Treatment of Seller-Funded Downpayment Assistance in FHA-Insured Home Loans

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Summary

In order to qualify for FHA-insured home loans, borrowers are required to contribute a minimum amount to the cost of purchasing the home. Under certain conditions the borrower's required contribution may be paid by others. Can the borrower's required contribution be paid by a nonprofit agency that is later reimbursed by the seller of the property? That has been the subject of regulation, litigation, and legislation. The Housing and Economic Recovery Act of 2008, P.L. 110-289, effective October 1, 2008, increases the borrower's required contribution from 3% to 3.5% and provides that the borrower's required contribution towards the purchase of an FHA-insured home may not be provided by the seller or by any third party that is being reimbursed by the seller. Enactment of the law does not mean that sellers may not provide downpayment assistance to borrowers obtaining FHA-insured home loans. It simply means that any contribution by the sellers will not count towards the 3.5% contribution required of the borrower. Current HUD rules provide that the seller or other interested third parties may contribute up to 6% of the property's sales price toward the buyer's costs. As introduced on January 16, 2009, H.R. 600 would amend the law to provide exceptions to the prohibition on seller contributions. This report will be updated as suggested by changes in law or regulation. (For information on the FHA mortgage insurance program, please see CRS Report RS20530, *FHA-Insured Home Loans: An Overview*, by Bruce E. Foote and Katie Jones.)

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The Housing and Economic Recovery Act of 2008

Under the Housing and Economic Recovery Act of 2008 (HERA), P.L. 110-289, as enacted on July 30, 2008, borrowers are required to contribute at least 3.5% in cash or its equivalent to the cost of acquiring a property with an FHA-insured mortgage. Amounts borrowed from a family member are considered as cash for this purpose. Prohibited sources of funding for the required funds include the seller or any entity that financially benefits from the transaction, or any third party that is directly or indirectly reimbursed by the seller or by anyone that would financially benefit from the transaction.

Enactment of the law does not mean that sellers may not provide downpayment assistance to borrowers obtaining FHA-insured home loans. It simply means that any contribution by the sellers will not count towards the 3.5% contribution required of the borrower. Nonprofits may still provide gifts that would pay borrowers' required downpayments, but the source of these gifts may not be the sellers. As noted below, current HUD rules provide that the seller or other interested third parties may contribute up to 6% of the property's sales price toward the buyer's actual closing costs.

These provisions of the law took effect on January 1, 2009.[1]

The Borrower's Up-Front Costs of Obtaining an FHA-Insured Mortgage

When obtaining an FHA-insured mortgage to purchase a home, a borrower becomes responsible for the downpayment and some closing costs. HERA has increased the borrower's required contribution from 3% to 3.5% of the sales price. HUD has interpreted this as a 3.5% downpayment requirement.[2]

Closing costs are the fees involved in the final transfer of the property from the seller to the buyer. Typical closing costs may include the following:

- Homeowners insurance which combines hazard insurance and liability insurance. Hazard insurance covers property damage caused by fire, wind, storms, and other similar events. Coverage for earthquakes and floods may or may not be included with hazard insurance, depending on the location of the property. Liability insurance coverage protects the borrower against claims alleging negligence or inappropriate action resulting in bodily injury or property damage.
- A borrower must pay FHA insurance in two stages: an upfront insurance premium which is paid when the mortgage is obtained, and an annual insurance premium. The upfront mortgage insurance is currently 1.75% of the loan amount. The cost of this insurance may be added to the mortgage.

[1] U.S. Department of Housing and Urban Development, *Revised Downpayment and Maximum Mortgage Requirements*, Mortgagee Letter 2008-22, Washington, DC, September 5, 2008, p. 1.

[2] See footnote 1.

- Title insurance to cover the lender in case the person who sold the house didn't actually own it or if information on the title was false. Title insurance to protect the borrower is at the borrower's option.
- Appraisal fee for the cost of an appraisal to determine the market value for the home and provide assurance to the lender that the property is worth at least the amount of the sales price.
- Property inspection fee for the cost of an inspection to evaluate the physical condition of the structure, construction and mechanical systems; estimate the remaining useful life of the major systems; and identify items that should be repaired or replaced. A property inspection is not required by FHA but it is recommended. An appraisal identifies the value of a property but not its condition.
- Points or origination fees to be paid to the lender for their services in creating the loan. A point is 1% of the loan.
- Survey fee for the cost of determining the exact boundaries of the property.
- Property taxes to repay the seller for property taxes that may already have been paid for a time period where the new buyer will occupy the property, and to establish a reserve for the payment of future taxes.
- City, county, and state transfer taxes depending on the location of the property.
- Attorney fees and document preparation fees.

Paying for the Up-Front Costs

The Downpayment

Under the HUD interpretation of HERA, borrowers are required to make downpayments of 3.5% of the purchase price. Revision 5 (REV-5) of HUD Handbook 4155.1 contains the underwriting guidelines for single family mortgage loans insured under the National Housing Act.[3] The Handbook establishes that HUD does not permit the downpayments to be made by the sellers of the property.[4]

The Handbook states that, other than the exceptions noted below, contributions from third parties do not count towards the buyer's required downpayment. An outright gift of the required downpayment is acceptable if the donor is (1) the borrower's relative, (2) the borrower's employer or labor union, (3) a charitable organization, (4) a government agency or public entity that has a program to provide homeownership assistance to low- and moderate-income families or first-time homebuyers, or (5) a close friend with a clearly defined and documented interest in the borrower.[5]

[3] Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties, Handbook 4155.1 REV-5, October 2003.

[4] Handbook 4155.1 REV-5, p. 1-8.

[5] HUD Handbook 4155.1 REV-5, p. 2-24.

The Handbook goes on to state that the donor may not be anyone with an interest in the sale of the property, such as the seller, real estate agent, builder, or any entity associated with the above. HUD considers gifts from these sources to be inducements to purchase, and the amount of the gift must be subtracted from the sales price and this reduces the maximum loan that FHA will insure on that property.

An FHA-insured loan on which the buyer has received a gift of the required funds must be documented with a so-called "gift letter." The letter must meet certain requirements: (1) be signed by the donor and the borrower; (2) specify the amount of the gift; (3) state that no repayment is required; (4) show the name, address, and phone number of the donor; and (5) state the nature of the relationship between the donor and borrower.

The Closing Costs

Handbook 4155.1 REV-5 provides that the seller or other interested third parties such as real estate agents, builders, developers, or a combination of parties, may contribute up to 6% of the property's sales price toward the buyer's actual closing costs, prepaid expenses, discount points, and other financing concessions.[6] These provisions may be included in the sales contract negotiated between buyers and sellers by the real estate agents.

A Brief History of Seller-Funded Downpayment Assistance Programs Sponsored by Nonprofits

Handbook 4155.1 REV-5 provides that borrowers must contribute toward the purchase of the home, and that a nonprofit may provide a gift of the required contribution as long as the funds are not provided by the sellers. In the 1990s, several nonprofits developed a form of seller-funded downpayment assistance (DPA) program that worked around this HUD restriction on seller funding. The seller-funded DPA programs were structured as follows: (1) the nonprofit would provide the borrower with a gift of the required funds; (2) after completion of the home sale, the seller of the home would make a donation to the nonprofit; and (3) the amount of the donation would be the amount the nonprofit had paid on behalf of the borrower plus a processing fee for the nonprofit.

Since the borrower's costs had already been paid by the nonprofit, technically, the contribution from the seller was not paying that borrower's costs, it was replenishing the funds of the nonprofit and enabling the nonprofit to contribute to the downpayment of some future borrower. Structured in this manner, the transaction did not appear to be prohibited by HUD's policy against having the borrower's required contribution paid by the sellers.

HUD, however, did not agree with this interpretation. The Nehemiah Progressive Housing Development Corporation (Nehemiah) of Sacramento, CA, had been given a 6-month approval of its DPA program by a local HUD office. The HUD national office reviewed the paperwork and concluded that gifts to borrowers by Nehemiah would no longer be counted as meeting the

[6] Handbook 4155.1 REV-5, p. 1-8.

borrower's contributions. Nehemiah filed a suit over HUD's decision.[7] A settlement agreement was reached in 1998 whereby Nehemiah was permitted to continue operation of its DPA program and HUD reserved the right to take regulatory actions with regard to DPA programs. The agreement also provided that if HUD took regulatory action regarding HUD's treatment of DPA providers, the applicability of the changes to Nehemiah would occur six months from the effective date of the new rule.

Nehemiah had invested in a for-profit marketing firm, Invision Marketing & Sales Inc., to help it reach real-estate agents, home builders and other industry professionals. It was reasoned that a for-profit company would perform better than a nonprofit group because marketing representatives who earned commissions would work harder.[8] The Nehemiah Program expanded nationally and became the largest provider of downpayment assistance for borrowers obtaining FHA-insured home loans. A number of other nonprofit organizations followed the Nehemiah pattern and offered similar downpayment assistance programs and for-profit marketing arms. For example, AmeriDream Inc., of Gaithersburg, MD, which became the second largest DPA provider, used a marketing firm called Synergistic Marketing Inc., which was started by the AmeriDream's founders. Buyer's Fund Inc. was created in Provo, UT, and its for-profit marketing firm was Neighborhood Gold.[9]

Issues with Seller-Funded Downpayment Assistance

IRS Ruling

Proponents of seller-funded DPA programs argue that the programs provide homeownership opportunities to low- and moderate-income families, without cost to the federal government. While seller-funded DPA programs do not require direct appropriations, the forgone income tax revenue that result from such transactions may be considered a cost. Under seller-funded DPA programs, a charitable organization makes a downpayment gift to the borrower, and the seller makes a nearly equivalent contribution to the charitable organization. So, for any given seller-funded DPA transaction, the cost to the government is the amount by which the seller's income tax liability is reduced because of the contribution to the charitable organization. This is the reason that the Internal Revenue Service (IRS) became involved in the issue.

In May 2006, the IRS published Revenue Ruling 2006-27, which provides guidelines on organizations that may provide downpayment assistance to homebuyers and qualify as tax-exempt charitable or educational organizations under Internal Revenue Code (IRC) section 501(c)(3), and those that do not qualify for this tax-exempt status. In its press announcement of the ruling, the IRS stated that funneling downpayment assistance from sellers to buyers through

[7] Nehemiah Progressive Housing Corp. v. Andrew Cuomo, et al., Civ. S-97-1817-GEB/PAN (E.D. Cal.).

[8] Michael Corkery, "Housing Ministry: Scrutiny of Down-Payment Gifts Threatens Charitable Movement; Nehemiah Aided Home Buyers While Founder Got Fees; IRS Questions Tax Status; A Sales Gimmick for Builders?," *The Wall Street Journal*, July 5, 2006, p. A.1, Eastern Edition.

[9] See footnote 8.

''self-serving, circular-financing arrangements'' is inconsistent with operation as a section 501(c)(3) charitable organization.[10]

The ruling provides that an organization providing downpayment assistance does not qualify as a 501(c)(3) organization if: (1) to finance its downpayment assistance activities, the organization relies on sellers and other real-estate related businesses that stand to benefit from the transactions the organization facilitates; (2) in deciding whether to provide assistance to a low-income applicant, the organization's staff knows the identity of the home seller and may also know the identities of other interested parties and is able to take into account whether the home seller or another interested party is willing to make a payment to the organization; (3) the organization's receipt of a payment from the home seller corresponds to the amount of the downpayment assistance in substantially all of the transactions; (4) the organization's reliance on these payments for most of its funding indicates that the benefit to the home seller is a critical aspect of the organization's operations; (5) the organization is structured and operated to assist private parties who are affiliated with those who fund the organization.[11]

The IRS noted that it was examining 185 organizations that operate downpayment assistance programs to determine whether they would maintain their tax-exempt status. In addition, the agency noted that it has denied applications for tax exemption from over 20 organizations that seek to provide this service. The IRS also expressed concern that some of the organizations may have paid excessive fees to the marketing firms.

Effect on the FHA Insurance Fund

FHA-insured home loans are insured under one of two insurance funds—the Mutual Mortgage Insurance (MMI) fund and the General Insurance/Special Risk Insurance (GI/SRI) fund.[12] Most of the FHA single-family home loans are insured under the MMI fund while multifamily housing, nursing homes, hospitals, and experimental housing loans are insured under the GI/SRI fund.

As amended by the Cranston-Gonzalez National Affordable Housing Act, P.L. 105-625, Section 205 of the National Housing Act requires HUD to ensure that the MMI fund maintains a capital ratio of 2.0% at all times.[13] Section 2118(a) of HERA amended the law to establish that HUD has the fiduciary responsibility to ensure that the MMI fund is financially sound.[14] HUD is required to have an annual independent actuarial study of the MMI fund and report to Congress on the financial status of the fund.[15]

[10] The article may be found at http://www.irs.gov/newsroom/article/0,,id=156675,00.html

[11] IRS Revenue Ruling 2006-27 at http://www.irs.gov/pub/irs-drop/rr-06-27.pdf.

[12] Different loan products are insured under the General Insurance fund and the Special Risk Insurance fund but administratively the funds are treated as one.

[13] 12 U.S.C. § 1711.

[14] 12 U.S.C. § 1708(a).

[15] Capital is defined as the economic net worth of the MMI fund as determined by the required annual audit of the MMI fund. The economic net worth is defined as the current cash available to the MMI fund, plus the net present value of all cash inflows and outflows expected to result from the outstanding mortgages in the MMI fund. The capital ratio is defined as the ratio of capital to unamortized insurance in force. Unamortized insurance in force is defined as the dollar amount of the outstanding mortgages that are obligations of the MMI fund.

HUD argues that seller-funded DPA programs do not provide homeownership opportunities without cost to the government. HUD suggests that the programs have provided homeownership but they have not provided sustainable homeownership in too many cases.[16] HUD notes that the rates of defaults, foreclosures, and claims involving seller-funded DPAs have increased, and these increases jeopardize the solvency of the MMI fund.[17]

Borrowers receiving gifts of the required funds had increasingly become a larger part of the FHA insurance pool. In FY2000, about 76% of the borrowers provided downpayments from their own funds. By FY2007, only about 48% of the borrowers provided downpayments from their own funds. In FY2000, about 2% of the borrowers received their downpayments from nonprofits. In 2007, nearly 38% of the borrowers received their downpayments from nonprofits.[18] HUD's analysis of its database indicated that more than 95% of the transactions with downpayment assistance from nonprofits were those that were seller funded.[19] HUD has found the default rate on loans with gifts from sellers to be nearly twice the default rate on loans with gifts from family members.[20]

According to the latest annual audit, the MMI fund had an economic value of $12.9 billion as of the end of FY2008, compared to an economic value of $21.3 billion at the end of FY2007. The audit report attributes this 39% decline in value to two things: (1) a weakening of the housing market since FY2007, and (2) the concentration of loans receiving downpayment assistance from nonprofits.[21]

In testimony before Congress, the Government Accountability Office (GAO) said that they analyzed a national sample and a Metropolitan Statistical Area (MSA) sample of FHA-insured loans. The analysis found that the probability that loans with seller-funded downpayment assistance would result in claims against the MMI fund was 76% higher in the national sample and 166% higher in the MSA sample than it was for comparable loans without such assistance.[22]

In DPA programs that do not involve gifts from the sellers, the sources of the downpayments do not alter the transactions. A given seller would be indifferent to whether a buyer provides the downpayment from the buyer's own funds, from relatives, from friends, from government agencies, or from nonprofits, because the seller would net the same amount from the sale. But if the seller has to reimburse the nonprofit for the downpayment assistance provided to the buyer, that reduces the amount the seller would net from the sale compared to the amount that the seller would net in other DPA transactions. This gives the seller the incentive to attempt to increase the

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[16] U.S. Department of Housing and Urban Development, "Standards for Mortgagor's Investment in Mortgaged Property," 72 *Federal Register* 27048, May 11, 2007.

[17] U.S. Department of Housing and Urban Development, "Standards for Mortgagor's Investment in Mortgaged Property: Additional Public Comment Period," 73 *Federal Register* 33941, June 16, 2008.

[18] See footnote 167. Table 1. p. 33952.

[19] See footnote 17.

[20] See footnote 17.

[21] Integrated Financial Engineering, Inc., *An Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund for Fiscal Year 2008*, Prepared for U.S. Department of Housing and Urban Development, Washington, DC, October 13, 2008, p. 27.

[22] U.S. Government Accountability Office, Seller-Funded Down-Payment Assistance Changes the Structure of the Purchase Transaction and Negatively Affects Loan Performance, Testimony Before the Subcommittee on Housing and Community Opportunity, Committee on Financial Services, House of Representatives, GAO-07-1033T, June 22, 2007, pp. 2-3.

price of the home in order to net the same amount that would be netted in the absence of reimbursing the provider of the downpayment assistance. To the extent that sellers are successful in increasing the price, the transactions have been altered.

In Columbus, Ohio, for example, homeowners sued Dominion Homes, alleging it defrauded buyers by not disclosing that the costs of downpayment grants they received from Nehemiah were added to the prices of their homes. "In essence, people paid more than fair-market value for their homes," said the homebuyers' lawyer.[23]

GAO noted that, according to mortgage industry participants and a HUD contractor's study,[24] sellers that provided downpayment assistance through nonprofits often raised the sales price of the homes in order to recover the payments. GAO analysis found that homes with seller-funded DPA were appraised at and sold for 2% to 3% more than comparable homes without that assistance.[25] HUD argues that inflated sales amounts result in inflated mortgage amounts, and this increases the size of claims against the MMI fund when the loans default.[26]

For these reasons HUD has sought to curtail the seller-funded DPA programs. The regulation containing the rules regarding borrower contributions are found in the Code of Federal Regulations at 24 CFR 203.19. On May 11, 2007, HUD published a proposed rule to revise 24 CFR 203.19 to establish that a prohibited source of downpayment assistance is a payment that consists, in whole or in part, of funds provided by any of the following parties before, during, or after closing of the property sale: (1) the seller, or any other person or entity that financially benefits from the transaction; or (2) any third party or entity (referred to as a ''donor'') that is reimbursed directly or indirectly by any of the parties listed in clause (1).[27] Only organizations that qualify as tax-exempt charitable or educational organizations under Internal Revenue Code Section 501(c)(3) would be eligible donors. This regulation was made final on October 1, 2007, and had an effective date of October 31, 2007.[28] For Nehemiah, the effective date was March 31, 2008, because of the terms of the 1998 settlement agreement between Nehemiah and HUD.

Nehemiah and several other organizations filed suit to block HUD's implementation of this new rule. The United States District Court for the District of Columbia issued a ruling on November 1, 2007, temporarily enjoining HUD from implementing the downpayment assistance rule. On March 5, 2008, the court vacated the final rule and remanded it to HUD for further processing consistent with the court's opinion.[29]

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[23] See footnote 8. *Clifford Rece et al. vs Dominion Homes, Inc., et al.*, 06CVH-2335 C.P.C. (Court of Common Pleas, Franklin County, Ohio 2006). The Court granted judgment for the Defendant in part because the Ohio Predatory Lending Act did not include the type of transaction involved in the case and the Court was not going to "create a remedy where none exists." In January 2008, the Court's decision was upheld on appeal.

[24] Concentrance Consulting Group, *An Examination of Downpayment Gift Programs Administered by Nonprofit Organizations*, prepared for the U.S. Department of Housing and Urban Development, Washington, DC, March 2005.

[25] See footnote 22.

[26] See footnote 16.

[27] See footnote 16.

[28] U.S. Department of Housing and Urban Development, "Standards for Mortgagor's Investment in Mortgaged Property," 72 *Federal Register* 56002, October 1, 2007.

[29] Ameridream Inc., et al. v. Jackson, No. 07-1752 (D.D.C. March 5, 2008) and Penobscot Indian Nation, et al. v. HUD, No. 07-1282-PLF (D.D.C. March 5, 2008).

With enactment of the provisions of P.L. 110-289 that prohibit seller-funded downpayments, the present regulation and the proposed revisions no longer represent current law. On December 31, 2008, a final rule was published which removes and reserves 24 CFR 203.19.[30] Presumably, HUD will be publishing a proposed rule that will make the regulation consistent with the provisions of P.L. 110-289. Those provisions require 3.5% downpayments from borrowers and provide that the funds may not come from the sellers of the property.

Analysis of Proposed Changes to Present Law

Though seller-funded DPAs were eliminated by P.L. 110-289, proponents of the program would like to see the law amended to permit seller-funded DPAs in a manner that benefits borrowers and provides safety and soundness to the MMI fund. Supporters include the Mortgage Bankers Association, U.S. Conference of Mayors, National Association of Realtors, National Association of Homebuilders, and National Association of Counties. As introduced on January 16, 2009, H.R. 600, the FHA Seller-Financed Downpayment Reform Act of 2009, would amend the National Housing Act to provide exceptions to the prohibition on seller contributions. Sellers would be permitted to contribute to the borrower's required funds on certain mortgages: (1) mortgages under which the borrower has a credit score in excess of 680; (2) mortgages under which the borrower has a credit score between 620 and 680, and upon which the borrower is charged a mortgage insurance premium that is high enough to permit the loan to be insured without the need for an appropriation of credit subsidy; and (3) mortgages insured in FY2010 or thereafter under which the borrower has a credit score of 619 or less, but only if HUD certifies that such loans can be insured without the need for an appropriation of credit subsidy.[31] HUD would be authorized to use risk-based pricing of mortgage insurance for borrowers with lower credit scores. Downpayment assistance entities would be required to offer to make counseling available to the borrower regarding the responsibilities and financial management involved in homeownership and to provide such counseling if the borrower accepts the offer. For borrowers with FICO scores between 620 and 680, the bill would provide that the up-front insurance premium could not exceed 3% of the original loan amount. For borrowers with FICO scores of at least 640 but less than 680, the bill would provide that the annual insurance premium could not exceed 1.5% of the loan balance. HUD would be authorized to impose civil money penalties on parties that try to coerce appraisers into assigning an appraised value that supports the contract price on sales transactions that involve seller-funded DPA.

In a study of subprime mortgages made in 2005, 2006, and 2007, a recent Federal Reserve article notes that default rates increased for borrowers with all categories of FICO scores, and that higher FICO scores were associated with bigger increases in default rates over time.[32] This suggests that any negative impact of seller-funded DPA on the MMI fund may not necessarily be prevented by using the FICO scores of the borrowers to determine their eligibility for seller-assisted downpayments.

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[30] U.S. Department of Housing and Urban Development, "Standards for Investment in Mortgaged Property: Compliance With Court Order Vacating Final Rule," 73 *Federal Register* 80297, December 31, 2008.

[31] A credit subsidy is the estimated long-term cost to the federal government of a loan guarantee. That cost is the net present value of estimated payments by the government to cover defaults and delinquencies, interest subsidies, or other payments, offset by any payments to the government, including origination and other fees, penalties, and recoveries.

[32] Yuliya Demyanyk, "Did Credit Scores Predict the Subprime Crisis?," *Federal Reserve Bank of St. Louis - Regional Economist*, October 2008, pp. 12-13.

If the seller were permitted to contribute to the borrower's downpayment, the services of a nonprofit would no longer be needed to facilitate the transaction. The downpayment assistance could be a matter of negotiation between the seller and borrower and become a part of the sales contract. Instead of assisting the buyer indirectly through a nonprofit, the seller could assist the buyer directly. This would add transparency to seller-funded downpayment transactions.

Under present rules, borrowers pay an up-front insurance premium of 1.75% of the loan amount and annual insurance premiums of 0.50% of the loan balance on loans with downpayments of 5% or more and annual premiums of 0.55% on loans with downpayments of less than 5%.[33]

Table 1 presents HUD's estimates of the up-front and annual insurance premiums HUD would have to charge borrowers who receive seller-funded downpayment assistance, if the MMI fund is to break even on the loans. The table suggests that, under the current insurance premiums, the MMI fund could more than break even on loans with seller-funded downpayment assistance when the loans are made to borrowers with credit scores of 680 or more. Such loans to borrowers with lower credit scores, however, would not be profitable when using the current insurance premiums.

Table 1. Breakeven Up-Front and Annual FHA Insurance Premiums for Seller-Funded Downpayment Assistance Loans

(Percent)

	FICO Score Range						
	300-499	**500-559**	**560-599**	**600-619**	**620-639**	**640-679**	**680-850**
Up-front Premium	28.95	12.09	6.88	5.92	5.99	5.56	0.95
Annual Premium	2.00	2.00	2.00	2.00	0.55	0.55	0.55

Source: Department of Housing and Urban Development, "Standards for Mortgagor's Investment in Mortgaged Property: Additional Public Comment Period," 73 *Federal Register* 33955, June 16, 2008.

HUD estimates that up-front premiums of 5.56% or more would be required from borrowers with FICO scores of less than 680 if the MMI fund is to break even on the loans. Furthermore, as noted in **Table 1**, upfront premiums of nearly 30% would be required from borrowers with FICO scores of less than 500.[34]

Even if HUD were permitted to charge the amount of mortgage insurance premiums suggested by **Table 1,** it could be difficult politically for HUD to actually charge such premiums. The federal government might be seen as charging high fees to low- and moderate-income homebuyers with credit problems. In addition, since studies have shown that minorities tend to have a higher incidence of low credit scores, HUD might be seen charging higher fees to minorities. For example, HUD's analysis, as shown in **Table 1**, suggests that a borrower with a 550 credit score

[33] U.S. Department of Housing of Housing and Urban Development, *Moratorium on Risk-Based Premiums for FHA Mortgage Insurance,* Mortgagee Letter 2008-22, Washington, DC, September 4, 2008.

[34] Under present HUD guidelines, however, borrowers with credit scores less than 500 are not eligible for FHA-insured home loans unless the borrowers make downpayments in excess of 10% of the purchase price. So it is unlikely that borrowers with credit scores less than 500 would be participants in seller-funded DPA transactions. See footnote 1.

would have to pay an up-front insurance premium of 12.09% of the mortgage amount, and a borrower with a 650 credit score would have to pay 5.56%.[35] On a $200,000 mortgage, the up-front insurance premiums would be $24,180 and $11,120, respectively.

Present law permits a borrower to finance the insurance premium through the mortgage, but the sum of the amount borrowed for the property and the mortgage insurance may not exceed 100% of the value of the property. It is not possible to add a 12% or 6% insurance fee to a mortgage on which the borrower has made a 3.5% downpayment without exceeding the value of the property. As a result, the borrower would have to pay cash for a significant part of the insurance. If the law were amended to permit the mortgage to exceed 100% of value, then vulnerable borrowers could be entering homeownership with mortgages that exceed the value of their homes.

If HUD's calculations are correct, and if, politically, HUD would not be able to charge the insurance fees required by the transactions, then seller-funded DPA transactions would result in losses for the MMI fund. What level of losses could the fund sustain?

The FHA share of the mortgage market was about 4% when HUD proposed eliminating seller-funded DPA in FY2007. At the end of FY2008, however, the FHA market share had increased to nearly 13%.[36] The turmoil in the mortgage market has made FHA an increasingly attractive option for homebuyers. It could be argued that, with the new influx of borrowers using FHA-insured loans, the MMI fund might be able to sustain any losses from loans with seller-funded DPA.

It has also been argued, however, that some subprime lenders may have turned to the FHA program and are continuing their past practices. A recent article suggests that loans by such lenders may bring a fresh wave of defaults and foreclosures to FHA in the next few years.[37] The future financial position of the Mutual Mortgage Insurance fund is uncertain, given the present housing market. As a result it is difficult to assess how the MMI fund would be affected by a revival of seller-funded DPA, even if HUD had the authority for limited risk-based pricing.

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[35] According to FHA Outlook, a bi-weekly report by FHA, the average FICO score for home purchasers was 657 in FY2008.

[36] U.S. Department of Housing and Urban Development, *FHA Market Share*, Washington, DC, February 9, 2009, p. 1, http://www.hud.gov/offices/hsg/comp/rpts/fhamktsh/fhamktcurrent.pdf.

[37] Chad Terhune and Robert Berner, "The Subprime Wolves are Back; And they're feeding off the bailout. The new game is FHA-backed loans, and it could cost taxpayers billions more," *Business Week*, December 1, 2008.