

FHA's 203(b) Purchase Money Loan Guarantee Program

Introduction

The Federal Housing Administration (FHA) administers several programs to promote homeownership. These programs are popular because they allow borrowers to buy a home with a lower down payment and less restrictive underwriting criteria than might be the case with conventional loans. The FHA's 203(b) program is the agency's flagship initiative to support the availability of low-cost housing finance assistance to borrowers.

Information in this fact sheet is accurate as of January 2016. The FHA's policies periodically change, and lenders are advised to consult the FHA's [Single Family Housing Policy Handbook \(Handbook 4000.1\)](#) (to be referred to as the FHA Handbook), regulations, and [Mortgage Letters](#) for the most current information concerning the program.

What Is the FHA 203(b) Program?

The FHA 203(b) program provides mortgage insurance to protect lenders against the risk of default on mortgages to qualified buyers. Banks originate the mortgages, and the FHA provides the mortgage insurance. If a borrower defaults, once the lender completes foreclosure, the lender may file a claim with the FHA for payment of the remaining principal balance on the mortgage and certain other expenses.

A borrower may use an FHA-insured mortgage to finance either a purchase or a refinance. Both new and existing one- to four-family housing may be financed under 203(b). This fact sheet focuses on purchase financing.

Section 203(b) purchase money loans have important features:

- FHA loan limits vary by geography and are adjusted on an annual basis by FHA. As of January 1, 2016, the nationwide loan limit for a single-family unit is \$271,050. FHA loan limits, however, are adjusted up to \$625,500 in high-cost areas. FHA maintains a [loan limits](#) section on its Web site to identify the loan limit for a particular geographic region such as a state, county or Metropolitan Statistical Area.
- Loans must be for the purchase of a primary residence. A borrower may purchase a multi-unit property with up to four units if the buyer intends to reside in one of the units.

How Can Banks Participate in the 203(b) Program?

Lenders can participate in the FHA 203(b) program in two ways. The first way is to become a direct endorsement (DE) lender. DE lenders can originate, underwrite, fund, service or own FHA-insured loans. DE

lenders need to meet net worth, management, and experience requirements and have a dedicated FHA-approved underwriter on staff. Specific DE eligibility requirements include:

- Three years' experience in the origination of single-family mortgages.
- Fidelity bond and errors and omissions insurance, with each having a minimum coverage of \$300,000.
- A license to originate loans in the state in which the bank is chartered.
- No conviction for mortgage fraud, or any suspension or debarment for any mortgage-related offense.
- Quality control plan in place.
- Submission of audited financial statements.
- A minimum net worth of not less than \$1 million plus an additional net worth of 1 percent of the total volume in excess of \$25 million of FHA single-family insured mortgages originated, underwritten, purchased, or serviced during the previous fiscal year, up to a maximum required net worth of \$2.5 million. Not less than 20 percent of a mortgagee's required net worth must be liquid assets consisting of cash or its equivalent acceptable to the FHA.

Banks that do not meet the FHA's approval criteria for DE lenders or do not have sufficient loan volume to justify the costs of being a DE lender may originate FHA 203(b) loans as a sponsored third-party originator. In this scenario, an approved DE lender agrees to act as a sponsor that underwrites and approves the loan on the sponsored originator's behalf.

What Are the Benefits for Borrowers?

One of the major advantages the FHA 203(b) program offers to borrowers is that

the FHA underwriting criteria regarding the borrower's credit history can be less restrictive than conventional underwriting requirements. Additional benefits include:

- Financial gifts for down payment assistance are permitted and can come from an approved source such as an employer, a relative, or a nonprofit or government agency that offers down payment assistance. Any party with an interest in the sale, such as the seller, may not provide a gift to the borrower.¹
- The home seller or another interested party can elect to contribute up to 6 percent of the purchase price toward the closing costs associated with the loan.² Care must be taken not to exceed the 6 percent contribution limit because doing so may trigger a reduction in the maximum loan amount. Interested party contributions may be applied toward any of the following items:
 - Loan discount points
 - Loan origination fees
 - Interest rate buy downs
 - Other closing costs³

Down Payment Requirements

Single-family mortgages insured by the FHA under section 203(b) make it possible for borrowers to make down payments of as little as 3.5 percent of the lesser of the sales price or the appraised value. FHA insurance is available to finance up to 96.5 percent of

¹ FHA Single Family Housing Policy Handbook (4000.1) II.A.4.d.iii.(F) and II.A.5.c.iii.(F).

² The FHA has proposed revising the maximum contributions from interested parties on properties with sales price greater than \$100,000 to 3 percent, or \$6,000, whichever is higher. 77 Fed. Reg. 36, 10695-10707 (February. 23, 2012).

³ FHA Single Family Housing Policy Handbook (4000.1) II.A.4.d.iii.(G) and II.A.5.c.iii.(G).

the value of the home. Borrowers with a credit score of 580 or higher must make a 3.5 percent down payment. Borrowers with a credit score between 500 and 579 must make a 10 percent down payment. Borrowers with credit scores below 500 are not eligible for FHA financing.⁴

Mortgage Insurance

Borrowers who obtain FHA mortgages pay both an upfront mortgage insurance premium (UFMIP) and an annual mortgage insurance premium (MIP). Mortgage insurance coverage protects lenders against some or most of the credit loss if a borrower defaults. The maximum amounts that the FHA is allowed to charge for the annual and the upfront premiums are established by statute. Since these are maximum amounts, however, the FHA has the discretion to set the premiums at lower levels.

Presently, the FHA 203(b) UFMIP is 1.75 percent of the base loan amount and is collected at closing. The UFMIP may be financed in the mortgage amount, but the loan-to-value (LTV) ratio may not exceed 96.5 percent or 90 percent, depending on the borrower's credit profile, as discussed above. The annual premium is collected monthly as part of the borrower's mortgage payment. The payment amount is based on the loan type, loan term, and LTV ratio.

The annual MIP is established as follows:
Loan term more than 15 years:

.85 percent—LTV 95.01 percent or more
.80 percent—LTV 95.00 percent or less

Loan term 15 years or less:

0.70 percent—LTV 90.01 percent or more

⁴ FHA Single Family Housing Policy Handbook (4000.1) II.A.2.b.

0.45 percent—LTV 78.01 percent to 90.00 percent

(See Appendix 1 of the [FHA Handbook](#).)

What Are the Benefits for Banks?

Banks can gain a number of benefits by offering 203(b) loans. For example, the program can expand a bank's customer base by offering credit opportunities to market segments that may not be adequately served in today's lending environment. In addition to origination income, FHA 203(b) loans generate a slightly higher servicing premium of 44 basis points than conventional loans. Additionally, 203(b) loans are eligible to be placed in highly liquid Ginnie Mae securities, thus providing secondary market fee income.

Risk Mitigation and Regulatory Capital Requirements

The FHA 203(b) program provides mortgage insurance against loan default, and that insurance is backed by the full faith and credit of the federal government. When a borrower defaults and the lender forecloses, the FHA pays the lender the remaining unpaid principal balance of the loan, accrued interest, and certain expenses associated with the foreclosure action. This government guarantee reduces the credit risk that banks face in originating and holding or servicing FHA 203(b) loans.

Under the regulatory agencies' current risk-based capital requirements, the guaranteed portion of loans guaranteed by the federal government through the FHA is risk-weighted at 20 percent.

What Risks Do Lenders Face?

- **Indemnification risk:** The lender must agree to indemnify the FHA if the FHA finds fraud or other material defects in a loan. This means that if the originating lender holds a fraudulent or materially defective loan in its portfolio, the lender cannot submit a claim for insurance if the loan fails. If the loan is sold, the originating lender agrees to indemnify the FHA when the new holder of the loan submits a claim for insurance.
- **Operational risk:** A bank should have appropriate risk management systems in place to ensure compliance with the FHA's and the mortgagee's own origination and servicing requirements throughout the bank's operations; to guard against errors, omissions, and fraud; and ensure timely and appropriate corrective action. Lenders must properly train staff and provide them access to current guidelines relating to the operations that they review.
- **Program termination risk:** If a lender's default rate exceeds limits set by the FHA, a lender's authority to originate FHA loans may be terminated.

Loss Mitigation

Regulations issued by the Department of Housing and Urban Development (HUD) identify acceptable standards and prudent servicing of FHA 203(b) and other FHA-insured mortgages.⁵ HUD expects lenders and servicers to develop and implement policies and practices consistent with those standards and to prudently service loans. Lenders and servicers have some flexibility to offer different loss mitigation options, but

⁵ 24 CFR 203.500.

they must take appropriate actions that are reasonably expected to generate the smallest financial loss to HUD. Such actions include deeds in lieu of foreclosure, pre-foreclosure sales, partial claims, assumptions, special forbearance, and recasting of mortgages. According to HUD's regulations regarding loss mitigation, "Before four full monthly installments due on the mortgage have become unpaid, the mortgagee shall evaluate, on a monthly basis, all loss mitigation techniques provided at section 203.501 to determine which is appropriate. Based upon such evaluations, the mortgagee shall take the appropriate loss mitigation action."⁶

Underwriting

Automated Underwriting

When underwriting an FHA 203(b) loan, the lender evaluates standard credit risk factors such as debt-to-income and LTV ratios, and current and past credit history of the borrower. The FHA requires all purchase money loan applications, except transactions involving borrowers without credit scores, to be submitted through an automated underwriting system using the FHA's TOTAL⁷ Scorecard. TOTAL evaluates the overall creditworthiness of an applicant based on a number of credit variables and determines an associated risk level of a borrower's eligibility for a 203(b) loan.

The TOTAL Scorecard provides two risk classifications: "Accept" and "Refer." An "Accept" indicates that the borrower meets the FHA's credit standards and thus permits reduced documentation requirements. If the loan receives a "Refer" classification, the lender is required to manually underwrite the loan. It is the FHA's policy that no

⁶ 24 CFR 203.605.

⁷ Technology Open to Approved Lenders.

borrower is to be denied an FHA-insured mortgage based solely on a risk assessment generated by the TOTAL Scorecard. (See [FHA TOTAL Mortgage Scorecard User Guide](#), page 4.)

Manually Underwritten Loans

The FHA Handbook provides guidelines for lenders when they manually underwrite mortgage applications. The guidelines are intended to assist lenders in objectively quantifying a borrower's risk. The guidelines establish reserve requirements for all manually underwritten borrowers, set maximum qualifying ratios based on credit score and compensating factors, and provide a list of acceptable compensating factors that can be used to qualify borrowers who exceed the FHA's standard housing payment and debt-to-income ratios. The guidelines also provide objective documentation requirements for assessing these factors.

The maximum mortgage payment to income ratio (PTI) and maximum total fixed payments to income ratio (DTI) for a borrower with a credit score below 580 with no compensating factors are 31 percent and 43 percent, respectively. A borrower with a credit score of 580 or higher and two compensating factors is permitted to have a 40 percent PTI and 50 percent DTI.⁸

The [FHA Handbook](#) indicates that compensating factors to justify an approval when qualifying ratios exceed 31 percent PTI and 43 percent DTI are the following:

- Verified and documented cash reserves that equal or exceed three total monthly mortgage payments (one and two units) or that equal or exceed six total monthly

mortgage payments (three and four units);

- New total monthly mortgage payment is not more than \$100 or 5 percent higher than previous total monthly housing payment, whichever is less, and there is a documented 12-month housing payment history with no more than one 30-day late payment;
- No discretionary debt;
- Verified and documented significant additional income that is not considered effective income; and
- Residual income.⁹

FHA Underwriting Flexibility

Previous Bankruptcy

Historically, the FHA's underwriting requirements have been more flexible than conventional underwriting requirements for borrowers who have been involved with a bankruptcy.

According to the FHA Handbook, "A Chapter 7 bankruptcy (liquidation) does not disqualify a borrower from obtaining an FHA-insured mortgage if, at the time of case number assignment, at least two years have elapsed since the date of the bankruptcy discharge. During this time, the borrower must have:

- re-established good credit, or
- chosen not to incur new credit obligations.

An elapsed period of less than two years, but not less than 12 months, may be acceptable, if the borrower:

⁸ FHA Single Family Housing Policy Handbook (4000.1) II.A.5.d.viii.

⁹ Ibid., II.A.5.d.ix.

- can show that the bankruptcy was caused by extenuating circumstances beyond the borrower’s control, and
- has since exhibited a documented ability to manage his/her financial affairs in a responsible manner.”¹⁰

“The lender must also document that the borrower’s current situation indicates that the events which led to the bankruptcy are not likely to recur.”¹¹

According to the FHA Handbook, a Chapter 13 bankruptcy (reorganization) also does not automatically disqualify a borrower from FHA eligibility, if the lender documents that one year of the pay-out period under the bankruptcy has elapsed. The lender also must determine that during this time “the borrower’s payment performance has been satisfactory and all required payments have been made on time, and the borrower has received written permission from the bankruptcy court to enter into the mortgage transaction.”¹²

Previous Foreclosure

Borrowers who have previously gone through a foreclosure on their primary residence are generally ineligible for an FHA-insured mortgage for three years from the date of foreclosure sale. The FHA Handbook states, “The mortgagee may grant an exception to the three-year requirement if the foreclosure was the result of documented extenuating circumstances that were beyond the control of the borrower, such as a serious illness or death of a wage earner, and the borrower has re-established good credit since the foreclosure.”¹³

¹⁰ Ibid., II.A.5.a.iii.(H)(1).
¹¹ Ibid., II.A.5.a.iii.(H)(3).
¹² Ibid., II.A.5.a.iii.(H)(2).
¹³ Ibid., II.A.5.a.iii.(I)(1).

This policy also applies to former homeowners who have completed a deed in lieu of foreclosure, or a short sale, where a bank approves the sale for less than the amount owed.

Nontraditional Credit

The FHA recognizes that some prospective borrowers may not have established a credit history.

In these situations, the lender must obtain a nontraditional mortgage credit report (NTMCR) from a credit reporting company or independently develop a credit history from such sources as utility payment records, rental payments, and automobile insurance payments.¹⁴

The FHA Handbook states, “An NTMCR is designed to access the credit history of a borrower who does not have the types of trade references that appear on a traditional credit report, and used either as a

- substitute for a [traditional credit report], or
- supplement to a traditional credit report that has an insufficient number of trade items reported to generate a credit score.”¹⁵

Ensuring there are enough items to make a credit analysis and review is critical to approving this type of borrower. According to the FHA Handbook, “to be sufficient to establish the borrower’s credit, the credit history must include three credit references, including at least one of the following:

¹⁴ Ibid., II.A.5.a.ii.(B).
¹⁵ Ibid., II.A.5.a.ii.(B)(1)(a).

- rental housing payments (subject to independent verification if the borrower is a renter);
- telephone service; or
- utility company reference (if not included in the rental housing payment), including:
 - gas;
 - electricity;
 - water;
 - television service; or
 - Internet service.

If the mortgagee cannot obtain all three credit references from the list above, the mortgagee may use the following sources of unreported recurring debt:

- insurance premiums not payroll deducted (for example, medical, auto, life, renter’s insurance);
- payment to child care providers made to businesses that provide such services;
- school tuition;
- retail store credit cards (for example, from department, furniture, appliance stores, or specialty stores);
- rent-to-own (for example, furniture, appliances);
- payment of that part of medical bills not covered by insurance;
- a documented 12-month history of savings evidenced by regular deposits resulting in an increased balance to the account that:
 - were made at least quarterly;
 - were not payroll deducted; and,
 - caused no insufficient funds (NSF) checks or charges;
- an automobile lease;
- a personal loan from an individual with repayment terms in writing and supported by cancelled checks or other methods to document the payments; or
- a documented 12-month history of payment by the borrower on an account

for which the borrower is an authorized user.”¹⁶

The FHA Handbook further states that “the underwriter may consider a borrower to have an acceptable payment history if the borrower has made all housing and installment debt payments on time for the previous 12 months and has no more than two 30-day late mortgage payments or installment payments in the previous 24 months.

“The underwriter may approve the borrower with an acceptable payment history if the borrower has no major derogatory credit on revolving accounts in the previous 12 months.

Major derogatory credit on revolving accounts must include any payments made 90 or more days after the due date, or three or more payments made 60 or more days after the due date.”¹⁷

The FHA Handbook also specifies, “The qualifying ratios for borrowers with no credit score are computed using income only from borrowers occupying the property and obligated on the mortgage. Non-occupant co-borrower income may not be included.”¹⁸

The PTI and DTI of borrowers with no credit score may not exceed 31 percent and 43, percent respectively.

Important: Compensating factors are *not* applicable for borrowers with insufficient credit references.

The FHA continuously monitors the underwriting policy requirements for the 203(b) program to promote access to

¹⁶ Ibid., II.A.5.a.ii.(B)(3).

¹⁷ Ibid., II.A.5.a.iii.(B)(1).

¹⁸ Ibid., II.A.5.d.viii.

affordable credit while simultaneously ensuring the strength of its mortgage insurance fund. Therefore, it is possible that the FHA could make changes to the 203(b) underwriting criteria.

Appraisal Requirements

Section 202(f) of the National Housing Act mandates that all appraisers chosen or approved to conduct appraisals of properties that will be security for FHA-insured mortgages must “(1) be ‘certified’ by the state in which the property to be appraised is located; or by a nationally recognized professional appraisal organization, and (2) have demonstrated verifiable education in the appraisal requirements established by the FHA.”¹⁹ The FHA Register lists appraisers who are eligible to perform FHA single-family appraisals. To conduct an appraisal for FHA insurance endorsement, the appraiser must be on the FHA Register. (See the [FHA’s appraiser register Web page](#).)

Qualified Mortgage

The Dodd–Frank Wall Street Reform and Consumer Protection Act²⁰ requires lenders to make a reasonable and good faith determination at or before the time of loan consummation that the customer will have a reasonable ability to repay the mortgage. The Consumer Financial Protection Bureau (CFPB) issued regulations detailing the specific underwriting requirements to meet this “ability to repay” standard.²¹

¹⁹ 12 USC 1708(g).

²⁰ Public Law 111-203, 124 Stat. 1376 (2010).

²¹ 12 CFR 1026.43(c)(2). The ability to repay underwriting factors include: 1) current or reasonably expected income or assets; 2) employment status; 3) monthly mortgage payment for the loan; 4) monthly payment on simultaneous loans secured by the same property; 5) monthly mortgage-related debt obligations (such as tax and insurance payments); 6) debts, alimony, and child support obligations; 7)

A presumption of compliance with the general ability to repay requirement arises if a lender originates a qualified mortgage (QM). A loan is considered a QM if it either meets the QM requirements established by the CFPB²² or falls within the definition of QM in rules promulgated by HUD, the Department of Veterans Affairs (VA), the Department of Agriculture, or the Rural Housing Service (RHS) for loans they guarantee or insure.²³

FHA Qualified Mortgage

HUD issued its own QM rule with respect to FHA loans separate from the rule issued by the CFPB. HUD’s QM rule, published on December 11, 2013, includes two QM loan categories, each category offering different protections for consumers and different liabilities for lenders.²⁴ A “rebuttable presumption” QM assumes lenders have vetted the borrower’s ability to repay the loan, but that the borrower can challenge that presumption in court. A “safe harbor” QM allows legal challenges only if the borrower believes the loan does not meet the definition of a safe harbor QM.

Under HUD’s regulations, the total points and fees of a QM “... shall not exceed the CFPB’s limit on points and fees for qualified mortgage in its regulations at 12 CFR 1026.43(e)(3).”²⁵ HUD’s regulations require a safe harbor QM to have “... an annual percentage rate that does not exceed

monthly debt-to- income or residual income of all mortgage and non-mortgage obligations, as a ratio of gross monthly income; and 8) credit history.

²² 12 CFR 1026.43(e), (f).

²³ 12 CFR 1026.43(e)(4). Both HUD and the VA have promulgated rules. See [78 Fed. Reg. 75215](#) (December 11, 2013)(HUD), and [79 Fed. Reg. 26620](#) (May 9, 2014)(VA). RHS has proposed a rule. [80 Fed. Reg. 11950](#) (March 15, 2015).

²⁴ 78 Fed. Reg. 238, 75215-75238 (December 11, 2013).

²⁵ 24 CFR 203.19(b)(1).

the average prime offer rate [APOR]²⁶ for a comparable mortgage, as of the date the interest rate is set, by more than the combined annual mortgage insurance premium and 1.15 percentage points.”²⁷

Under HUD’s rebuttable presumption, the rule requires a QM to have an annual percentage rate that “exceeds the average prime offer rate for a comparable mortgage, as of the date the interest rate is set, by more than the combined annual mortgage insurance premium and 1.15 percentage points.”²⁸

Unlike the CFPB’s QM rule, HUD’s rule does not require that borrowers have a DTI ratio of 43 percent or less. According to HUD, FHA underwriting standards already require lenders to assess a borrower’s ability to repay his or her mortgage.

Federal Home Loan Bank of Chicago Pilot Program

The Federal Home Loan Bank (FHLB) of Chicago has begun issuing securities backed by FHA loans and other government-insured mortgages originated by FHLB member financial institutions. The new secondary market conduit product, Mortgage Partnership Finance (MPF) government mortgage-backed securities (MBS), provides lenders, particularly smaller institutions that lack direct access to the secondary mortgage market, a new source of liquidity. Under the program, the FHLB of Chicago purchases FHA and other government-insured loans

from its member lenders, holds the loans on-balance sheet, and then pools them into Ginnie Mae-guaranteed securities, which may then be sold to investors. The FHLB of Chicago issued its first Ginnie Mae-guaranteed security on July 21, 2015. The \$5 million security was comprised of FHA loans and loans guaranteed by the VA and the RHS.

Lenders are able to choose whether to retain or release servicing on the loans they sell to the FHLB of Chicago. Currently, the MPF government MBS product is available to eligible participating members of the FHLB of Chicago, FHLB of Atlanta, FHLB of Boston, and FHLB of Des Moines.

Community Reinvestment Act Considerations

Section 203(b) loans may also assist banks in receiving positive consideration under the Community Reinvestment Act lending tests. Under those tests, examiners evaluate a bank’s record of helping to meet the credit needs of its assessment area(s).²⁹ FHA 203(b) loan originations may be considered under the lending tests applicable to large banks or to small and intermediate small banks. The fact that a loan made under the FHA 203(b) program is government-guaranteed does not affect its consideration under the Community Reinvestment Act.³⁰

For More Information

- [FHA Single Family Housing Policy Handbook \(4000.1\)](#)
- [HUD mortgagee letters](#)

²⁶ The APOR is an annual percentage rate that is derived from average interest rates, points, and other loan pricing terms currently offered to mortgagors by a representative sample of mortgagees for mortgage transactions that have low-risk pricing characteristics as published by the CFPB in accordance with the CFPB’s regulations at 12 CFR 1026.35.

²⁷ 24 CFR 203.19(b)(3)(ii).

²⁸ 24 CFR 203.19(b)(2)(i).

²⁹ 12 CFR 25.22 and 25.26(b).

³⁰ “Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestment; Notice,” 75 Fed. Reg. 47, March 11, 2010, __.22(a)(2) – 5.

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