RD AN No. 3940 (1980-D)
February 18, 2004

TO: All State Directors
Rural Development

ATTENTION: Rural Housing Program Directors, Rural Development Managers, Guaranteed Rural Housing Coordinators, and Community Development Managers

FROM: Arthur A. Garcia ***(Signed by James E. Selmon, III) for***
Administrator
Rural Housing Service

SUBJECT: Guaranteed Rural Housing (GRH)
Single Family Housing Guaranteed Loan Program (SFHGLP)
GRH Approved Lender Underwriting Guidelines

PURPOSE/INTENDED OUTCOME:

The purpose of this AN is to reiterate Agency methodology for evaluating "payment shock." The outcome of this AN is to provide underwriting guidance to SFHGLP lenders. It is the Agency's expectation that lenders will act responsibly when originating and underwriting loans under RD Instruction 1980-D.

COMPARISON WITH PREVIOUS AN:

This AN replaces RD AN No. 3818 (1980-D) dated January 10, 2003. A section has been added to clarify the requirement for lenders to document their underwriting analysis.

EXPIRATION DATE:
February 28, 2005

FILING INSTRUCTIONS:
Preceding RD Instruction 1980-D

BACKGROUND:

Analysis of early delinquency by loans guaranteed under the SFHGLP indicates that payment shock is a delinquency factor when other risk factors (risk layering) is present. The presence of payment shock is especially significant when the borrower's credit history contains derogatory information. Aside from our internal studies, our findings are supported by numerous observations from the State Offices as well as a major study by one of our largest nationwide approved lenders.

The term “payment shock” signifies the increase in housing expenses experienced by a borrower. Payment shock is defined as a percentage under the following formula:

(New Principal Interest Taxes and Insurance (PITI) ÷ Previous Housing Expense) − 1

The following three examples illustrate payment shock as a percentage.

A. The borrower’s new PITI is $187.00 and their former rent was $100.00.

187.00 ÷ 100.00 = 1.87; 1.87 − 1 = .87; .87 = 87 percent
The payment shock in this example is 87 percent.

B. The borrower’s new PITI is $345.00 and their former rent was $150.00.

345.00 ÷ 150.00 = 2.30; 2.30 − 1 = 1.30; 1.30 = 130 percent
The payment shock in this example is 130 percent.

C. The borrower’s new PITI is $2,000.00 and their former rent $1,000.00

2,000.00 ÷ 1,000.00 = 2.00; 2.00 − 1 = 1.00; 1.00 = 100 percent
The payment shock in this example is 100 percent.

In cases where the borrower did not have prior housing expenses prior to purchasing a home, such as if the borrower was living with relatives, payment shock cannot be measured as a percentage.

IMPLEMENTATION RESPONSIBILITIES:

When conducting an underwriting analysis, lenders should be sure that:

- An applicant’s credit history indicates a reasonable ability and willingness to meet obligations as they become due. If the lender grants an adverse credit waiver, they should properly document that the applicant’s adverse circumstances were of a temporary nature beyond the applicant’s control and have been removed, or that the delinquency was the result of a justifiable dispute relating to defective goods or services. See RD Instruction 1980-D, §1980.345(d).

- The applicant has adequate repayment ability and a history of dependable, available income to support their credit obligations, including the contemplated extension of credit. Cosigned obligations and contingent liabilities should be evaluated with care under RD Instruction 1980-D, §1980.345(c).

- The real property securing the loan must meet all Agency standards including property standards, appraisal standards, thermal requirements, and those pertaining to water and waste disposal systems (see RD Instruction 1980.313). It is imperative that lender underwriters carefully evaluate the condition of a property offered as collateral under the SFHGLP.

In cases where payment shock is 100 percent or higher as well as in cases where the applicant did not have housing expenses prior to purchasing a home, no additional risk layering (such as adverse credit waivers, debt ratio waivers, or buydowns) should be allowed without strong compensating factors. Acceptable compensating factors include, but are not limited to, the following examples:

- The borrower has an excellent credit history reflecting timely repayment of credit obligations;

- The borrower has a Fair Isaacs & Company (FICO) credit score of 660 or higher;

- The borrower has demonstrated a conservative attitude toward the use of credit and an ability to accumulate savings;

- The borrower has a stable employment history over the past two years, demonstrating a dependable income stream;

- The borrower has potential for increased earnings, as indicated by job training or education in the borrower's profession.

Because the lender that is requesting the Conditional Commitment from the Agency is responsible for underwriting the loan, it is critical that the lender understand Agency underwriting guidelines Agency staff should offer approved lenders regular training on GRH loan program guidelines.

RD Instruction 1980-D, §1980.353(c)(12) encourages the lender to submit a written loan underwriting analysis as part of the application submitted to the Agency. Typically, the underwriting analysis must be more than just evidence that an underwriter has reviewed and approved the file; i.e., the underwriter's signature. The Agency expects the lender's underwriter to prepare a sufficiently detailed underwriting summary describing the key factors in the underwriting process, with an emphasis on the strengths and weaknesses of the individual case. Many underwriters use Fannie Mae Form 1008, *Uniform Underwriting and Transmittal Summary*. Underwriters that choose to use Fannie Mae Form 1008 should use Sections III and VII to summarize key factors in the underwriting process, such as stability of income, debt-to-income ratios, credit history, adverse credit waivers, payment shock, property considerations, and other comments pertinent to the underwriting decision. The lender's underwriter should list any underwriting exhibits that are attached.

Although the Agency is not responsible for underwriting individual GRH loans, approved lenders should be periodically monitored for GRH loan program underwriting compliance. Existing lenders with incidences of high early delinquencies or high loan losses should be subjected to quality control reviews to ensure that Agency underwriting standards are being adhered to. Newly approved lenders should have their underwriting reviewed based on the criteria outlined in RD Instruction 1980-D, §1980.309(g)(1).

State Offices having questions regarding this AN should contact Joaquín Tremols or Robert Keyes at (202) 720-1452.