

FHA does a solid for mortgage credit rejects. Will it move the needle for loan officers?

The latest FHA waiver is expected to give borrowers a fairer shot at obtaining financing, but whether the waiver will boost origination volume for LOs remains unclear

September 14, 2023, 3:00 pm *By Connie Kim*

Adrian Gastelum, a vice president and branch manager at **Nova Home Loans**, recently had a prospective borrower apply for a **Federal Housing Administration** (FHA) mortgage. The client had just started a new job, and that can be tricky.

FHA guidelines require a two-year work history and allow for a gap of one month or longer in employment with a letter of explanation. If the current job does not span at least two years, the lender is required to contact the prior employer. If the borrower has had multiple jobs in the past two years, the lender has to verify that the current job is stable.

Because Gastelum's client started a new job within 30 days, an underwriter at Nova decided that there was no interruption to his income and approved the loan.

But depending on how a lender interprets the guidelines, the client could have gotten his application rejected for not having consistent employment for a two-year period without interruptions, explained Gastelum.

"It really comes down to interpretation of the guideline. One lender could have said, 'Oh, he was out a week, so it's interrupted and therefore, the second employment doesn't work.' The problem is, a mortgage credit reject (MCR) is kind of like your scarlet letter, to be completely honest," Gastelum said.

When a lender rejects an FHA application, it discourages the next lender from even reviewing the application because of the extra work the underwriters have to do to override that MCR, mortgage pros told HousingWire.

All FHA mortgage lenders use a system by the **U.S. Department of Housing and Urban Development** (HUD) called FHA Connection, a database used to insure and generate FHA case numbers associated with the borrower's home

loan application. When the borrower is denied for an FHA mortgage loan, an MCR report had to be created for that denial. That changed on September 11.

The FHA's announcement in early September to waive a requirement that FHA-approved lenders flag rejected loans in the FHA Connection system is a step in the right direction since declined borrowers don't have to overcome a stigma, loan officers said.

In a rate-rising environment where it has become more difficult for first-time buyers to get into the market, borrowers won't have to deal with a file that has an MCR for six months. Even after the six-month period is over, the borrower's case number would still be attached to his/her social security number.

Demand for FHA loans have risen over the past year to comprise 23.8% of mortgage applications in August 2023, up from 17% from the same period a year ago, according to the **Mortgage Bankers Association**.

The FHA/VA share in Q2 2023 stood at 22.9% of the entire mortgage origination volume, up from 18% in Q2 2022, according to data compiled by **Inside Mortgage Finance** and **Urban Institute**.

Loan officers said that the FHA's waiver will give borrowers a fairer shot at obtaining financing. Borrowers won't be subject to lenders' different underwriting interpretations that could lead to a rejection of their mortgage applications.

"That (MCR) is a subjective stigma based on credit risk tolerance of the particular lender that you went to initially. "This is an underwriting technicality that is unfair and it is a good move to create more fairness," Billy Taylor, CEO of **Hometown Lenders**, said.

"We are really happy about this change because it's going to provide more opportunity for loan officers and is going to provide more opportunity for buyers to get a second chance," Michael Borodinsky, VP and branch manager at **Caliber Home Loans**, said.

Overcoming overlays

The FHA credit requirements are strict, but borrowers can get an FHA loan with no credit score. In fact, HUD forbids lenders from declining a borrower's FHA loan application simply because they lack a credit history.

In such a case, lenders will ask for documentation, including a letter from the landlord documenting on-time rent payments, payment history of utility companies and cell phone or internet provider.

Lenders, however, have overlays – rules on top of the federal rules that were published as lenders need to sell those loans to investors who do not want to buy high-risk loans.

“Those overlays – it could be higher standards, it could be lower debt-to-income (DTI) ratios – still exist on a subjective basis on a lender-by-lender basis. So a borrower not knowing that they could qualify for a loan where their credit score is below 640 or 620 could be subject to a denial and then not realize that they could be approved somewhere else,” Borodinsky said.

Generally, the FHA requires a minimum 580 credit score with a down payment of 3.5% to qualify for a FHA loan. Under FHA guidelines, borrowers with credit scores between 500 and 579 must make a down payment of at least 10%. But they may also face tighter requirements. Lenders may require a lower loan-to-value (LTV) ratio or ask that the borrower make a larger down payment.

Reasons for a MCR vary, said Ted Tozer, non-resident fellow at the **Urban Institute's** Housing Finance Policy Center (HFPC) and the former head of **Ginnie Mae**.

“It could be low credit scores, or it could be geographics too – maybe they're in a market that it's a soft market where they're looking at home prices that could be falling. Lenders don't want to tilt their portfolio to one where these 3.5% down payments could very well become over 100% LTV just because home prices fall,” Tozer noted.

Industry personnel frequently complained that FHA Connection often didn't provide sufficient information about mortgage credit rejects to determine why the applicant was rejected, said Peter Idziak, senior associate attorney at **Polunsky Beitel Green**.

“It could be the lender's own standards could be higher or different, or in addition to just the FHA qualifications,” Idziak said.

For a prospective homebuyer, the new waiver should avoid a possible misrepresentation of their actual creditworthiness, JR Younathan, SVP and California state mortgage production manager at **California Bank & Trust**, said

“The given waiver doesn’t necessarily open new paths to compete as they could have done that previously. It would only open a new path in the instance that the other lender wasn’t willing to investigate the reasons the denial was registered, and instead rejected the loan file/borrower on the fact it existed at all, thus eliminating that ability to compete,” Younathan noted.

Regardless of whether the applicant is walking in to the lender for the first or second time, the lender should be armed with enough financial information to assess the credit risk.

“The lender should be confident enough to know what questions to ask, how to analyze their income, how to analyze all the other risk profiles, it really shouldn’t make that much difference, because they should be in a situation where they should be asking the right questions to really understand,” Tozer said.

Beggars can’t be choosers

Though loan officers are unanimous that the waiver will make FHA loans more accessible for borrowers, LOs interviewed by HousingWire don’t expect it to increase their production volume.

In a highly competitive environment, lenders had already taken that extra effort to approve loans that would’ve been rejected or already rejected from another lender.

“We’re more likely to underwrite a 500 credit score than a big bank who’s saying ‘I don’t want that risky loan in my portfolio. I don’t want I don’t even want to underwrite it, because I don’t want a 500 or 520 or 560 borrower in my portfolio,’” Taylor, of Hometown Lenders, said.

Hometown Lenders would perform a manual underwriting for an applicant with a lower credit score to try to get an approval rather than simply rejecting a lower credit score borrower, he said.

The FHA loan program requires lenders to seek manual underwriting review when a borrower has a credit score lower than 620 and a DTI greater than

43%. According to HUD, borrowers could qualify with a 580 credit score and a DTI of 50%.

“That (loan origination) is the only way we make income. I don’t think it (the new waiver) would affect us at all, we would have looked at that borrower whether there’s an MCR on there or not,” Taylor noted.

To override an existing MCR would require a level two underwrite – meaning two underwriters would have to underwrite the file as they have the authorization to override the MCR in the FHA Connection system.

Because the mortgage credit reject is going to be eliminated, we’re no longer going to have to deal with a second underwrite, Gastelum said.

“It’s not going to be more business. If anything it’s going to bring some of the borrowers that got declined at other companies back to the marketplace sooner,” Gastelum said.

FHA loan limits rose to a maximum of more than \$1 million and mortgage insurance premiums for FHA loans were cut by 30 bps this year in line with home price inflation and to provide relief from the steep rise in mortgage rates.

Some loan officers noted that while the FHA’s decision to cut MIPs was a step in the right direction, the upfront mortgage premium (UFMIP), which amounts to 1.75% of the base loan amount, as well as a monthly premium for the life of the loan, could still be a burden for borrowers compared to those with a conventional loan.

However, affordability will still remain challenging for borrowers as wages would need to rise and home prices would need to fall to tackle that issue, Taylor noted.

“You’re not going to change affordability — which is the real reason people don’t have access to housing — by taking MCR off,” said Taylor.

But any little bit helps, Borodinsky said, citing a tough mortgage origination market that he’s never seen before.

“I welcome anything that moves the needle even fractionally. Because in this market, beggars can’t be choosers. This market is unlike any market we’ve seen in over 30 years in terms of there being no inventory, high interest rates

and a real problem compounded with what's called the lock-in effect," Borodinsky said.