality is that the mortgage industry is still reeling from high foreclosures and unprecedented loan losses. Originating lenders, secondary market buyers, mortgage insurers, and even FHA have responded to the crisis by offering more conservative mortgage products and cautious risk-adverse underwriting. As several lenders participating in the 2011 HUD-sponsored Mortgage Roundtable put it, "the mortgage pendulum has swung in the opposite direction, reflecting losses in the marketplace; in time, we will recalibrate the process."

However, rather than view the current lending climate as difficult, NSP grantees are encouraged to look to the many positives in the mortgage marketplace today, including:

- A low interest rate environment
- Historically very low, affordable housing prices
- Availability of responsible fixed-rate and adjustable-rate mortgage products with clear, upfront terms and pricing
- Flexible resources to provide soft second support for prospective homebuyers
- A growing cadre of public, nonprofit and for-profit partners working on neighborhood reclamation
- A gradual return of focus among many lenders to Community Reinvestment Act (CRA) and other community lending and investment motivations

Neighborhood stabilization campaigns may be promoted as markets of lending opportunity. As you engage mortgage lenders in your community, it will be important to highlight and contrast current neighborhood stabilization efforts with the high loan-to-value (LTV), high-risk lending practices that contributed to distressed and declining markets. NSP grantees need to help the mortgage industry to see how NSP activity is creating a more fertile lending environment of renovated homes and mortgage-ready borrowers.

So, what do you need to know as an NSP grantee to optimize mortgage opportunities for your homebuyers? To be successful with neighborhood stabilization activities, grantees must understand how the mortgage landscape has changed and be knowledgeable about:

- Designing an NSP program and how the structure of financial subsidy impacts homebuyer financing opportunities
- Understanding which mortgage products and secondary market options – FHA or conventional – make the most sense for your borrowers
- Promoting the value of your neighborhood stabilization efforts in terms mortgage lenders understand in order to secure strong mortgage lender participation

The Return of the 3 “Cs”

During the days of exotic mortgage products and “no doc” (little or no documentation) lending, it seemed as if the mortgage industry had lost its connection with the key elements of sound loan underwriting. Today, however, there is a return to more traditional underwriting and credit standards for borrowers, with a heavy reliance upon the Three Cs – Credit, Capacity, and Collateral.

Credit

Lenders review the credit reputation of borrowers to determine a willingness and ability to repay a mortgage. A key component to predicting a borrower’s ability to repay a mortgage is reflected in a borrower’s “credit score” or FICO credit score. This score, which can range from 300 to 850, is heavily influenced by the following factors:

- Credit accounts: type, age, limits, usage, and status of revolving accounts
- Borrower's request for new credit in last 12 months
- Credit delinquencies, repossessions, collections, or charge-offs
- Foreclosures, bankruptcies, liens and/or judgments
- Mortgage delinquencies

When reviewing credit scores, lenders will use credit reports from the three major credit reporting bureaus: Equifax, Experian, and Transunion. The middle score between the three bureaus is generally used for underwriting purposes. For FHA-insured mortgages, most lenders are unlikely to approve many borrowers with scores below 620, especially if the level of borrower equity is low. Obtaining a conventional mortgage with favorable lending terms in the current market might require a credit score

that is above 680, or in some cases, over 700. Fannie Mae's My Community Mortgage and Freddie Mac's Home Possible Mortgage will permit credit scores to 620, making these products a highly suitable option for use with NSP lending programs where the loan-to-value is typically at or below 80 percent. (For more detail on these products, see Section 3.)

But keep in mind that while current lending standards call for credit scores that are much higher than in the recent past, the loan determination will depend on many factors beyond the score itself. Other factors as described below will also play a role in the lending decision.

Capacity

A lender will ask a borrower to fully document all assets and all sources of regular, predictable income to understand the borrower's ability to pay. In the course of this analysis, a lender will consider the following:

- Debt ratios: qualifying monthly housing expense-to-income ratio and/or monthly total debt payment-to-income ratio
- Salaried versus self-employed borrower (a self-employed borrower can be viewed as more risky and will often need to provide a two year history of stable income, among other requirements)
- Amount of savings
- Number of borrowers

Collateral

The lender must also determine the value of the asset underlying the loans – often a difficult proposition in a neighborhood stabilization environment – as well as the equity being contributed by various sources. The following factors affect this analysis:

- Borrower's total equity investment (down payment, closing costs) from credible and verifiable sources
- Other contributed soft and subordinate financing, including federal NSP assistance
- Property type: a 1-unit or 2- to 4-unit detached property, condominium unit or manufactured home
- Property use: primary residence, second home or investment property
- And, first and foremost, the property appraiser's determination of market value

One of the most common methods that appraisers use to estimate the value of single-family property is comparable sales; that is, past history of market sales in the near vicinity. While this practice makes sense in most markets, NSP grantees may want to discuss trends in the neighborhood with appraisers and share plans for renovating and improving the community that will have an impact on housing prices in that particular market. A valuation approach that relies too heavily on past transactions may hinder reclamation efforts by depressing house values and discouraging lender interest.

The lender will make a loan decision based upon an assessment of the layering of such credit, capital and collateral risk factors, often using sophisticated automated underwriting engines. These automated underwriting tools will be discussed in Section 3 of this guide.

During the summer of 2011, Enterprise Community Partners and the National Community Stabilization Trust conducted six regional roundtables for NSP grantees and mortgage lenders to discuss issues related to securing mortgages for NSP-assisted homebuyers and to craft practical solutions to increase private mortgage lending in NSP markets. Lessons learned from these interactive discussions will be shared throughout this document.

Roundtable Insights: Appraisals

Low appraisals were frequently cited as a serious hindrance to resale efforts for Grantees at all six regional mortgage roundtables. Grantees frequently stated that low valuations by appraisers on fully renovated NSP properties appeared to be due in part to the use of blighted or even vacant non-rehabbed properties as the “comps”. In addition, local appraisers were often unaware of neighborhood stabilization programs. Low valuations can greatly increase the amount of subsidy to be left in projects, reducing program income, and preclude access to mortgage capital for potential homebuyers. Difficulty in obtaining a mortgage due to low appraisals, in turn, lessens housing demand, making lower values in the NSP market inevitable. While the appraisal issues is outside of a lender’s sphere of control, Grantees have been successful in securing more fair valuations by educating appraisers on NSP homes. Grantees shared several tested solutions to mitigating the appraisal factor for their NSP sales:

- Educate appraisers on NSP homes – quality of and standards applied to rehab, green construction, energy efficiency – to help create fairer valuations.
- Host a workshop, roundtable, or seminar for local appraisers and real estate professionals to learn about your local program.
- Establish a special designation for local appraisers with an understanding of the nuances of conducting property valuations in declining markets and experience with NSP homes (i.e. NSP appraisers).
- Engage lenders and local appraisal management companies to limit the number of appraisers working on NSP properties to a core team of appraisers with experience working on subsidized properties, while still complying with the Home Valuation Code of Conduct (HVCC).
- Collaborate with the state appraiser licensing board to convene trainings on NSP valuations.
- Document and appeal appraisals with the lender when valuations come in too low, by collecting geographically closer or more relevant comps and present them to loan officer.
- Focus on rehab activity to specific blocks to control comps and valuations, and increase the overall value of targeted blocks as activities are concentrated.

Key Takeaway: Lenders will evaluate a borrower’s ability to repay a loan by assessing credit, capacity, and collateral. Understanding the basics of each component will help NSP grantees have a better understanding of what mortgage lenders are looking for and how they can help prepare more potential homebuyers.

Understanding the Primary and Secondary Market

Goal: Provide information on what lenders may do with a loan once they originate it. Understanding their strategies can help NSP grantees partner more effectively with lenders in their market.

Most homebuyers principally interact with one primary entity in the mortgage market – the mortgage lender. The mortgage lender will serve as the chief point of contact with the borrower, conveying all relevant lending terms and conditions; that happens whether the mortgage is being originated by a local commercial bank, a mortgage company or a credit union, or a national, multi-faceted financial institution. Think of the mortgage lender as the “front office” for an entire industry of providers.

In order to help homebuyers successfully obtain mortgage financing and reshape hard hit neighborhoods, the NSP grantee must understand the broader mortgage market and the motivations of the primary market lender, as well as other industry organizations, including, where applicable, the role of secondary market players, and mortgage insurers.

Depending on the type of institution and their lending objectives, lenders typically fund loans from either:

- The lender’s assets and the loan is “held on the books” (e.g., a portfolio loan), or
- The lender’s assets or short-term lines of credit from institutional investors to fund loans that are then sold in the secondary market

Banks will sometimes portfolio loans due to loan characteristics that would make selling the mortgages in the secondary market difficult or financially unattractive, or because they are motivated by community and investment factors. In a neighborhood stabilization program, such portfolio products may often include greater lending flexibility due to homebuyer counseling, higher loan-to-values, or elimination of mortgage insurance.

More frequently, however, mortgage lenders will originate a loan with the intent of selling it to a secondary market investor, such as Freddie Mac or Fannie Mae. Being able to sell mortgages in the secondary market allows the lender to maintain liquidity, while earning revenue off of the origination fees and servicing rights. In order to sell that loan in the secondary market, the primary lender will need to adhere to the underwriting and credit criteria and mortgage product terms and conditions established by the secondary market buyer.

Fannie Mae and Freddie Mac can only purchase loans from lenders with loan-to-values in excess of 80 percent of the appraised market value if the purchases are credit-enhanced. This “loan protection” is most often provided by private mortgage insurers. As such, lender loan decisions will be influenced by the risk tolerance of their institution, the secondary market buyer, and the private mortgage insurer.

Role of the GSEs – Fannie Mae and Freddie Mac

For private, conventional loans, the dominant secondary market investors are Fannie Mae and Freddie Mac, sometimes referred to as the Government Sponsored Enterprises (GSEs). In fact, Fannie Mae and Freddie Mac purchase more than 70 percent of all mortgage loans originated in today’s market.

Fannie Mae and Freddie Mac provide liquidity, stability, and affordability to the mortgage market. These agencies, currently regulated by the Federal Housing Finance Authority (FHFA), were chartered by Congress expressly to purchase mortgages from banks and mortgage lenders to increase liquidity in the primary market. Freddie Mac and Fannie Mae’s core activities include:

- ❑ Setting underwriting standards for loans eligible for purchase
- ❑ Standardizing the forms, requirements and processes for mortgage origination
- ❑ Creating mortgage-backed securities sold to capital investors to refuel the mortgage marketplace

While the long term future of Fannie Mae and Freddie Mac is uncertain, for the next few years these two large industry-setting institutions will likely remain essential to the mortgage lending industry.

Role of FHA

The Federal Housing Agency (FHA) has played a pivotal role in stabilizing the housing market. FHA, an office within the U.S. Department of Housing and Urban Development (HUD), provides mortgage insurance on loans made by FHA-approved lenders on single family and multifamily homes, including manufactured homes and hospitals, throughout the United States. It is the largest insurer of mortgages in the world, insuring over 34 million properties since its inception in 1934.

Historically, FHA-insured mortgages have been a key product for first-time homebuyers, offering low down payment levels and more flexible credit requirements. In today’s market, FHA-insured loans are now very popular financing products for many types of homebuyers, comprising over 40 percent of all new loan originations. FHA-insured loans are a strong option for many borrowers within the NSP program.

The Government National Mortgage Association (Ginnie Mae) serves as the secondary market for government-insured loans (FHA or VA).

Most national mortgage lenders and many regional and community lenders will offer a range of Fannie Mae or Freddie Mac mortgages, as well as FHA mortgage products. Determining what mortgage path and product are right for specific borrowers will be covered in Section 3 of this guide.

Key Takeaway: Talk to lenders in your area to understand their loan origination strategies and product offerings. Ask lenders whether specialized portfolio products are available and whether they tend to originate conventional or FHA loans. The approach they take will impact your borrower’s ability to obtain mortgage financing.

Section 2: NSP Program and Subsidy Design Options

Goal: Provide information on the pros and cons of two NSP homebuyer program design options. By understanding the implications each approach has on mortgage financing for your borrowers, NSP grantees can create a program that effectively meets their goals.

There are two fundamental approaches to creating an NSP homebuyer program – direct to homebuyer and turnkey development. Each approach will have significant implications regarding the form of mortgage financing for the homebuyer. Many NSP grantees leverage both approaches to meet homebuyer needs and provide more options for neighborhood revitalization in their market.

Direct to Homebuyer

In a direct to homebuyer approach, the homebuyer purchases the foreclosed or abandoned property directly from the servicer, often with some NSP down payment and other subsidy assistance.

The direct to homebuyer approach would typically be used when certain conditions exist, including:

- The properties being purchased are in relatively good physical condition
- There is high demand for homes in the NSP markets among eligible buyers
- Sufficient financing in the market seems to be available for purchase mortgages and/or purchase/renovation mortgages
- The market area is relatively large and public and private capital available for property redevelopment is sufficient

There are a limited number of mortgage products that can wrap the renovation costs into a 30-year fixed-rate mortgage, permitting the construction to be amortized over the life of the mortgage. Many lenders are inexperienced and uncomfortable with taking on the risks associated with property repairs as part of a long-term mortgage.

When purchase and renovation mortgages are made available, these specialized purchase and renovation mortgages permit a deferral of monthly principal and interest payments for a fixed period of time (typically six months or less), particularly if the homebuyers must temporarily live elsewhere until the improvements have been completed. Mortgage fees for such purchase and renovation mortgages can be somewhat higher, including costs associated with additional loan processing, an after-rehab appraisal, renovation escrow, construction management responsibilities, and other renovation-related costs. Please see the *Mortgage Products for NSP Homebuyers* section for information on the FHA 203(k) Rehabilitation Mortgage.

Turnkey Development

In a turnkey approach, the NSP grantee or designee locates the house, then purchases, renovates, and sells the property to a qualified homebuyer.

In many ways, the turnkey approach is an easier, more comprehensive approach for many NSP grantees and their clients. Key benefits of the turnkey approach include the following:

- Homebuyer mortgage financing is easier to secure because the property has been fully renovated prior to purchase. Lenders are generally adverse to mortgage financing that incorporates moderate to major renovation
- Because the property is fully renovated, it's more attractive to potential buyers, which increases the likelihood of a sale at a healthy price
- The NSP provider selects the property so there is no question that the location is within the target area
- Counseling is integrated into the turnkey approach, which makes the path easier and more defined for the borrower
- Relationships have been established with both mortgage lenders and real estate professionals to promote the program and identify available housing and mortgage finance options
- The turnkey approach can provide a smoother, coordinated effort, in which all parties are prepared to move the borrower through each stage of the process

Key Takeaway: Consider the pros and cons of each NSP approach. Generally, it will prove easier to access permanent and affordable mortgage financing when property renovation needs have already been accomplished. Implementing both design options may be the best choice for your program, where property conditions warrant and a variety of mortgage products are readily available.

Using NSP to Help Homebuyers

Goal: Provide information on how NSP grantees can provide loans, subsidies, and guarantees to help potential homebuyers obtain mortgage financing.

Once an NSP grantee has defined its target neighborhoods and the population its program is designed to serve, it is important for the NSP grantee to understand the obstacles potential homebuyers may face when attempting to secure permanent mortgage financing. For example, consider the following questions:

- Do clients have significant credit deficiencies that might prevent loan qualification?
- Do clients lack resources for down payment or closing costs?
- Do clients have steady income but at a level insufficient to carry monthly payment requirements?

- Do clients require more education and assistance to understand the home buying process, resolve credit or other issues, and identify affordable homes?
- Is additional financial subsidy necessary to attract income eligible and qualified clients to NSP target neighborhoods?

By identifying the issues and possible solutions, NSP grantees are better able to work closely with lending partners that are willing to extend conventional financing with flexible parameters in conjunction with program goals.

NSP direct assistance can be structured to help potential borrowers that have difficulties with one or more of the 3 Cs – credit, capacity, or collateral. Subsidy options provided to potential homebuyers can:

- Assist homebuyers who lack upfront resources with down payment and closing costs
- Reduce the mortgage amount to reduce monthly payments
- Help overcome credit-related hurdles (through guarantees)

Overcoming the Affordability and Cash-to-Close Barriers to Homeownership

Many potential homebuyers who are otherwise qualified do not have sufficient personal savings to cover the required down payment and settlement cost for a typical home purchase. These same buyers may also find that there is a gap between their personal buying power and the actual purchase price of the home they wish to buy.

NSP grantees have a unique opportunity to assist families overcome these common barriers to home ownership. By layering the NSP assistance with a combination of the buyer’s personal resources, private mortgage financing, and/or other state and local housing assistance resources, many low- and moderate-income buyers who felt homeownership was beyond their reach can achieve their home buying goals.

NSP grantees can design homeownership programs that incorporate the resources and strategies described below. Please see *Appendix A* for a summary of these forms of direct and indirect financial assistance to homebuyers.

Down Payment and Closing Cost Assistance

NSP grantees can use NSP funds to provide up to 50 percent of the down payment or closing cost assistance directly to potential homebuyers. This direct assistance can be structured as an amortizing loan, a deferred payment loan, or in some instances, as a grant.

In the current lending environment, it is important for homebuyers to enter into the home buying transaction with some “skin in the game,” which means a contribution of the borrower’s own funds. Lenders will want to see a meaningful equity contribution from the borrower, even in instances where considerable subsidy support is being made available. Each NSP grantee should determine what level of personal contribution will result in a meaningful investment from the homebuyer. This contribution amount may vary based on demographics and market conditions.

With this in mind, a grant would typically not be an eligible use of NSP funding and is not always viewed by lenders in today's market as acceptable as the sole source of contribution from a borrower.

A deferred payment loan requires an enforceable commitment from the homebuyer, does not add to the monthly obligations of the borrower, and is well understood and accepted by primary and secondary market financial institutions.

Deferred payment loans are also a good way to accomplish the following:

- Achieve flexibility with the subsidy structure (can be designed as repayable or forgivable, interest bearing or non-interest bearing, with flexible payment schedule)
- Enforce residency and resale restrictions to prevent windfall gain, as appropriate
- Recoup all or a portion of NSP assistance at sale or transfer of the property

To ensure that NSP grantees can help the maximum number of homebuyers through this type of program, the level of subsidy provided per borrower should be based on the minimum down payment requirements to secure conventional financing. That is why it is important to have local lenders as active partners – to understand what level of down payment will be required for the products that are the best match for NSP-assisted homebuyers.

When NSP is used to assist with closing costs, it may not reduce monthly obligations of the borrower. However, this assistance can be very helpful to ensure that homebuyers are able to retain sufficient liquid assets (cash reserves) after loan closing for unexpected expenses.

Principal Reduction or "Gap Financing"

Many low- and moderate-income homebuyers have difficulty of overcoming the "affordability gap," which is difference between the buyer's mortgage capacity and typical home prices in the market. Grantees can help homebuyers to bridge this "affordability gap" by layering the NSP assistance into the purchase transaction. Normally this is done through "gap financing," where NSP assistance takes the form of a subordinate loan that reduces the principal amount of the first mortgage.

"Gap financing" is often perceived as simply another version of down payment assistance; that is, the grantee is providing a subsidy significant enough to help the borrower qualify for the prospective mortgage needed to purchase the desired home. NSP grantees typically structure principal reduction subsidies or "gap financing" as deferred loans to reduce the first mortgage amount borrowed. Gap financing through a deferred loan is an attractive option in several ways:

- Reduces the first mortgage lender's risk when the loan-to-value ratio is decreased
- If the LTV is reduced below 80 percent, the borrower will not be required to carry mortgage insurance, which eliminates a monthly expense and increases buying power.
- Does not add to the borrower's monthly carrying costs while permitting partial or full repayment at a future date

- Accommodates, if necessary, additional rehabilitation costs

Seller Concessions

Another way to help potential homebuyers overcome the cash-to-close barrier is through a seller concession (sometimes called a seller-credit). Both FHA and conventional underwriting guidelines allow the property seller to credit up to three percent of the home purchase toward the buyer's recurring and non-recurring closing costs. In many markets, seller concessions are extremely common. The credit is negotiated by the homebuyer (or their real estate professional on behalf of the homebuyer) as part of the initial purchase contract. It is reasonable for the homebuyer to request the credit in the initial offer to the seller. If it is not accepted, further negotiations in the counter-offer stage related to price and other contract terms may result in the credit being approved. It should be noted that a seller credit can never be used to meet the borrower's minimum equity contribution requirement or to pay off debt needed to qualify for the loan.

Alternative Borrower Contributions

NSP program applicants should be counseled to consider all of the forms of equity that they can personally and prudently contribute to the home purchase. Both conventional and FHA underwriting guidelines allow for a wide-range of assets that may be counted toward the borrower's contribution include:

- Properly documented gift funds
- Withdrawals from retirement savings plans
- Proceeds from sale of assets
- Funds accumulated for a seasonal or part-time job
- Income tax refunds, employer assistance programs
- Matched savings programs (Individual Development Accounts)

Rebate Pricing

In some instances, the interest rate on the first mortgage selected by the homebuyer may result in the availability of a lender-paid rebate to the homebuyer, funds that can be applied to all but loan-related closing costs. Rebate pricing is the opposite of "paying points," which act to lower the mortgage interest rate. An interest rate that generates a rebate is by definition a higher-than-market interest rate. In a particular situation, a rebate may be more useful to the homebuyer's ability to close the purchase than a slightly lower interest rate would be. The mortgage loan originator or housing counselor can help the homebuyer by providing a simple cost-benefit analysis of using this approach.

Mortgage Credit Certificates

In many communities, local and state housing finance agencies offer Mortgage Credit Certificates (MCCs) to first-time homebuyers. MCCs allocate federal income tax credits that homebuyers can use as

long as they own the home. The credit, typically between 15 to 20 percent of the mortgage interest paid in the prior tax year, is applied by homebuyers each year when they file their federal income taxes. This credit reduces the actual taxes that homebuyers owe, increasing their ability to make mortgage payments.

The dollar value of an MCC can be used during the initial loan underwriting to help boost the homebuyer's purchasing power. Freddie Mac and FHA guidelines allow the monthly value of the credit to be deducted from the borrower's PITI (Principal, Interest, Taxes and Insurance) calculation. Fannie Mae allows the value of an MCC to be counted as additional borrower income. Either way, the MCC is a powerful tool for expanding an NSP participant's homebuying power. Contact your state or local housing finance agency for more information on MCCs in your area. Contact information can be found on the websites of the National Council of State Housing Finance Agencies' website www.ncsha.org and the National Association of Local Housing Finance Agencies (www.nahlfa.org).

Options for Credit-Challenged Borrowers

Borrowers with credit deficiencies may be the most difficult to assist. In some instances, when lenders are unwilling to make loans due to the credit profile of a potential borrower, NSP grantees can pledge NSP funds to guarantee loans or contribute to borrower reserves to balance the credit challenges.

Loan Loss Reserve

A loan loss reserve is a written promise to pay the lender some percentage of the outstanding principal balance in the event the borrower defaults. NSP funds can be deposited into a guarantee account held by the lender.

Continued Counseling

Borrowers with non-qualifying credit scores can make relatively quick changes to their credit profiles that can raise their scores to qualifying levels. These changes can include paying down the balances on their revolving credit accounts, bringing past-due accounts current, settling or paying off collection accounts and correcting erroneous information on the credit file. Many mortgage loan originators will help clients through this "rapid re-score" process. It is no longer necessary for a borrower to wait passively many months for his or her credit scores to rise. All three credit bureaus now cooperate with reporting agencies, lenders and borrowers to rapidly (e.g. 10 days or less) re-score credit files when the proper documentation is presented.

NSP grantees may also want to recommend further credit counseling for some borrowers, beyond the minimum 8 hours of homebuyer education required in the Neighborhood Stabilization Program, prior to home purchase and post-purchase. During longer-term credit counseling, a housing counselor can assist the potential homebuyer in identifying ways to pay down non-mortgage debts, improve payment history, or resolve credit report challenges that are adversely affecting credit scoring.

Please see *Appendix A* for a summary of structures, in both direct and indirect ways, that NSP grantees can provide financing assistance to homebuyers.

Subordinate Financing Requirements

NSP grantees and the homebuyers receiving assistance will have an easier time securing permanent mortgage financing if the subsidy structure doesn't cause any concerns for mortgage lenders and fits within the secondary marketing guidelines for "soft seconds."

Keeping the form of assistance simple to understand and implement is important. Deferred loans for down payment and closing cost assistance or principal reduction are the cleanest secondary financing option with conventional first mortgages. Deferred loans may be structured with a number of flexible features including:

- Zero interest or a very low simple interest rate
- In lieu of charging interest, the subsidy provider may want a "share in the appreciation" of the property
- Payment deferral for the first 5 to 10 years
- No payment at all for the entire term of the loan, but full principal repayment at sale of the property, or change in occupancy whichever occurs first
- Forgiveness of the debt, either partially or fully over a period of time
- Accrual of interest is not allowed during period when payments on the loan are deferred (negative amortization)

Soft second financing can come from the following approved sources:

- Federal, state, or local municipal authority or agency
- State or local housing finance agencies.
- Community-based non-profit organization
- Employer (if part of a company-wide Employer Housing Assistance Program)
- Federal Home Loan Bank (FHLB) affordable housing program

Roundtable Insights: Gap Financing – A Need-Based Subsidy Approach

One way to minimize the amount of NSP assistance in order to qualify borrowers is “gap” financing, in which initial principal amount the assistance is adjusted to the amount necessary (up to a stated maximum) to bridge the affordability gap experienced by the home buyer. Adopting this approach may allow the NSP grantee to help more home buyers.

The best way to ensure that each borrower receives a sufficient level of assistance is to establish a minimum housing debt-to-income (“front-end”) ratio, below which the amount of NSP assistance available will be reduced.

For example, an NSP grantee may decide after an assessment of their housing market that homeowners should reasonably expend at least 28 percent of their gross monthly income on housing costs. Normally, this includes the principal and interest payments of the mortgage, property taxes, insurances, HOA fees (if applicable), but could also include a utility allowance. This standard ratio would be used to determine the amount of NSP subsidy the borrower would be eligible to receive in order to reach the 28 percent threshold, up to the maximum amount of assistance available through the program. If upon reviewing the borrower’s application the grantee finds that the amount of assistance requested by the lender for the applicant will bring the front end ratio below the minimum 28 percent threshold, the grantee would inform the lender and applicant that the NSP assistance will be reduced and the first mortgage loan amount must be increased to the point where the housing expense ratio is at least 28 percent. This approach will conserve NSP funds to help more prospective homebuyers.

Preserving Affordability - Recapture Versus Resale Approaches

NSP imposes requirements that are designed to ensure that assisted properties remain affordable to income-eligible occupants for a certain period of time. NSP grantees can choose to structure the homebuyer soft seconds either through a recapture structure or through resale requirements.

Recapture

The recapture approach can be used to recover all or a portion of the NSP assistance to the homebuyer when a property is sold or transferred. The homeowner may sell the property to any buyer at any price the market will bear. Once recapture of the NSP assistance is made at sale, the properties no longer will be subject to requirements under a long-term affordability period. This is a market-oriented option for NSP grantees that seek to increase buyer demand for NSP renovated homes in distressed market areas without limiting future market values.

Resale Restrictions

NSP assistance used in combination with resale restrictions provides the assurance that NSP-assisted properties will remain affordable under the full term of the affordability period, even upon subsequent sale or transfer to a new owner. Using this option, when a homeowner subsequently seeks to sell their home, the NSP grantee will require the homeowner to sell to another income-eligible borrower or establish a fixed affordable price to the property sale.

This option is typically used in high cost or rapidly appreciating housing markets. As such, it may not be a beneficial approach in distressed NSP target neighborhoods, where a primary program goal is to stabilize or increase housing values. Additionally, the provisions of any recapture restrictions must be

subordinate to the rights of the first lien holder in the event of a foreclosure, making the resale approach a less desirable option for most lenders given its inherent level of complexity.

Soft Second Approval Process for Conventional Financing

The terms and conditions of the NSP soft second structure must be approved by the first mortgage originator to ensure the secondary market requirements are met. Both Fannie Mae and Freddie Mac allow deferred repayment loans from public agencies and not-profit organizations under their Community Seconds (Fannie Mae) or Affordable Seconds (Freddie Mac) guidelines. Although soft seconds that fit the GSEs' requirements can be used in conjunction with first-lien products without GSE review or approval, primary mortgage lenders will often have their own review and approval process for soft second programs.

For compliance with conventional financing, NSP programs must follow these requirements:

- If interest is charged on the NSP subsidy (subordinate lien), the interest rate cannot be higher than two points above the interest rate of the first mortgage
- The NSP subsidy may not provide for negative amortization (accrual of interest during a period when payments on the loan are deferred) or provide rights in advance of the first mortgage
- While the combined loan-to-value (CLTV) of the first mortgage and the NSP subsidy cannot exceed 105 percent of the property value, NSP strongly discourages any NSP home to have a CLTV above 100 percent
- The NSP subsidy may not require a balloon payment that is earlier than 15 years after the note date of the first mortgage or the maturity date of the first mortgage
- Be aware of any covenants or deed restrictions that would restrict the use or resale of the property
- The NSP subsidy may not require both interest and shared appreciation
- There are often limits on the amount of shared appreciation the subsidy provider can receive

When the NSP grantee requires payment of the soft second by the borrower before month 61 of the loan (5 years), at origination the lender will be required to include the NSP soft second loan as debt in their debt-to-income ratio calculations, thereby negating the benefit of the assistance provided. If this scenario can be avoided by the grantee, it greatly improves the homebuyer's chances of qualifying for the first mortgage amount.

While the soft second approach of the GSEs is relatively straight-forward, many originating lenders have adopted specific soft second review requirements that are more complex than the GSE provisions, sometimes with multiple layers of review. The level of complexity of these requirements varies considerably among mortgage lenders. It is important to inquire with lenders as to their baseline requirements, how centralized or delegated is the soft second review and approval process, and what is the time frame for a lender's review. Many lenders will readily accept soft second structures for NSP activity, particularly if: 1) the same subsidy approach was used by the housing provider for previous housing and community development initiatives; and 2) this approach was approved by the lender.

Roundtable Insights: Structuring Soft Second Programs

The main advice from participating lenders at the roundtables: keep it simple. The more complicated the subordinate financing, the less likely it is lenders will participate. When soft second programs are structured similar to HOME or CDGB-funded assistance, lenders will typically be able to streamline the review process.

Here are other things that Grantees should be aware of when it comes to gaining lender approval for soft second programs:

- Even if your program meets the minimum GSE requirements, be aware that lenders add on additional overlays
- Lenders have to approve every subsidy program, even small tweaks. Although you may have had a similar program in the past the lender has approved, new programs do have to be reviewed and individually approved
- Deed restrictions or other covenants that might restrict marketability of a property are very unpopular with lenders and GSEs. Most lenders will not consider deed restricted executions, unless those restrictions extinguish upon a foreclosure
- Most lenders cannot accommodate negative amortizing subsidy programs (accrual of interest is not allowed during period when payments on the loan are deferred) or loans that require a balloon payment prior to resale

Soft Second Approval Process for Government Financing

Government-insured loans – FHA or VA mortgages – have somewhat different secondary financing requirements than conventional loans.

FHA Loans

While down payment assistance programs used in connection with FHA single family mortgages has historically been capped at serving households with an income limit of 115 percent of the area median income (AMI), HUD has granted a waiver for the NSP program so that FHA single family mortgage can be used to assist borrowers up to 120 percent AMI will be approved.

- If the soft second mortgage is offered through a government agency or a non-profit acting on behalf of the government, the soft second may be used to cover all or a portion of the down payment and closing costs, including the borrower's minimum investment. If it is through any other non-profit or a private entity, the borrower must still make their minimum investment per standard FHA requirements. Please note that NSP funds can cover up to 50 percent of the down payment assistance needed to make the transaction viable.
- The subordinate lien must be in the name of the eligible subsidy provider. It may not be made in the name of the lender or any other "agent."

If, with the subordinate lien, resale restrictions are imposed on the borrower, those restrictions must terminate in the event of a foreclosure or deed-in-lieu of foreclosure.

Down payment assistance for FHA loans can come from the following providers:

- **Nonprofit and Nonprofit Instrumentality of Government:** Nonprofits and Nonprofit Instrumentalities of Government that provide down payment assistance (also known as Downpayment Assistance Providers or DAPs) in the form of a lien in conjunction with an FHA first mortgage lien must be approved by HUD.
- **Government Entity DAPs:** No approval is required for Government Entities that provide secondary financing in the form of a lien in conjunction with an FHA first mortgage lien. HUD does not maintain a list of Government Entity DAPs. Mortgage lenders are responsible for assuring that a Government Entity DAP meets all appropriate FHA requirements.
- **Gift Programs:** FHA does not "approve" down payment assistance programs in the form of gifts administered by charitable organizations (i.e., nonprofits). Mortgage lenders are responsible for ensuring that the gift to the homebuyer from the charitable organization meets the appropriate FHA requirements and the transfer of funds is properly documented.

VA Loans

- Generally, the VA requires the lender to simply confirm that the veteran benefits from the community second.
- VA does not require their approval of a community seconds program offered through a government entity.
- Programs offered through non-profits or private entities must be directly approved by the VA.

Key Takeaway: There are many ways that NSP grantees can use the program to assist borrowers with mortgage financing, but straight-forward subsidy structures such as the deferred payment loan forgiven incrementally over time or repaid at sale or transfer of the property will likely generate the most success in attracting lender participation in your program. It is critical that you understand the options and work with the lenders in your community to determine the right solution for each borrower.

Section 3: Mortgage Products for NSP Homebuyers

Goal: Provide an overview of available mortgage products and options for NSP borrowers. By understanding the common mortgage products, NSP grantees can more easily discuss options with borrowers and lenders.

Though there may be fewer mortgage products in the marketplace today than in the past, there are still plenty of options for borrowers. This section provides high-level information on the general characteristics of conventional/conforming mortgages and FHA mortgages.

For detailed information, grantees should speak with their local community lenders and visit the following websites for mortgage product details:

[Freddie Mac](http://www.freddiemac.com) (www.freddiemac.com)

[Fannie Mae](http://www.fanniemae.com) (www.fanniemae.com)

[Federal Housing Administration](http://www.hud.gov) (FHA) (www.hud.gov)

Conventional/Conforming Products

A conventional loan is generally defined as a mortgage loan that is not directly guaranteed or insured by the U.S. government (FHA, VA or USDA), whether held in portfolio or sold in the secondary market. A conforming loan is a loan that conforms to Fannie Mae's and Freddie Mac's loan requirements. Lenders often originate conventional/conforming loans in order to permit the subsequent sale of the loan to the GSEs. When originating conforming loans, lenders must follow the underwriting criteria set by the GSEs to ensure that the loans meet the GSEs' standards for purchase. GSE guidelines for such loans change frequently, so lenders sometimes take a conservative approach in order to ensure marketability.

Automated Underwriting

To aid lenders in ensuring that they meet GSE underwriting standards and to improve quality control, the GSEs make available to originators the use of an automated underwriting system. Some national mortgage lenders maintain their own automated underwriting system, but most conventional lending is reviewed through Freddie Mac's Loan Prospector® or Fannie Mae's Desktop Underwriter®. Automated underwriting is a technology-based analytical tool that combines historical loan performance, statistical models, and an assessment of layered risk factors to determine whether a loan can be sold into the secondary market.

Mortgage originators use automated underwriting to help them:

- Evaluate the credit, collateral and capacity of borrowers to make their monthly mortgage payments
- Identify the appropriate type of loan for the borrower
- Evaluate multiple risk factors in a consistent and predictable manner
- Determine the terms under which the loan can be sold into the secondary market

Automated underwriting tools have been proven to save time and improve the quality of the risk assessment. However, they are not failsafe and may, on occasion, miss borrower circumstances that may support a mortgage approval. For example, the automated underwriting systems typically do not take into consideration homebuyer counseling/education benefits.

Mortgage Insurance

Private mortgage insurance (PMI) is another important component to loan origination. Private MI is extra insurance that lenders require from most homebuyers who obtain loans that are more than 80 percent of their new home's value, or loan-to-value (LTV). The purpose of private mortgage insurance is to protect the lender or the subsequent owner of the loan against loss if borrowers default on a loan.

Conventional loans with LTVs equal to or above 80 percent must have private MI or another form of credit enhancement in order to be purchased by Fannie Mae or Freddie Mac.

For low- to moderate-income homebuyers, private MI creates the possibility of attaining conventional mortgage financing with as little as a 5 percent down payment.

The following are general features of private MI:

- Monthly premiums are fixed at loan origination
- The annual amount paid toward mortgage insurance is tax deductible for homeowners
- The underwriting requirements of private mortgage insurers are generally stricter than FHA guidelines (FHA is government mortgage insurance), although the differences are narrowing
- By law, private MI is cancelable when the borrower's Loan-to-Value ratio reaches below 80 percent.

Private MI versus FHA

The premium on private mortgage insurance is generally less than the cost of FHA mortgage insurance. Some private MI providers will allow deferred repayment ("silent") subordinate financing from governmental or non-profit entities when the LTV on the first mortgage will be over 80 percent. In many cases, this will be a lower cost approach than utilizing an FHA loan; the cost of the monthly MI premium on an FHA loan is higher and it is more difficult to cancel in the future. Additionally, unlike FHA, conventional loans with private MI do not require an upfront mortgage insurance premium.

GSEs' Conforming Affordable Mortgages

Both Fannie Mae and Freddie Mac have affordable mortgage products that have underwriting flexibilities designed for borrowers that meet certain income criteria and/or are looking to purchase a home in certain underserved geographic locations.

The GSEs offer flexible affordable mortgage products through Fannie Mae's [MyCommunity Mortgage](#)[®] and Freddie Mac's [Home Possible](#)[®] [Mortgage](#). Many of the national primary market originators offer affordable mortgage products under a variety of names, but the underlying underwriting standards are often based on the requirements for MyCommunity Mortgages or Home Possible Mortgages.

General guidelines include the following:

- ❑ 30-or 40-year fixed rate.
- ❑ Minimum, middle FICO credit score of 620 or higher. Generally, however, higher credit scores will be necessary in tighter credit environment. Depending on other borrower and loan characteristics, a credit score of 660 or higher is more typical in today's lending market.
- ❑ Borrowers with no established credit may be able to utilize non-traditional credit references (typically four are required including a rental housing rating). Borrowers with serious past credit problems (e.g., bankruptcy) require at least four years of re-established, positive credit history.
- ❑ Single-qualifying debt-to-income ratio of 45 percent with manual underwriting (higher ratios possible with very strong compensating factors and automated underwriting approval. Loans must go through automated underwriting first.)
- ❑ Borrower must have stable and durable income sources typically described as full-time employment in the same line of work (not necessarily same employer) for two years or other incomes source that can be documented and will continue for at least three more years (e.g., child support income, permanent disability benefits, etc.).
- ❑ Sufficient properly documented assets to cover the minimum required down payment and two months of housing reserves.
- ❑ Loans with LTVs above 80 percent require private mortgage insurance.
- ❑ Mortgage insurance can be financed into mortgage up to 97 percent LTV with the Fannie Mae MyCommunity Mortgage product and up to 95 percent with Freddie Mac's Home Possible product.
- ❑ For the Fannie Mae MyCommunity Mortgage product, the combined loan-to-value (CLTV) can reach as high as 105 percent with an approved soft second. Freddie Mac's Home Possible loan caps the maximum LTV and CLTV at 95 percent. NSP discourages the practice of exceeding 100 percent for the CLTV.
- ❑ The Fannie Mae MyCommunity Mortgage product will finance up to 95 percent of the home purchase price and current guidelines do not stipulate a minimum borrower contribution from their own sourced and seasoned funds. While in theory, the entire down payment requirement can be met through silent seconds), NSP funds can only provide up to 50 percent of the down payment requirement. Additionally, MyCommunity allows a combined or total loan-to-value of up to 103%. However, NSP discourages TLTVs above 100 percent.
- ❑ The Freddie Mac Home Possible product will finance up to 95 percent of the home purchase price. The balance of the required down payment must be from properly documented and sourced borrower contributions, gift funds and grants from approved entities, it may not come from secondary financing (soft seconds) sources. Additionally, Home Possible restricts both the LTV and CLTV to 95 percent. However, closing costs can be covered through seller or other interested-party concessions, between three to nine percent of the home purchase price.

Both Fannie Mae and Freddie Mac's suite of regular mortgage products can be utilized in NSP programs as well. The principal difference between the regular line of conventional loans and their community lending programs (Home Possible and My Community Mortgage), is that a minimum 5 percent borrower contribution is always required in their regular loan programs. It should be noted that where a larger personal contribution from the borrower is possible, the overall loan costs will typically be more favorable.

FHA Mortgage Products

FHA offers purchase mortgages that can be effectively utilized in NSP programs. The two FHA products that can be used are the 203(b) and 203(k) programs. The 203(b) mortgage is a purchase only loan and the 203(k) is a purchase-rehabilitation loan.

Like the GSEs, FHA has made changes to FHA-insured mortgages to ensure their sustainability. In some ways, the changes make FHA-insured loans more comparable to conventional financing. The changes include the following:

- ❑ FHA loans require mortgage insurance regardless of the loan-to-value. There are two components to the FHA mortgage insurance requirements:
 - **Up-Front Mortgage Insurance** – The current up-front premium is one percent of the loan amount. This up-front premium may be paid as part of the borrower's total closing costs, but more typically it is financed into the loan amount.
 - **Monthly Mortgage Insurance** – The cost of the monthly mortgage insurance is currently 1.150% of the loan amount and is included in the borrower's monthly payment (principal amount of loan x 1.15 percent / 12 Months = Monthly Premium).
- ❑ *Proposed change:* Seller concessions may be reduced from 6 to 3 percent.

An FHA loan is a viable option for an NSP-assisted homebuyer particularly when the LTV is above 80 percent and a conventional loan with private mortgage insurance is not available to the borrower. The key elements of an FHA loan that make it a good product for many first-time homebuyers or other low-to moderate-income families include the following:

- ❑ FHA loans will finance 96.5 percent of the home purchase as opposed to the 95 percent LTV limit on conventional loans.
- ❑ FHA guidelines currently permit the entire down payment requirement to be satisfied with an NSP grant or silent loans, as long as the assistance comes from a governmental or non-profit entity. NSP, however, requires that up to 50 percent of the down payment requirement is satisfied with NSP funds.
- ❑ FHA loans offer credit flexibility in some areas that are not permitted under conventional underwriting guidelines, including that lenders often will accept a minimum FICO credit score of 620 for FHA, a borrower with a bankruptcy requires only two years of re-established credit after

the discharge date, and applicants with no established tradeline credit references may be approved using non-traditional credit references.

- ❑ Flexible qualifying debt-to-income ratios beyond 45 percent (usual convention loan cap) are possible with compensating factors and automated underwriting approval.
- ❑ No post-closing reserve requirements (helpful for cash-strapped borrowers).
- ❑ Non-occupant co-signers are permitted. The co-signer income and credit can replace 100 percent of the income and credit requirements of the actual borrower. However, it should be noted that co-signers are typically not allowed in community lending programs and depending on how local NSP grantees have created their program this flexibility may not be available.
- ❑ FHA underwriting guidelines allow for the exclusion of some deferred repayment of non-housing debt, such as student loans that are in deferral. This can boost the buying power of borrowers with student loan debt that is not currently in repayment (conventional underwriting would require that these payments be included in the debt-to-income calculations even if the payment is currently in deferral).
- ❑ FHA is often called a “story loan” – lenders can use “common sense” underwriting guidelines as opposed to following more conventional rules. This means that a borrower with a strong, well-documented explanation for unusual income, assets, or credit profiles may be approved for an FHA loan. The interpretation and application of this flexibility varies among FHA lenders so it is important to develop relationships with a variety of lenders with experience underwriting FHA loans.

FHA 203(b) Program

A common misconception is that FHA insurance is limited to a single product, but there are actually a number of FHA products available. FHA 203(b) mortgage is the most prevalent and provides mortgage insurance for a household to purchase or refinance a principal residence. The mortgage loan is funded by a lending institution, such as a mortgage company, bank, savings and loan association and the mortgage is insured by HUD. The key features include:

- ❑ 15- or 30-year purchase mortgage or refinance of principal residence
- ❑ Eligible properties are one-to-four unit structures
- ❑ 3.5 percent down payment

FHA 203(k) Program

The 203(k) program is HUD's primary program for the rehabilitation and repair of single-family properties. As such, it is an important tool for community and neighborhood revitalization and for expanding homeownership opportunities.

With many NSP grantees sharing the concern about housing quality issues related to homes purchased, the 203(k) loan may be an effective tool since some or all of the rehabilitation costs can be financed into the final loan amount.

With the 203(k) program, homeowners can address a range of renovation, from minor to substantial rehabilitation. There is a \$5,000 renovation minimum. The total mortgage amount (purchase and renovation) must fall below the FHA mortgage limit for the area. The value of the property is either (1) the value of the property before rehab plus the cost of rehab, or (2) 110 percent of the appraised value of the property after rehab, whichever is less. NSP, however, does not encourage practices that exceed 100 percent TLTV. Additionally, up to six months of principal, interest, taxes and insurance (PITI) may be incorporated into the mortgage payment.

Typically, lender fees are higher for 203(k) loans than the basic single family mortgage insurance product to cover costs associated with origination, preparation of work specifications and cost estimates, construction management reviews, escrow management and higher appraisal fees.

While the 203(k) program has historically been time consuming to underwrite, FHA's *Streamlined 203(k)* program is easier to implement. It permits homebuyers to finance up to an additional \$35,000 into their mortgage to improve or upgrade their home before move-in. The Streamlined 203(k) is much simpler. Borrowers are not required to hire consultants and/or architects to prepare work specifications and loan originator oversight is less onerous. Up to two payments can be made to the contractor from a rehab escrow.

But use caution with the Streamlined 203(K) product: work must commence within 30 days of closing and all work must be completed within six months. With this new product, homebuyers can tap into cash to pay for property repairs or improvements.

For more information on the FHA 203(k) Mortgage or FHA's Streamline 203(k) Mortgage visit [HUD's website \(www.hud.gov\)](http://www.hud.gov) or [contact your local HUD representative](#).

Finding the Right Product Fit

By understanding the features of affordable mortgage products, NSP grantees can help homebuyers choose the mortgage product that best meets their needs. Below is an assessment of the factors to consider when determining whether conventional financing or government financing is the best match for your NSP-assisted homebuyer. Please see *Appendix B* for an assessment of each product given the credit profile of the NSP applicant.

When a Conventional Loan Makes the Most Sense

In some cases, a conventional loan will be the lowest-cost financing strategy for homebuyers utilizing NSP financing assistance. For qualified borrowers, the savings on up-front and monthly mortgage insurance premiums over an FHA loan can increase buying power and decrease monthly mortgage expenses. Additionally, loan documentation and processing times for conventional products can be faster, with less extensive appraisal requirements.

When determining if a conventional loan is the best fit for a NSP applicant, the following guidelines should be considered:

- Borrower has a satisfactory credit history, with a minimum FICO score of at least 620, and more likely more than 660. Many lenders will establish a higher credit score threshold if the mortgage is being sold in the secondary market and/or requires mortgage insurance
- No borrower bankruptcy, foreclosure or other serious credit issues within the last four years
- The borrower's total debt-to-income ratio does not exceed 45 percent without significant compensating factors
- The borrower has documented income sources that are stable and durable and sufficiently verified assets for the minimum required down payment and post-closing reserves
- As a result of the NSP assistance and/or the borrower's contribution, the loan-to-value is 80 percent or less OR the LTV exceeds 80 percent but private mortgage insurance is available

When an FHA Loan Makes the Most Sense

In many markets, FHA financing is the default choice for lenders participating in first-time homebuyer or other community lending programs. FHA is a well-understood mortgage product and some lenders may not have access to conventional or portfolio mortgage programs.

FHA loans can make sense for many borrowers utilizing NSP assistance in the purchase of their first home. An FHA loan may be the best fit for an NSP applicant when the following conditions are present:

- Borrower's documented assets are limited but sufficient for the minimum down payment requirement (3.5 percent of purchase price, or less if NSP or gift funds are available) and/or the LTV is likely to be 95 percent or higher.
- Borrower has a minimum, middle FICO score of at least 620 and all serious derogatory credit instances (e.g., bankruptcy) are at least two years old and the borrower has re-established a positive credit history.
- Borrower is able to document stable income sources.
- Borrower needs to utilize a non-occupant co-signer to qualify and/or borrower has large amounts of deferred student loan debt.
- Borrower has a unique credit, income, or asset profile that would not meet conventional underwriting rules but can be reasonably explained and supported with documentation.
- If, after including the NSP assistance and the borrower's contribution, the LTV will exceed 80 percent AND it has been determined that the borrower does not qualify for private mortgage insurance on a conventional loan (as noted above, private mortgage insurance underwriting requirements are tougher than FHA guidelines), then an FHA loan will likely be the only option.

Roundtable Insights:

Grantees shared that to ensure homebuyers are placed in the most appropriate mortgage product; it is helpful to follow up with lenders on a case-by-case basis as to why specific products are used for NSP-buyers. This can help a grantee gain familiarity with lending requirements and make program refinements, if necessary, to assist more homebuyers successfully secure financing.

Lender Portfolio Products

In some markets, lenders may offer mortgage products with more flexible underwriting features than conforming affordable products in order to increase lending activity and meet CRA obligations. These are proprietary mortgage products that a bank will hold in portfolio because their terms do not make them salable to the secondary market. These products are often income-restricted or geographic specific. For example, a portfolio product may be offered by a financial institution only for eligible borrowers with incomes below 80 percent of the Area Median Income (AMI) or the property must be in a low- to moderate-income (LMI) census tract.

Portfolio products may reduce qualification barriers for borrowers and/or increase the affordability of homeownership, by accommodating higher LTVs, lowering acceptable credit thresholds, not requiring mortgage insurance so monthly payments are reduced, or using less stringent requirements for income or credit history (for example, only looking at previous 12 months of income rather than requiring 24 months history). Many such portfolio products offer increased flexibility due to the existence of homebuyer preparation.

There are a growing number of portfolio-held products targeting NSP target markets and LMI communities, which expand financing options for NSP-borrowers. Grantees may want to ask their community lenders if there are portfolio products that might be right for borrowers in the NSP program. Be aware of the following potential disadvantages:

- CRA-specific or portfolio products may be priced higher than conforming affordable products
- Availability will vary across lenders and from market to market
- If products are geographically targeted to specific LMI census tracts, they may not be available borrowers across the entirety of a local NSP program's target area
- Income eligibility guidelines may be more restrictive than NSP requirements (e.g., borrowers may be at 80 percent AMI vs. 120 percent AMI)
- Portfolio products often come with a limited dollar amount of mortgage origination volume or fixed timeline before the product offering expires

Roundtable Insights: Availability of Mortgage Products Beyond FHA

A number of roundtable participants expressed frustration that in their market only FHA mortgage financing was available, which limited borrower flexibility. However, in almost every roundtable, one or more lenders made reference to new or recently revised portfolio products specifically designed for underserved or distressed neighborhood markets. Several portfolio products were offered by community banks, by several large regional mortgage originators, and even large national banks. NSP grantees are encouraged to check periodically to determine what might be available in your local market.

Lease-to-Own Products

While there are a number of affordable mortgage products available in the market, for some borrowers, homeownership may still not be immediately attainable with financing through these products. Also, in some hard hit neighborhoods, demand among qualified borrowers may not be strong. In such situations, NSP grantees may want to consider a lease-to-own program using specialized mortgage products.

With the lease-to-own option (sometimes referred to as contract-for-deed or a lease-purchase), a qualified non-profit organization takes out a permanent mortgage on a rehabilitated property and holds the mortgage on the home. The non-profit then leases the home to a tenant who would like to purchase the property in the future. Typically, all or a portion of the rental payments are applied as equity into the property; after 1 to 5 years, depending upon the agreement, the tenant assumes the mortgage and becomes a homeowner.

The lease-to-own option can be administratively cumbersome and requires a strong real estate management capability. But, it remains a viable solution for non-profits and prospective homebuyers when more traditional mortgage programs are not available. This is especially true in a credit-tightened market.

Lease-to-own programs can have the following benefits:

Allows families to access the positive benefits of homeownership sooner

- Enables tenant-purchasers with blemished credit and/or a lack of cash for the downpayment and closing costs, but with sufficient income to support housing payments, to move into a home to their liking immediately and rebuild their credit during the lease-purchase period
- Provides tenant-purchasers with credit and homeownership counseling during the lease period
- Builds equity for the tenant-purchaser from the onset of the lease period

The Self Help Credit Union offers a special Lease-to-Own Program specifically designed for NSP activity. More information may be found on their website at www.self-help.org. Mortgage Revenue Bonds

State and local housing finance agencies (HFAs) provide below-market interest rate home loans for first-time homebuyers through the issuance of tax-exempt mortgage revenue bonds. The lower interest rate provides buyers with more purchasing power. It should be noted that recent conditions in the bond

market reduced the availability of housing finance agencies to issue tax-exempt mortgage revenue bonds. As such, MRB program offerings from housing agencies have been limited. Moreover, uncharacteristically low mortgage rates may render such products less attractive. Still, NSP grantees should contact their state and local HFAs to learn about their current program offerings and encourage lender participation when appropriate.

Key Takeaway: The first step to finding the right mortgage product for your homebuyer is to find a lender(s) offering responsible mortgage products. The second step is getting your soft seconds program approved by the lender. And finally, you should take into consideration your homebuyer's financing needs in order to determine if an FHA or conventional mortgage is the best option.

Section 4: Working With Lenders in Your Community

Goal: Provide ideas on how NSP grantees can work with lenders in their communities to facilitate mortgage financing for NSP-assisted homebuyers.

Developing strong relationships with lenders in the community is a key component to a successful program for NSP grantees. Communication and understanding between grantees and lenders can create true partnerships in which each side can help the other to be more successful. A well-designed NSP program can offer tangible benefits to private lenders, and it is important that grantees articulate the value proposition of NSP-assisted lending to mortgage originators.

Key Criteria to Consider When Engaging Lenders

Grantees should take an informed approach to engaging lender partners. Understanding mortgage products and underwriting guidelines is important, but it is also necessary to determine which lenders are knowledgeable regarding local market dynamics and have motivation to act as participating originators for NSP-assisted homebuyers.

Going Local or National

Grantees must do research on which lending institutions are most active in the community. It will likely be a combination of large national lending institutions and smaller community or regional banks and mortgage companies. Depending on the type of institution, these lenders will be driven by different factors to serve the community and will bring different resources to NSP-assisted homebuyers:

- Local lenders may have a strong, vested interest in serving the specific communities in which the majority of their business is based, but may lack experience with affordable lending products, or may have limited portfolio lending capacity or limited flexibility to access secondary market lending waivers and exceptions.
- National lenders may have varied ties to the community, but have a deeper breadth of experience with affordable lending programs and working with subsidies, and may have business or regulatory obligations to fulfill for service within the community. These lenders may also have underwriting flexibilities or loan costs that smaller lenders may not be able to match.

Grantees must ask the right questions to find out more about a lender's goals and strategies. When meeting with lenders within your community, consider asking the following questions:

- Is this community a growth market for your financial institution?
- Do you plan to open more branches?
- Are you looking for new sources of qualified borrowers to grow your mortgage lending?
- Do you service your originated loans? If yes, do you have a loss mitigation office?
- How can we support your Community Reinvestment Act (CRA) goals?

Beyond the importance of determining the willingness of a lender to be a partner, NSP grantees should also assess the value that the lender can bring to NSP-assisted homebuyers. Grantees should take the following areas into consideration when assessing lender partners:

- Learn about the products available from both national and local lenders; identify products that best suit the buyer characteristics in your NSP program
- Be aware of a lender's requirements for soft second products and understand the differences between private and FHA soft second requirements. Also, for larger financial institutions, determine where those soft second and product decisions are made – locally or way up the corporate ladder
- Find out if national or regional banks or mortgage companies are looking to acquire local banks or mortgage companies or are seeking to open new branches; your organization can help them identify potential projects, understand the community, and help banks with CRA-eligible projects
- Do these lenders sell off all originations to the secondary market or do they portfolio some of them on their own balance sheets?
- What was each lender's last CRA assessment grade for mortgage lending? Those at the top want to stay there; those at the bottom want to improve. Offer to help make that happen through a partnership. (Tip: visit the [Federal Financial Institutions Examination Council](#) (FFIEC) website for the CRA ratings from all the regulators.)

Adopted in 1977, the Community Reinvestment Act (CRA) is intended to encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods. Financial institutions have requirements to meet CRA standards, consistent with safety and soundness of operations. The majority of mortgages are now being originated by financial institutions with CRA responsibility. That is good news for NSP grantees since a significant number of loans will likely count toward a lender's CRA requirement.

In addition, regulatory agencies are increasing their guidance on the interplay between neighborhood stabilization and foreclosure mitigation and activities eligible for CRA credit for investment, lending, and service. In 2010, the Office of the Comptroller of the Currency came out with important new financial institution guidance that clarifies CRA applicability in neighborhood stabilization initiatives. This guidance covers NSP program activity for the CRA lending, investment and service criteria.

Promoting NSP Benefits

It is important for NSP grantees to understand, from the lender's point of view, the advantages and disadvantages to originating loans as part of the local NSP program. Then the grantee can concentrate on selling the positive attributes of the program to potential lending partners and offer transparency about potential program downsides.

Securing mortgage financing for prospective homebuyers starts with selling the concentrated neighborhood recovery effort itself, helping to eliminate property abandonment and reverse declining home value trends.

Next, NSP grantees need to help the mortgage industry see how NSP activity is creating a fertile lending environment. The mortgage industry will need to understand that NSP grantees have the ability to use flexible funding to help homebuyers qualify for the right mortgage. Mortgage lenders need to view prospective homebuyers as pre-qualified, financially responsible consumers often buying a fully renovated home. These homebuyers are coming to the closing table with equity, flexible down payment assistance, and comprehensive homeownership education preparation.

Emphasize the Advantages of NSP-Assisted Homebuyers

- Borrowers have received extensive homeownership education and counseling, required of all NSP-assisted homebuyers.
- In turnkey developer programs, the home has been fully renovated, often to very high standards that greatly exceed minimum code requirements.
- Direct NSP assistance is often provided to homebuyers reducing the first mortgage loan amount, improving loan-to-value ratios, and lowering monthly borrower payments, thereby decreasing exposure for the lender.
- Lenders can strengthen their community ties and can gain recognition for stabilizing their community.

These additional considerations can help grantees strengthen relationships with lenders in their community:

- Be willing to discuss empathetically with these lenders the pressures NSP-assisted homebuyers are facing due to restricted credit availability. Discuss ways to help these lenders “find” truly qualified borrowers through NSP.
- Help lenders understand that most of your NSP borrowers need a basic mortgage – not necessarily a rehabilitation product.
- Offer to help lenders stay up to date on the changes in federal subsidy programs – provide them with information on eligible income ranges and geographic requirements.
- Find out if the lenders in your community have a Community Outreach officer, a CRA officer, and/or a Community Affairs office. If so, these people should be your first contacts to discuss mortgage lending in your neighborhoods. Let them know what the NSP program is doing; share examples of the program’s successes and discuss ongoing needs.

The Value of Public Relations

In the wake of the housing crisis and economic recession, the remaining, active financial institutions in the market want to enhance their corporate reputation and community visibility. Help highlight the public visibility they will receive as a partner in your NSP program.

Increasingly, banks and top mortgage lending firms want to be seen as part of the solution and embrace public relation opportunities where they can participate in positive programs and events. Holding highly visible events with state or local officials and inviting the participating lenders to share the podium is an effective way for your lending partner to garner much valued publicity.

Key Takeaway: Use your local power as catalysts for community change. Increasing the engagement of mortgage lenders in NSP markets begins with relationship building and clarity of purpose. Meet with your lenders and sell the compelling opportunities that supporting NSP efforts provides mortgage lenders.

Roundtable Insights: Lender Collaborations

Although conventional lending standards have become more stringent, the primary lenders participating in the roundtables indicated that they have the willingness and vested interest in providing mortgage financing to NSP-assisted homebuyers and other qualified homebuyers in NSP target neighborhoods.

Some grantees at the roundtables voiced concern about a pattern of not getting enough traction with loan officers or branch managers at local retail branches, many of whom are without sufficient knowledge of affordable or flexible mortgage products or understanding of NSP. Many local branch staff are not aware of the affordable products offered by their institution. Grantees reported that lender responsiveness improved when specific loan officers that specializing in originating the institution's designated affordable or community mortgage products were utilized.

Grantees and lenders emphasized the importance of developing ongoing relationships with and sticking to a core group of dedicated lender contacts that have knowledge of and experience with their financial institution's affordable or community lending programs and, more importantly, have been educated and kept up-to-date on your local NSP efforts.

For many lenders, a good starting point of contact is the local or regional community development or community relationship representative, who may be able to assist you soft second program review and approval and facilitating connections to dedicated loan officers with expertise in the lender's affordable or community lending programs.

Grantees who indicated that they had strong working relationships with lenders for their programs confirmed the core strategies that proved successful getting collaborative lenders into the fold:

- **Outreach:** Prepare lender-oriented informational materials on the key features of your NSP program, such as brochures, FAQs, or cheat sheets that provide all the information a lender would need at hand to understand your program.
- **Education:** Convene training sessions for local loan officers. Grantees have found that it can be helpful to facilitate these meetings through the bank's community development/community relations staff.
- **Visibility:** Employ strategies to 'give credit' to active lenders and raise their visibility by making them easy to identify for NSP-homebuyers. One of the easiest resources to for grantees to create and for prospective homebuyers to access is to include contact information, and if available, corresponding product information, for active lenders with NSP experience on your program's website.

Appendix A: Financial Subsidy Structures

Homebuyer Financing Options	Description
Direct Grantee Lending	
Grants or forgivable loans	Grantee directly provides grant funds that do not need to be repaid or provides forgivable loans that are forgiven on a pro-rata or other basis over time. For example, a \$20,000 secondary mortgage might be forgiven at \$2,000 a year over a 10-year period, so long as the household remains in the unit.
Amortizing first position (senior) loans	Grantee directly lends funds that are typically paid back on a monthly basis, usually with some interest payment. While uncommon, the grantee might provide the first mortgage when no private financing is provided.
Amortizing second or lower position (junior or subordinate) loans	Grantee directly lends funds where there is also NSP financing and that other financing has a senior lien position. This typically occurs when there is a private first mortgage and a HOME or NSP second mortgage.
Deferred payment loans	Grantee directly lends funds that are not repaid until a specific point in time or activity occurs, such as the subsequent sale of the home, with or without interest.
Tools to Make Private Loans More Affordable	
Down payment assistance for principal reduction	Grantee uses NSP funds to write down the loan amount that a private lender provides. Example: Assume a homebuyer needs \$100,000 to buy a home, but can only afford the payments on a \$60,000 mortgage. The grantee could provide NSP assistance or other public subsidy to the lender to write down the difference. #
Interest rate write-downs	Grantee provides assistance to a private lender so that it is able to make a first mortgage to a homebuyer at a lower interest rate. Example: Assume the market interest rate is 7 percent, but the homebuyer cannot afford the monthly payment at this rate. The grantee provides an interest rate buy-down to the lender so that the effective interest rate is 2 percent, making the monthly payment affordable.
Private mortgage insurance	Grantee pays insurance premium to a private mortgage insurance (PMI) company, which makes a loan guarantee to the private lender (allowed if paid up-front for first year only). PMI is required only on those mortgage loans exceeding 80 percent of property value.
Loan loss reserves	An amount of funds held in a reserve as a percentage of a lender's total loans on the balance sheet. The amount held represents the amount thought to be adequate to cover estimated losses in the loan portfolio.

Appendix B: Right Product Fit – Conventional vs. FHA

The table below provides an assessment of the factors to consider when determining whether conventional financing or government financing is the best match for your NSP-assisted homebuyer.

If NSP Borrower Has This Credit Profile...	Then This Type of Financing Should Be Considered...
Borrower has good credit history, with a minimum FICO score of 660 to 680	CONVENTIONAL FINANCING
No bankruptcy, foreclosure or serious credit issues in the last 4 years	
Total DTI (debt-to-income) ratio doesn't exceed 45%	
Borrower can make at least a 5% downpayment	
Documented income sources	
LTV (loan-to-value) is below 85 to 90% with DPA	
Borrower has a minimum FICO score of 620	GOVERNMENT FINANCING
All serious credit issues are at least 2 years old	
Borrower can make 3.5% downpayment	
Borrower has a unique credit, income or asset profile	
If CLTV exceeds 100% after including NSP assistance	
Borrower needs to use a non-occupant co-signer to qualify or has large amounts of deferred student loan debt	