



PROPOSED ACTION
MEMORANDUM

Advancing Racial Equity in FHA Single-Family Mortgage Insurance Program

Department of Housing and Urban Development
December 2020

I. Summary

The Federal Housing Administration (FHA) offers mortgage insurance for single-family homes, multi-family properties, and healthcare facilities. In its early decades, FHA excluded Black families from its programs altogether.¹ But currently, FHA-insured mortgages serve as an important source of financing for minority homebuyers.² As of 2018, FHA-insured loans accounted for 37.2% of all purchase mortgages for Black homeowners; the numbers are similar for Latino homeowners.³ Ensuring fair housing compliance in the FHA single-family program is thus an important component of decreasing the homeownership gap.⁴

After the 2008 financial crisis, the Obama administration took steps to shore up FHA's finances. Among other things, HUD tightened credit criteria for FHA loans and raised annual premium rates. By the end of the administration, the economy was growing, so HUD loosened those restrictions and lowered the fees. But when the Trump administration took office, it re-imposed those crisis-driven measures, even though the housing market had been growing since 2012. The result: for most of the past decade, HUD has made it harder to qualify for, and costlier to maintain, an FHA-insured mortgage for traditional forward mortgage borrowers, substantial number of whom are people of color.

This memo proposes three immediate steps to promote more equitable outcomes in the FHA-insured single-family mortgage program:

- Eliminate the debt-to-income (DTI) ratio and credit score thresholds imposed in 2019.
- Adopt alternative credit scoring models that include credit proxies such as utility, telecom, and rental payments.
- Decrease mortgage insurance premium (MIP) rates.

II. Justification

The history of redlining, segregation, and other discrimination by HUD and before that by FHA make fair housing compliance at HUD of the utmost concern.

In an attempt to end FHA redlining, President Kennedy signed Executive Order 11063, entitled Equal Opportunity in Housing.⁵ Thereafter, Congress passed the Civil Rights Act of 1964, which requires nondiscrimination in all federal programs and activities,⁶ and the Fair Housing Act of 1968, declaring it “the policy of the United States to provide, within constitutional limits, for fair housing throughout the United

¹ Rothstein, Richard, *The Color of Law: A Forgotten History of How Our Government Segregated America* (2017).

² HUD Annual Report to Congress Regarding the Financial Status of FHA Mutual Mortgage Fund, page 23, available at: <https://www.hud.gov/sites/dfiles/Housing/documents/2020FHAAnnualReportMMIFund.pdf>.

³ Vanessa Gail Perry, Ph.D., 2020 State of Housing in Black America: Challenges Facing Black Homeowners and Homebuyers During the COVID-19 Pandemic and an Agenda for Public Policy, page 2-3, Figure 2-2, available at: <https://www.nareb.com/site-files/uploads/2020/10/2020-SHIBA-REPORT-OFFICIAL-COPY.pdf>.

⁴ “The Black-white homeownership gap in 2020 was 26 percentage points, only slightly lower than the 26.8 percentage point gap in 1960, before the passage of the 1968 Fair Housing Act.” Vanessa Gail Perry, Ph.D., 2020 State of Housing in Black America: Challenges Facing Black Homeowners and Homebuyers During the COVID-19 Pandemic and an Agenda for Public Policy, ES-1, available at: <https://www.nareb.com/site-files/uploads/2020/10/2020-SHIBA-REPORT-OFFICIAL-COPY.pdf>.

⁵ Executive Order 11063, Equal Opportunity in Housing (Nov. 20, 1962). HUD issued implementing regulations in 1980. See 24 CFR part 107.

⁶ 42 U.S.C. § 2000d. The high priority attached to ensuring civil rights compliance in HUD programs is signaled by the placement of “Nondiscrimination in Federally Assisted Programs” in the first part of the CFR title dedicated to HUD. See 24 CFR Part 1.

States.”⁷ The 1968 Fair Housing Act prohibits housing discriminating in the private housing market as well as by HUD and other federal agencies.⁸ It also requires federal agencies and executive departments to “administer their programs and activities relating to housing and urban development (including any Federal agency having regulatory or supervisory authority over financial institutions) in a manner affirmatively to further the purposes of this title [the Fair Housing Act].”⁹ Congress added this affirmative requirement so the Fair Housing Act would not only end redlining and segregation by the federal government, but undo their effects. In 1994, President Clinton signed a five-page Executive Order implementing the Fair Housing Act’s affirmative fair housing requirement.¹⁰

In 2013, HUD published a regulation formalizing the standard for proving disparate impact discrimination prohibited by the Fair Housing Act.¹¹ This doctrine is used to redress, among other things, discriminatory housing practices by banks¹² and insurance companies.¹³ The disparate impact standard recognizes that housing discrimination need not be grounded in bias or ill will to be illegal; assumptions, stereotypes, and standard industry practices can also lead to Fair Housing Act violations. The question turns on whether a practice leading to worse outcomes for one group (e.g., Black or Latino borrowers) as compared to another group (e.g., White borrowers) is justified.

Redressing racial inequities in housing is thus central to HUD’s mission—which makes it all the more concerning that, as discussed in more detail below, FHA’s current eligibility criteria appear to discriminate against Black and Latino borrowers, while the fee structure does not seem to meet HUD’s obligation to affirmatively further fair housing.

III. Current State

Federal Housing Administration

FHA is a mortgage insurance program operated by HUD, within HUD’s Office of Housing. FHA was created as a free-standing federal agency by the National Housing Act of 1934¹⁴ and became a program within HUD in 1965, when HUD was established.¹⁵

Background

FHA insures private lenders against losses on home mortgages that meet certain eligibility criteria. For example, the mortgage must be within maximum loan limits, fully amortizing, with a down payment of at least 3.5%.¹⁶ HUD is required to charge the borrower an upfront fee and is authorized, but not required, to

⁷ 42 U.S.C. § 3601.

⁸ 42 U.S.C. §§ 3604, 3605, 3606.

⁹ 42 U.S.C. § 3608(d); *see also* 42 U.S.C. § 36083608(e)(5).

¹⁰ Executive Order 12892, Leadership and Coordination of Fair Housing in Federal Programs: Affirmatively Furthering Fair Housing (Jan. 17, 2004).

¹¹ 24 CFR § 100.500. HUD’s attempt to rescind the 2013 disparate impact rule was blocked by a federal court pending the outcome of an Administrative Procedure Act challenge. *Massachusetts Fair Housing Center, et al. v. HUD, et al.*, Civ Action No. 20-11765-MGM (D. Mass., Order filed Oct 25, 2020). 2013 rule is the governing law and is consistent with the Supreme Court decision recognizing the Fair Housing Act disparate impact standard. *See Texas Dept. of Housing and Community Affairs v. Inclusive Communities Project, Inc.*, 576 U.S. 519 (2015).

¹² Policy Statement on Discrimination in Lending, 59 FR 18266, 18269 (Apr. 15, 1994).

¹³ *See* Application of the Fair Housing Act’s Discriminatory Effects Standard to Insurance, 81 Fed. Reg. 69012 (Oct. 5, 2016).

¹⁴ 42 U.S.C. § 1701, *et seq.*

¹⁵ Description of the FHA single-family mortgage insurance program is taken from two Congressional Research Service Reports: *FHA-Insured Home Loans: An Overview* (updated Jan. 16, 2019), available at: <https://crsreports.congress.gov/product/pdf/RS/RS20530FHA>; and *Single-Family Mortgage Insurance: Financial Status of the Mutual Mortgage Insurance Fund (MMI Fund)* (updated June 11, 2018), available at: <https://crsreports.congress.gov/product/pdf/R/R42875/15>.

¹⁶ 42 U.S.C. § 1709(b).

charge annual fees, all within statutory ranges.¹⁷ The upfront fee can be financed with the mortgage.¹⁸ If the borrower defaults, the lender can submit a claim to HUD pursuant to prescribed conditions and procedures.¹⁹

As of 2018 data, FHA insured 37.2% of all purchase mortgages for Black households, 32.8% of all purchase mortgages for Latino households, 14.5% of all purchase mortgages for White households, and 7.1% of all purchase mortgages for Asian-American/Pacific Islander households. Of the FHA single-family portfolio, 59% of its purchase mortgage borrowers are White, 23% are Latino, and 15% are Black.²⁰

When refinance loans are included, and using FY2020 HUD data, 32.6% of FHA endorsements served borrowers of color (17.3% Latino; 12.7% black; 2.2% Asian; and 0.4% American Indian), and 50.1% served White borrowers. For 17.3% of mortgages, race/national origin was not recorded.²¹

These figures reflect the forward mortgage portfolio. FHA also insures reverse mortgages (Home Equity Conversion Mortgages or HECM). Using 2018 HMDA data, over 77.6% of HECM borrowers are White, 7.2% are Black, 5.8% are Latino, and 1.7% are Asian.²²

Obama and Trump Administration Actions

The Obama administration took steps after the 2008 financial crisis to shore up FHA's finances. Among other things, HUD raised annual premium rates five times between 2010 and 2013 and added a DTI threshold in 2013.²³ By 2015, as the crisis eased, HUD began to loosen those restrictions. It lowered annual premium rates in 2015 and 2017, and eliminated the DTI threshold in 2016.

But under the Trump administration, HUD re-imposed those crises measures, even though the underlying housing market had been growing since 2012. On the first day of the Trump administration, January 20, 2017, HUD reverted to the higher annual premium rates for traditional forward mortgage borrowers, a substantial number of whom are people of color. A few months later, on August 29, 2017, HUD cut the annual premium rate for reverse mortgage borrowers, a predominant number of whom are White. The predominantly white reverse mortgage program routinely runs at a loss and is effectively subsidized by the substantially minority forward mortgage program.²⁴

In 2019, HUD re-imposed the 2013 DTI restriction. DTI ratios are notorious for disproportionately excluding Black and Latino borrowers.

HUD put in place these restrictions and revenue enhancing measures even though, during the four years between 2017 and 2020, the MMI Fund grew to surpass the statutorily set 2% capital ratio threshold by a factor of three. Meanwhile, Black homeowners pay on average about \$550 per year more in mortgage insurance premiums than White homeowners.²⁵

MMI Fund

¹⁷ 12 U.S.C. §§ 1709(c), (d).

¹⁸ 12 U.S.C. § 1709(d).

¹⁹ 12 U.S.C. 1710.

²⁰ Vanessa Gail Perry, Ph.D., 2020 State of Housing in Black America: Challenges Facing Black Homeowners and Homebuyers During the COVID-19 Pandemic and an Agenda for Public Policy, page 2-4, Figure 2-2, available at: <https://www.nareb.com/site-files/uploads/2020/10/2020-SHIBA-REPORT-OFFICIAL-COPY.pdf>.

²¹ HUD Annual Report to Congress Regarding the Financial Status of FHA Mutual Mortgage Fund, page 23 and table B-3 in Appendix B, available at: <https://www.hud.gov/sites/dfiles/Housing/documents/2020FHAAnnualReportMMIFund.pdf>. The percentage of loans for which race/national origin is not recorded more than doubled between the end of the Obama Administration (2016) and the end of the Trump Administration (2020).

²² Karan Kaul, Sarah Storchak, and Laurie Goodman, Reverse Mortgage Use Differs by Race and Ethnicity. Here's Why It Matters, available at: <https://www.urban.org/urban-wire/reverse-mortgage-use-differs-race-and-ethnicity-heres-why-it-matters>.

²³ FHA 2016 Annual Report to Congress on the Financial Status of the MMI Fund, page 37, Appendix A, available at: <https://portal.hud.gov/hudportal/documents/huddoc?id=2016fhaannualreport1.pdf>.

²⁴ HUD Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance, page 63 and Exhibit II-6, available at: <https://www.hud.gov/sites/dfiles/Housing/documents/2020FHAAnnualReportMMIFund.pdf>.

²⁵

The FHA single-family mortgage program is supported by the Mutual Mortgage Insurance Fund (MMI Fund).²⁶

Background

The MMI Fund is supported by borrower fees, proceeds from the sale of foreclosed properties, and financial recoveries from enforcement actions. The Fund also has access to permanent and indefinite budget authority with the U.S. Treasury to cover unanticipated losses, which does not require additional action by Congress. HUD has invoked this budget authority only once.

The MMI Fund includes reserves for a number of different single-family mortgage insurance programs. The largest, the forward mortgage program, insures traditional home purchase and refinance mortgages. In 2008, Congress added another program, HECM reverse mortgages,²⁷ to the MMI Fund's obligations. The HECM program is volatile and usually results in large projected losses to the Fund. The positive performance of the forward portfolio, which serves substantially borrowers of color, "in effect 'subsidizes' the HECM book of loans,"²⁸ whose borrowers are predominately White.

HUD has a fiduciary responsibility "to ensure that the [MMI] Fund remains financially sound."²⁹ The operational goals of the Fund are to minimize default risk to the Fund and the borrowers subsidized by the Fund, and to meet the housing needs of the borrowers the program is designed to serve.³⁰

Each year, HUD is required to obtain an independent actuarial study of the MMI Fund.³¹ The actuarial review is used to determine whether the MMI Fund is in compliance with a statutory requirement to maintain a capital ratio of at least 2%.³² The fund ratio is the economic value of the MMI Fund including projected future cash-flows divided by the total dollar amount of mortgages insured under the Fund. It is a measure of the Fund's ability to pay for unexpected losses on currently insured loans.

If, pursuant to the actuarial study, HUD determines the MMI Fund is not meeting its operational goals (as defined by statute), or there is a "substantial probability" the Fund will not maintain the established target subsidy rate of 2%, HUD may either make certain programmatic adjustments as necessary to reduce the risk to the Fund or make appropriate premium adjustments with the goal of bringing the Fund back into compliance with the 2% standard over time.³³

HUD is required to submit an annual report to Congress describing the results of the actuarial study.³⁴ The requirements for the report include borrower demographics; "the extent to which the Secretary in carrying out the program has employed methods to ensure that needs of low and moderate income families, underserved areas, and historically disadvantaged groups are served by the program;" and "the current impediments to having the program serve low and moderate income borrowers[,] borrowers from central city areas[,] borrowers from rural areas[,] and minority borrowers."³⁵ HUD also submits quarterly reports to Congress detailing the status of the portfolio and updating risk projections."³⁶

²⁶ 12 U.S.C. § 1708.

²⁷ 12 U.S. Code § 1715z-20(i)(2).

²⁸ HUD Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance, page 63 and Exhibit II-6, available at: <https://www.hud.gov/sites/dfiles/Housing/documents/2020FHAAnnualReportMMIFund.pdf>.

²⁹ 12 U.S.C. § 1708(a)(3).

³⁰ 12 U.S.C. § 1708(a)(7).

³¹ 12 U.S.C. § 1708(a)(4).

³² 12 U.S.C. § 1711(f).

³³ 12 U.S.C. § 1708(6).

³⁴ 12 U.S.C. § 1708(a)(4).

³⁵ 12 U.S.C. § 1709(w).

³⁶ 12 U.S.C. § 1708(a)(5).

The Current Capital Ratio is Well above its Statutory Minimum

The 2% minimum capital ratio represents Congress's assessment of the appropriate balance between financial soundness of the MMI Fund and FHA's housing mission. In the years following the 2008 financial crisis, multiple factors contributed to increases in expected losses on FHA-insured loans. The capital ratio fell below 2% in FY2009 and remained below 2% for several years thereafter, turning negative in FY2012 and FY2013. At the end of FY2013, for the first time in its history, supplemental funds were required. Under the Obama administration, HUD added \$1.7 billion to the Fund, based on projections of future losses that did not actually materialize.

Since that time, the financial position of the MMI Fund has continued to improve. The capital ratio exceeded the 2% threshold in FY2015 and has grown beyond that every year since. As of the FY2020 Annual Report, the capital ratio is 6.10%,³⁷ up from 4.84% in 2019, and over three times the 2% threshold established by Congress to balance the stability of the MMI Fund and FHA's mission to encourage homeownership.³⁸

The latest Annual Report (November 2020) suggests that HUD is making a policy decision to build the MMI Fund up to a level that would withstand catastrophic conditions. But that goal does not appear consistent with Congress's intent. According to testimony from the General Accounting Office (GAO, now the Government Accountability Office) from 2000:

Determining what constitutes an adequate reserve level is essentially a question of what kinds of adverse economic conditions—moderately severe or catastrophic—the reserve should be able to withstand.... In the actuarial review of the Fund conducted by Price Waterhouse for fiscal year 1989, the researchers concluded that actuarial soundness would be consistent with a reserve that could withstand adverse, but not catastrophic, economic downturns. They further concluded that the Treasury implicitly covers catastrophic risk.... By contrast, rating agencies have taken the position, when evaluating private mortgage insurers, that they should have enough capital to withstand catastrophic risk.... However, requiring FHA to hold capital equivalent to that held by private mortgage insurers would likely impair FHA's public purpose.³⁹

More recently, in 2019, GAO suggested that if Congress expects the MMI Fund to maintain a capital ratio high enough to withstand catastrophic economic conditions, it “should consider specifying the economic conditions the MMI Fund would be expected to withstand without supplemental funds.”⁴⁰ As GAO pointed out, “[a]ny reconsideration of the capital requirement would involve policy decisions that would need to be made through congressional deliberations. . . . The tension between the financial and mission aspects of FHA's goals and requirements poses trade-offs that must be weighed by policymakers in setting the MMI Fund's capital requirement.”⁴¹

Over the past four years, HUD has taken on that policymaking role itself, expressing a preference for the private sector capital management strategies of JP Morgan Chase, Bank of America, and Wells Fargo over the guidelines set by Congress for balancing financial risk and FHA's housing mission.⁴² This has resulted, it seems, in overcharging minority borrowers and overly restricting access to credit for Black and Latino borrowers.

³⁷ Table C-1, available at: <https://www.hud.gov/sites/dfiles/Housing/documents/2020FHAAAnnualReportMMIFund.pdf>.

³⁸ https://www.hud.gov/press/press_releases/media_advisories/HUD_No_20_194.

³⁹ United States General Accounting Office, Mortgage Financing: Financial Health of the Federal Housing Administration's Mutual Mortgage Insurance Fund, Statement of Stanley J. Czerwinski before the Subcommittee on Housing and Transportation, Senate Committee on Banking, Housing and Urban Affairs, September 12, 2000, p. 7-8, available at: <http://gao.gov/assets/110/108623.pdf>.

⁴⁰ Government Accountability Office, Federal Housing Administration: Capital Requirements and Stress Testing Practices Need Strengthening, GAO-18-92, November 2017, available at: <https://www.gao.gov/products/GAO-18-92>.

⁴¹ Government Accountability Office, Federal Housing Administration: Capital Requirements and Stress Testing Practices Need Strengthening, GAO-18-92, November 2017, available at: <https://www.gao.gov/products/GAO-18-92>.

⁴² HUD Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance, pages 19 and 76, Exhibit II-16, available at: <https://www.hud.gov/sites/dfiles/Housing/documents/2020FHAAAnnualReportMMIFund.pdf>.

Borrower Eligibility

For the most part, the FHA program delegates underwriting assessments to the private lender issuing the mortgage. To that end, HUD created an interface with lenders' automated underwriting systems (AUSs). The instructions to lender AUSs are recorded in TOTAL Scorecard and described in the Developer's Guide for TOTAL Scorecard.⁴³ Detailed instructions for automated and manual underwriting of FHA-insured single-family mortgages are recorded in FHA's Single-Family Housing Policy Handbook.⁴⁴

In 2010, in response to the 2008 financial crisis, HUD for the first time instituted minimum credit score requirements for the program.⁴⁵ HUD established a two-tier threshold. Borrowers with credit scores below 500 are ineligible for FHA financing. Borrowers with credit scores between 500 and 579 are required to make a greater down payment (10% minimum) than the statutory minimum (3.5%).

In 2013, HUD went further and imposed a credit overlay on top of lenders' AUSs. Borrowers with a credit score below 620 and DTI ratio over 43% were referred for manual underwriting.⁴⁶ Technically, these applicants might still have qualified for a loan if they satisfied certain compensating factors. But in practice, fewer lenders are willing to engage in manual underwriting.

HUD's move coincided with publication of CFPB's Ability to Repay and Qualified Mortgage Standards under the Truth in Lending Act rule, which imposed a single-factor, forty-three DTI threshold for what it termed "Qualified Mortgages."⁴⁷ The CFPB definition of Qualified Mortgage temporarily patched in FHA and GSE loans.

By the end of the 2013, HUD issued its own Qualified Mortgage Rule, which, for FHA loans, supplanted the CFPB definition of Qualified Mortgage.⁴⁸ HUD's Qualified Mortgage Rule did not include any credit thresholds. Its DTI credit overlay was removed from TOTAL Scorecard three years later, in 2016.

Three years after that, in Spring 2019, the Trump administration announced that it would update TOTAL Scorecard "to specifically manage the decrease in average borrower credit scores and the excessive risk layering that results when multiple risk factors are present."⁴⁹ The announcement did not specify what action was intended, but in operation, the 2013 Obama-era DTI credit overlay was reinstated.⁵⁰ The Trump administration took this step even though, during the four years between 2017 and 2020, the MMI Fund's capital ratio grew to three times that set by Congress.

The 2013 DTI Threshold Added to the Scorecard in 2019

⁴³ Developer's Guide for TOTAL Scorecard, HUD Single Family Housing (Dec. 9, 2019), available at: <https://apps.hud.gov/pub/chums/aus-developers-guide-SOAP-MISMO.pdf>.

⁴⁴ FHA Single Family Housing Policy Handbook (Handbook 4000.1), HUD Assistant Secretary for Housing-Federal Housing Commissioner (Aug. 14, 2009), available at: <https://www.hud.gov/sites/dfiles/OCHCO/documents/4000.1hsgh.pdf>.

⁴⁵ 75 Fed. Reg. 54020 (Sept. 3, 2010).

⁴⁶ FHA Mortgagee Letter 2013-05, Manual Underwriting for Loans with Decision Credit Score Below 620 and Total Fixed Payments to Effective Income Ratio Exceeding 43.00% (Jan. 31, 2013), available at: <https://www.hud.gov/sites/documents/13-05ML.PDF>.

⁴⁷ 78 FR 6408 (Jan. 30, 2013). CFPB issued a final rule eliminating the DTI threshold altogether. Qualified Mortgage Definition under the Truth in Lending Act (Regulation Z): General

QM Loan Definition (final rule), available at:

https://files.consumerfinance.gov/f/documents/cfpb_atr-qm-general-qm-final-rule_2020-12.pdf.

⁴⁸ 24 CFR § 209.19, 78 Fed. Reg. 75215 (Dec. 11, 2013).

⁴⁹ News and Updates, FHA INFO #19-07, Managing Mortgage Risk Trends in the FHA Single Family Portfolio: Comprehensive Approach Starts with Total Mortgage Scorecard Updates to Address High Debt-to Income/Low Credit Score Combinations, FHA Single Family Housing (March 14, 2019), available at: https://www.hud.gov/sites/dfiles/SFH/documents/SFH_FHA_INFO_19-07.pdf.

⁵⁰ Developer's Guide for TOTAL Scorecard, HUD Officer of Single Family Housing (Dec. 9, 2019), available at: <https://apps.hud.gov/pub/chums/aus-developers-guide-SOAP-MISMO.pdf>.

The use of DTI ratios for credit decisions is known to have a significant, adverse disparate impact on Black and Latino borrowers. Black homebuyers pay an average of 41% of monthly income to creditors compared to 37% for White homebuyers.⁵¹ Black and Latino families are about 1.5 times more likely to have DTI ratios above 45 than White families.⁵² Not surprisingly, then, research has shown that DTI thresholds disproportionately deny access to mortgage credit to Black and Latino Borrowers.⁵³ Lenders and some regulators nonetheless rely on DTI thresholds, even though “it is not particularly important as a predictor of default.”⁵⁴ Generally, researchers have concluded, “putting overlays on top of an automated underwriting system decreases efficiency.”⁵⁵ The CFPB seems belatedly to have recognized this, as it has now removed the DTI threshold from its Qualified Mortgage rule.⁵⁶

HUD nonetheless continues to follow this misguided trend of relying on DTI credit overlays, without justification. In its FY2020 Annual Report to Congress, HUD identifies a concern about insuring mortgages with three “extreme layered risk factors”: DTI ratio over 50, credit score below 640, and less than two months reserves. The Annual Report asserts that mortgages with these three credit characteristics perform worse than those without those factors. The Report concludes that the 2016 removal of the 2013 DTI-credit score threshold “contributed” to early payment defaults between 2017-2019.⁵⁷

Those conclusory assertions about DTI ratios over 50 or credit scores under 640 plainly do not justify imposing a 43 DTI or 620 credit score threshold. HUD has the data and could readily analyze the impact of accepting or rejecting mortgages in the over 43 DTI/under 620 credit score bucket. The Report does not indicate that HUD has done so. The Report analyzes whether any financial or mission-related losses result from excluding potentially performing loans that fall within the targeted credit bucket. For example, how many credit-worthy Black and Latino borrowers are deprived of homeownership opportunities? How much does the MMI Fund lose in fees it would have collected from potentially performing loans that are now excluded? For loans in the excluded credit bucket that would have defaulted, the Report neither quantifies the savings to the Fund from excluding those loans, nor balances those savings against losses to the Fund from fees it would have collected prior to default and the amount that would have been added to the Fund from sale of the defaulted asset. These are all factors that must be considered when applying credit criteria that have the effect of excluding borrowers based on race or natural origin.

Using a two-factor DTI-credit score threshold like the one HUD employs now presumably operates differently than a single-factor DTI threshold of the kind the CFPB employs. This is part of the analysis the Fair Housing Act requires HUD to perform. If the credit overlay cannot be justified—and it appears likely

⁵¹ Vanessa Gail Perry, Ph.D., 2020 State of Housing in Black America: Challenges Facing Black Homeowners and Homebuyers During the COVID-19 Pandemic and an Agenda for Public Policy, ES-4, available at: <https://www.nareb.com/sites/files/uploads/2020/10/2020-SHIBA-REPORT-OFFICIAL-COPY.pdf>.

⁵² Edward Golding, Laurie Goodman, and Jun Zhu. 2017, Fannie Mae Raises the DTI Limit, Urban Institute (July 2017), available at: https://www.urban.org/sites/default/files/publication/91936/fannie_mae_raises_dti_limit_0.pdf.

⁵³ Roberto G. Quercia, Lei Ding & Carolina Reid, Balancing Risk and Access: Underwriting Standards for Qualified Residential Mortgages, Univ. of N.C. at Chapel Hill, Ctr. For Community. Capital (Mar. 5, 2012), available at: <http://www.responsiblelending.org/mortgage-lending/research-analysis/Underwriting-Standards-for-Qualified-Residential-Mortgages.pdf>.

⁵⁴ Richard Green, “The Trouble with DTI as an Underwriting Variable—and as an Overlay,” Richard’s Real Estate and Urban Economics Blog, December 7, 2016, available at: <http://real-estate-and-urban.blogspot.com/2016/12/the-trouble-with-dti-as-underwriting.html>.

⁵⁵ Golding, Edward, Laurie Goodman, and Jun Zhu. 2017. “Fannie Mae Raises the DTI Limit.” Washington, DC: Urban Institute, available at: https://www.urban.org/sites/default/files/publication/91936/fannie_mae_raises_dti_limit_0.pdf; accord Stein, Eric, and Michael Calhoun. 2019. A Smarter Qualified Mortgage Can Benefit Borrowers, Taxpayers, and the Economy. Durham, NC: Center for Responsible Lending, available at: <https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-a-smarter-qualified-mortgage-july2019.pdf> (“DTI on its own is only minimally predictive of risk for prime- and near prime-priced loans”).

⁵⁶ Consumer Financial Protection Bureau, description of final rule amending Qualified Mortgage Definition under the Truth in Lending Act, available at: <https://www.consumerfinance.gov/rules-policy/final-rules/qualified-mortgage-definition-under-truth-in-lending-act-regulation-z-general-qm-loan-definition/>.

⁵⁷ HUD 2020 Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance, page 32, available at: <https://www.hud.gov/sites/dfiles/Housing/documents/2020FHAAnnualReportMMIFund.pdf>.

that it cannot—it must be removed. A trend of increasing capital reserves from 2013 to 2020 undercuts HUD’s view that the credit overlay is necessary to protect the MMI Fund.⁵⁸

Alternative Credit Scores

Current credit practices in the mortgage industry mean that those with no credit score or thin or stale credit files are precluded from gaining access to mortgage credit, though no evidence indicates that they are bad credit risks.⁵⁹ Black and Latino borrowers are disproportionately represented in this group. “Black borrowers have a median FICO score of 626 while the median FICO score for White borrowers is 750.”⁶⁰

Moreover, “[t]he influence of credit invisibility on mortgage lending also affects those who have good credit scores”:

Consider a couple, where one person is credit invisible, and the other has a strong credit score. Lenders will advise the couple to have one loan applicant—the member with the credit score. As a result of this, the couple’s measured income is lower than their actual income, meaning that they might fail lenders’ debt-to-income (DTI) test.⁶¹

HUD nonetheless requires a traditional credit report for automated underwriting. “The Mortgagee must obtain a Tri-Merged Credit Report (TRMCR) from an independent consumer reporting agency.” If a traditional credit report is not available or is insufficient, the application will be downgraded to manual underwriting.⁶² For manual underwriting, “[i]f a traditional credit report is available, the Mortgagee must use a traditional credit report. However, if a traditional credit report is not available, the Mortgagee must develop the Borrower’s credit history using the requirements for Non-Traditional and Insufficient Credit.”⁶³

New credit score models “that go beyond credit repository data are being developed that allow rental payments, utilities, remittances, and digital transactions to be used to establish credit histories.”⁶⁴ And there are scoring models commercially available today that score more consumers than FICO. HUD should review and modernize its scorecard to expand access to credit for borrowers with nontraditional credit. HUD’s obligation to affirmatively further fair housing demands no less, not to mention its obligation not to discriminate based on race or national origin.

MIP Rates

The racial and ethnic demographics of borrowers served by the FHA forward mortgage program, as well as the demographic and pricing disparities between the forward and reverse mortgage programs require HUD to take a hard look, from a fair housing perspective, at the pricing for each program, both independently and relative to each other.

⁵⁸ Page 41, Exhibit I-20, available at: <https://www.hud.gov/sites/dfiles/Housing/documents/2020FHAAnnualReportMMIFund.pdf>.

⁵⁹ Richard K. Green, Ashlyn A. Nelson, Credit Scoring Has Both Directly and Indirectly Affected the Ability of People of Color to Access Low-Cost Home Loans, 2-23, available at: <https://www.nareb.com/site-files/uploads/2020/10/2020-SHIBA-REPORT-OFFICIAL-COPY.pdf>.

⁶⁰ Vanessa Gail Perry, Ph.D., 2020 State of Housing in Black America: Challenges Facing Black Homeowners and Homebuyers During the COVID-19 Pandemic and an Agenda for Public Policy, ES-4, 2-21, Table 2-5, and Figure 2-12, available at: <https://www.nareb.com/site-files/uploads/2020/10/2020-SHIBA-REPORT-OFFICIAL-COPY.pdf>.

⁶¹ Richard K. Green, Ashlyn A. Nelson, Credit Scoring Has Both Directly and Indirectly Affected the Ability of People of Color to Access Low-Cost Home Loans, E-23, available at: <https://www.nareb.com/site-files/uploads/2020/10/2020-SHIBA-REPORT-OFFICIAL-COPY.pdf>.

⁶² FHA Single Family Housing Policy Handbook (Handbook 4000.1), HUD Assistant Secretary for Housing-Federal Housing Commissioner, page 187, sec. II.A.4(b)(ii) (Aug. 14, 2009), available at: <https://www.hud.gov/sites/dfiles/OCHCO/documents/4000.1hshg.pdf>.

⁶³ FHA Single Family Housing Policy Handbook (Handbook 4000.1), HUD Assistant Secretary for Housing-Federal Housing Commissioner, page 187, sec. II.A.5(a)(ii) (Aug. 14, 2009), available at: <https://www.hud.gov/sites/dfiles/OCHCO/documents/4000.1hshg.pdf>.

⁶⁴ Vanessa Gail Perry, Ph.D., 2020 State of Housing in Black America: Challenges Facing Black Homeowners and Homebuyers During the COVID-19 Pandemic and an Agenda for Public Policy, 3-4, available at: <https://www.nareb.com/site-files/uploads/2020/10/2020-SHIBA-REPORT-OFFICIAL-COPY.pdf>.

HUD charges FHA borrowers an upfront fee and annual premiums. The maximum upfront fee is 3% of the mortgage amount, or 2.75% for first-time homebuyers who have received homeownership counseling.⁶⁵ The maximum annual premium varies based on the loan's initial loan-to-value (LTV) ratio. For most loans, if the LTV ratio is above 95%, the maximum annual premium is 1.55% of the loan balance. Or, if the LTV ratio is 95% or below, the maximum annual premium is 1.5% of the loan balance.⁶⁶

Within statutory constraints, HUD periodically raises and lowers fees. Since April 9, 2012, HUD has set the upfront fee for forward mortgages at 1.75% of the loan amount, including for first-time homebuyers.⁶⁷ A list of changes to premiums and underwriting criteria between 2010 and 2016, with references to the FHA Mortgage Letters that implemented the changes, is available in the FY2016 Annual Report to Congress.⁶⁸

On January 9, 2017, the Obama administration determined that the appropriate balance of financial soundness for the MMI Fund and its operational goals and required a reduction of the annual premium rates for forward mortgages. Accordingly, for forward loans at or below 95% LTV, with a term greater than fifteen years, HUD reduced the annual premium rate to 0.55%. For loans over 95%, HUD reduced the rate to 0.60%.⁶⁹

Eleven days later, when Trump took office, HUD reversed the January 9 rate reduction before it took effect. FHA annual premium rates remained at between 0.80% and 1.05%, about 50% more than the rates proposed by the Obama administration.⁷⁰

Seven months after that effective rate increase for forward mortgage borrowers, on August 29, 2017, HUD cut the annual premium rate for HECM borrowers, from 1.25%⁷¹ down to 0.50%.⁷² HECM borrowers, who again are predominantly White, now pay about half the annual fee rate of forward mortgage borrowers, who are substantially people of color. At the same time, HUD adjusted the upfront fee for HECM loans to 2% of the Maximum Claim Amount, up from between 0.50% and 2.50%. The current HECM upfront fee of 2% is only slightly higher than the 1.75% upfront fee on forward mortgages.

In its FY2020 Annual Report to Congress, HUD identified HECM losses and the potential economic impact of the COVID-19 pandemic as justification for maintaining high fees in the forward mortgage program.

Using the forward mortgage program to compensate for losses in the HECM program raises potential fair housing concerns, given the relative racial and ethnic compensation of the two portfolios.⁷³ That Congress chose to support both programs through one fund does not justify HUD in charging unreasonably high fees to (substantially minority) forward mortgage borrowers to subsidize the (predominantly White) HECM borrowers.⁷⁴ Congress gave HUD discretion to set different fee rates for the two programs.

⁶⁵ 12 U.S.C. § 1709(c)(2)(A).

⁶⁶ 12 U.S.C. § 1709(c)(2)(B).

⁶⁷ HUD Mortgage Letter 12-4, Single Family Mortgage Insurance: Annual and Up-Front Mortgage Insurance Premiums—Changes (March 6, 2012), available at: <http://portal.hud.gov/hudportal/documents/huddoc?id=12-04ml.pdf>

⁶⁸ FHA 2016 Annual Report to Congress on the Financial Status of the MMI Fund, page 37, Appendix A, available at: <https://portal.hud.gov/hudportal/documents/huddoc?id=2016fhaannualreport1.pdf>

⁶⁹ FHA Mortgage Letter 2017-01, Reduction of Federal Housing Administration (FHA) Annual Mortgage Insurance Premium (MIP) Rates (Jan. 9, 2017), <https://www.hud.gov/sites/documents/17-01ML.PDF>

⁷⁰ FHA Mortgage Letter 2017-01, Suspension of Mortgage Letter 2017-01 – Reduction of Federal Housing Administration (FHA) Annual Mortgage Insurance Premium (MIP) Rates (Jan. 20, 2017), <https://www.hud.gov/sites/documents/17-07ML.PDF>

⁷¹ The new rate superseded Mortgage Letter 2014-21 (Nov 10, 2014), <https://www.hud.gov/sites/documents/14-21ML.PDF>

⁷² FHA Mortgage Letter 2017-12, Home Equity Conversion Mortgage (HECM) Program: Mortgage Insurance Premium Rates and Principal Limit Factors (Aug. 29, 2017), <https://www.hud.gov/sites/documents/17-12ML.PDF>

⁷³ Karan Kaul, Sarah Stochak, and Laurie Goodman, Reverse Mortgage Use Differs by Race and Ethnicity. Here's Why It Matters, available at: <https://www.urban.org/urban-wire/reverse-mortgage-use-differs-race-and-ethnicity-heres-why-it-matters>

⁷⁴ Edward Golding and Laurie Goodman, "To better assess the risk of FHA programs, separate reverse and forward

Moreover, HUD's invocation of the pandemic as justification for its steady overcharging of borrowers in the forward mortgage program is suspect. Now that the catastrophic event has arrived, HUD expects borrowers hardest hit by the pandemic and on the front lines of the crisis⁷⁵ to carry an oversized burden in protecting the MMI Fund (i.e., the taxpayers) from its financial effects. A mere 2% capital ratio requirement coupled with an open appropriation hardly sounds like a congressional delegation of policymaking authority on the scale HUD has recently exercised; indeed, they imply the opposite. To the extent there is uncertainty, HUD need only look to its affirmative fair housing obligation to see that in this case, it made the wrong choice in asking minority borrowers to carry more of the burden. A difference of between 105 basis points and 60 basis points on a \$200,000 home, for example, is about \$1,000 annually. Across the FHA portfolio, that amounts to billions of dollars in excess fees every year.

IV. Proposed Action

Borrower Eligibility

Eliminate the DTI-Credit Score Threshold Added to the Scorecard in 2019

HUD should eliminate the DTI-Credit Score threshold added to the Scorecard in 2019. The specific task here is to remove Review Rule 14 from TOTAL SCORECARD: "The lowest median FICO score is less than 620 and the Back-End Ratio (DTI) is greater than 43.00." HUD also would need to update the Developer's Guide for TOTAL Scorecard⁷⁶ and the FHA Single Family Housing Policy Handbook.⁷⁷

When HUD *tightens* credit criteria, it goes through a Paperwork Reduction Act Process, with OMB approval and an OMB control number. By contrast, HUD has used various processes to *loosen* credit criteria, sometimes with no public process at all.

Examples of HUD Mortgagee Letters announcing changes to FHA underwriting standards:

- On September 3, 2010, HUD published a notice-and-comment rule in the *Federal Register* to institute for the first time a minimum credit score requirements.⁷⁸
- On January 31, 2013, HUD published a Mortgagee Letter with a sixty-day future effective date (April 1, 2013) to announce the addition of the DTI-Credit Score credit overlay.⁷⁹ The ML indicated that a Paperwork Reduction Action process was underway. The Developer's Guide indicates the change was implemented March 30, 2013.⁸⁰

mortgages," Urban Institute, Urban Wire blog post, November 29, 2017, available at: <https://www.urban.org/urban-wire/better-assess-risk-fha-programs-separate-reverse-and-forward-mortgages>.

⁷⁵ Maurice Jourdain-Earl, The COVID-19 Forbearance Moratorium Enlarges the Wound Caused by the Lack of Homeownership in Black America, 3-10, available at: <https://www.nareb.com/site-files/uploads/2020/10/2020-SHIBA-REPORT-OFFICIAL-COPY.pdf>.

⁷⁶ Developer's Guide for TOTAL Scorecard, Appendix C – Scorecard Review Rules, HUD Officer of Single Family Housing (Dec. 9, 2019), available at: <https://apps.hud.gov/pub/chums/aus-developers-guide-SOAP-MISMO.pdf>.

⁷⁷ FHA Single Family Housing Policy Handbook (Handbook 4000.1), HUD Assistant Secretary for Housing-Federal Housing Commissioner (Aug. 14, 2009), available at: <https://www.hud.gov/sites/dfiles/OCHCO/documents/4000.1hshg.pdf>.

⁷⁸ 75 Fed. Reg. 54020 (Sept. 3, 2010).

⁷⁹ FHA Mortgagee Letter 2013-05, Manual Underwriting for Loans with Decision Credit Score Below 620 and Total Fixed Payments to Effective Income Ratio Exceeding 43.00% (Jan. 31, 2013), available at: <https://www.hud.gov/sites/documents/13-05ML.PDF>.

⁸⁰ Developer's Guide for TOTAL Scorecard, Appendix E, Exhibit E.18, HUD Officer of Single Family Housing (Dec. 9, 2019), available at: <https://apps.hud.gov/pub/chums/aus-developers-guide-SOAP-MISMO.pdf>.

- In 2016, HUD removed the same overlay with no public notice and no Mortgagee Letter.
- On May 14, 2019, HUD issued a press notice announcing that it would modify TOTAL Scorecard effective March 18 (three days later) to “specifically manage the decrease in average borrower credit scores and the excessive risk lawyer that results when multiple factors are present.”⁸¹ In its FY2019 Annual Report to Congress, HUD confirmed that in March 2019, it had “adjusted the TOTAL default risk attributes to account for emerging default risk indicators to help balance risk of loss against FHA’s mission of making sustainable homeownership available.”⁸² The Report was coy about revealing that it was reinstating the Obama-era 2013 credit overlay, merely stating: “As designed, the TOTAL Mortgage Scorecard adjustments will require mortgages with a combination of higher-risk characteristics to undergo a manual underwriting process.”⁸³

Even if HUD is not required to issue a Mortgagee Letter to announce its updates of TOTAL Scorecard and the Handbook to eliminate the credit overlay, doing so here would serve a worthy fair-housing educational and coordinating goal. HUD is the agency charged by Congress with coordinating the other federal agencies’ fulfillment of their affirmative fair housing obligations. This includes the federal financial regulators. As such, HUD should take the leadership role and explain the risks attendant to credit overlays.

Allow the Use of Alternative Credit Scores

HUD should allow the use of alternative credit scoring models that include credit proxies, such as utility, telecom, and rental payments, for both automated and manual underwriting. HUD should identify the availability and effectiveness of alternative credit scores that could be accepted by TOTAL Scorecard for automated underwriting and that could be used for manual underwriting.

Before adopting any specific credit score or credit factors for underwriting, HUD must perform a thorough fair lending analysis. This memo outlines the process for adjusting FHA underwriting criteria in the immediately preceding section about DTI-credit score thresholds.

Reduce MIP Rates

HUD should reduce MIP pricing to the level needed to maintain the Fund at the 2% capital ratio set by Congress, and it should require equitable pricing between forward and reverse mortgage borrowers. Lowering MIPs would reduce the unequal costs of homeownership for Black and Latino borrowers,⁸⁴ serve FHA’s mission to provide access to homeownership, and advance HUD’s obligation to affirmatively further fair housing and avoid discriminating.

Changing MIP rates must be cleared through the Office of Management and Budget (OMB), through a Paperwork Reduction Act process.⁸⁵ While this involves public comment and publication in the *Federal Register*, it is not rulemaking under Administrative Procedure Act. Once OMB approves the collection, it issues a control number, signaling compliance with the Paperwork Reduction Act. OMB control numbers have an expiration date, typically three years. Mortgagee Letters announcing rate changes always include the OMB

⁸¹ News and Updates, FHA INFO #19-07, Managing Mortgage Risk Trends in the FHA Single Family Portfolio: Comprehensive Approach Starts with Total Mortgage Scorecard Updates to Address High Debt-to-Income/Low Credit Score Combinations, FHA Single Family Housing (March 14, 2019), https://www.hud.gov/sites/dfiles/SFH/documents/SFH_FHA_INFO_19-07.pdf.

⁸² HUD 2019 Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance, page 85, available at: <https://www.hud.gov/sites/dfiles/Housing/documents/2019FHAAnnualReportMMIFund.pdf>.

⁸³ Page 86, available at: <https://www.hud.gov/sites/dfiles/Housing/documents/2019FHAAnnualReportMMIFund.pdf>.

⁸⁴ Michelle Aronowitz, Edward L. Golding, and Jung Hyun Choi, The Unequal Costs of Black Homeownership, MIT Golub Center for Finance and Policy, available at: <https://gcfp.mit.edu/mortgage-cost-for-black-homeowners/>

⁸⁵ 44 U.S.C. 3501-3520.

control number. The last time rates were lowered was January 9, 2017,⁸⁶ which was reversed on January 20, 2017.⁸⁷

Current MIP rates can be found in HUD's Single-Family Housing Handbook.⁸⁸



⁸⁶ Mortgagee Letter 2017-01 (Jan. 9, 2017), Reduction of Federal Housing Administration (FHA) Annual Mortgage Insurance Premium (MIP) Rates, HUD Assistant Secretary for Housing-Federal Housing Commissioner, available at: <https://www.hud.gov/sites/documents/17-01ML.PDF>.

⁸⁷ Mortgagee Letter 2017-07 (Jan. 20, 2017), Suspension of Mortgagee Letter 2017-01 -Reduction of Federal Housing Administration (FHA) Annual Mortgage Insurance Premium (MIP) Rates, HUD Assistant Secretary for Housing-Federal Housing Commissioner, available at: <https://www.hud.gov/sites/documents/17-07ML.PDF>.

⁸⁸ FHA Single Family Housing Policy Handbook (Handbook 4000.1), HUD Assistant Secretary for Housing-Federal Housing Commissioner (Aug. 14, 2009), available at: <https://www.hud.gov/sites/dfiles/OCHCO/documents/4000.1hsgh.pdf>.