

## **Becoming, Staying FHA Approved** **A look at FHA approval requirements for mortgagees**

As secondary market investors tighten conventional lending requirements and costs, government-insured programs are expanding to cover the shortfall -- with recent program changes benefiting a wider pool of borrowers. But these programs can only be tapped by approved mortgage lenders and brokers or by approved net branch correspondents who operate under strict arrangements.

One government program, the FHASecure program was created late last year to help struggling subprime borrowers refinance their loans and keep their homes. But it may only be accessed by lenders and brokers (loan correspondents) that have obtained approval to offer loans insured by the Federal Housing Administration.

Obtaining FHA approval and keeping that approval are not easy tasks, however.

The U.S. Department of Housing and Urban Development, which oversees the FHA mortgage insurance program, has only six analysts to review all applications for new mortgagee approval. This means it takes a relatively long time for HUD to review and approve a new application for mortgagee approval.

But the agency is adding hundreds of staff to its monitoring and RESPA enforcement areas, so that today, lenders must be careful that they're doing things "right," the "FHA way."

### **HUD Handbook and Policy Clarifications**

HUD published a revised Mortgagee Approval Handbook in August 2006. Mortgage lenders and brokers thinking of applying for HUD mortgagee approval should become familiar with the handbook, and with HUD policy statements that are issued in mortgagee letters that are posted on HUD's web-site from time to time.

Mortgage lenders and brokers thinking of originating FHA-insured mortgages also need to beware of certain HUD policies and regulatory requirements regarding the approved mortgagee's operations, employees, how the mortgagee pays its business partners, and similar issues. These rules are serious and HUD audits for compliance with them.

For example, HUD has strict requirements regarding net branch arrangements.

HUD rules state that the approved mortgagee must pay all of its own operating expenses, including those of its main and branch offices. Such items as equipment, furniture, office rent, overhead, employee compensation, and similar expenses are among those that must be paid by the mortgagee.

HUD specifically prohibits mortgage brokers, also known as loan correspondents, and mortgagees from engaging a separate legal entity to function as a branch of the approved mortgagee or allowing a separate entity to originate insured mortgages under the approved mortgagee's FHA ID number.

Additionally, HUD says, a branch office compensation plan that includes the payment of operating expenses by the branch manager, another employee or third party is prohibited.

HUD recently posted on its Web site a restatement of existing policy reminding mortgagees that FHA loan origination services must be performed only by an FHA-approved lender or FHA-approved loan correspondent. In transactions where the mortgage broker is not an FHA-approved loan correspondent, that broker may not perform any of the loan origination activities. Further, HUD's policy statement indicates that RESPA prohibits the payment to non FHA approved brokers for the origination of an FHA insured forward mortgage loan, because the origination services, under FHA regulations, would have to be performed again by an FHA approved lender or FHA approved loan correspondent. The payment to an unapproved broker for duplicated services, according to HUD, amounts to an unearned fee in violation of section 8(b) of RESPA. Referral fees of course are strictly prohibited under RESPA.

Two additional HUD policies that mortgagees seeking HUD approval should keep in mind:

1. The compensation paid to all employees of the FHA approved mortgagee or loan correspondent must be reported on W-2 forms. Independent contractors are not acceptable originators of FHA insured mortgages.
2. Although HUD permits approved mortgagees and loan correspondents to employ some staff on a part-time basis, those employees involved in FHA mortgage activities may not also have other employment, even self-employment, with other entities in the mortgage or real estate related industries.

There are additional HUD rules with which approved mortgagees and loan correspondents must comply, including those regarding the approved entity's officers, minimum staffing, outsourcing, office facilities requirements, and other operational issues, that may be found in the Mortgagee Approval Handbook and other HUD publications. They are discussed briefly below.

### **FHA Mortgagee Approval**

Three basic types of FHA approved originating mortgagees include supervised mortgagees, which are financial institutions that are members of the Federal Reserve System, and whose accounts are insured by the Federal Deposit Insurance Corporation or the National Credit Union Administration. Examples of supervised mortgagees are banks, savings associations, and credit unions.

Non-supervised mortgagees, such as mortgage lenders, are non-depository financial entities, either free-standing or privately-owned, or subsidiaries or affiliates of supervised entities.

Mortgage brokers are considered by HUD to be non-supervised loan correspondents. A loan correspondent must be sponsored by a fully approved supervised or non-supervised direct endorsement mortgagee, which agrees to underwrite all FHA loans originated by the loan

correspondent and to fund the loans. Loans originated by a loan correspondent may be closed in either the loan correspondent's name or in the name of its underwriting sponsor.

### **Direct Endorsement Authority**

Direct endorsement, or "DE," authority is an additional level of FHA approval available to supervised and non-supervised mortgagees. DE enables these mortgagees to underwrite and close an FHA loan before submitting the loan to HUD for insurance endorsement.

### **General FHA Approval Eligibility Requirements**

All FHA mortgagees must meet certain general requirements to be approved to participate in the FHA mortgage insurance programs. There are also specific requirements applicable to the different types of mortgagee approval and the different forms of business organization. General requirements include:

- **Business Form.** A company seeking FHA approval must be a corporation, partnership, or limited liability company. A sole proprietorship or trust is not an acceptable business form for FHA approval. The entity must be a chartered organization with permanence and succession.
- **State Licensing Requirements.** Applicants must have all appropriate business licenses for the state in which the applicant is located and for those additional states where it seeks to do business.
- **No Sanctions.** A state-licensed mortgagee must submit a certification to HUD indicating that neither the applicant company nor any of its principals have ever been refused a license or sanctioned by any states in which they do business. If the mortgage company or any of its principals have been subject to a state or investor sanction, then it must disclose the information to HUD and provide documentation concerning the action.
- **Net Worth Requirements.** Mortgagees and loan correspondents (brokers) must meet specific net worth requirements for initial FHA approval and to maintain that approval.

For initial approval, a supervised or non-supervised mortgagee must have an adjusted net worth of at least \$250,000 in assets acceptable to HUD. After the first year of its approval, the minimum net worth requirement for a supervised or non-supervised mortgagee increases based upon the volume of its FHA insured mortgage business. A broker must have and maintain an adjusted net worth of at least \$63,000, plus \$25,000 for each FHA approved branch office up to a maximum required adjusted net worth of \$250,000.

- **Liquid Assets.** All approved mortgagees and loan correspondents must have and maintain liquid assets of at least 20 percent of their adjusted net worth, up to a maximum liquid assets requirement of \$100,000.

- **Financial Statements.** Applicants for non-supervised mortgagee or loan correspondent approval must submit with its application for FHA approval, a copy of the applicant's most current CPA prepared audited financial statement, along with a computation of adjusted net worth in HUD-acceptable assets. (Legislation is being considered by Congress that would make this requirement more flexible.)

If the audited financial statement is for a period ended more than six months prior to submission of the application for mortgagee approval, then an additional management prepared and certified interim financial statement as of a recent month end also must be submitted to HUD.

- **Officers.** The applicant must have at least one officer who spends his/her full time managing and directing the entity's operations, and who has a minimum of three years acceptable experience in the mortgage activities for which the applicant is seeking approval. Experience in real estate sales or brokerage does not qualify.
- **Resumes.** The applicant must submit current resumes for all senior officers, showing qualifying mortgage origination or servicing experience covering at least the previous seven years of employment.
- **Minimum Staffing.** HUD requires that approved mortgagees and loan correspondents have at least two full-time employees in the entity's home office. An FHA approved branch office must have at least one full-time employee.
- **Good Credit History.** The applicant entity, its parent, owners and officers must have good credit histories. The applicant must submit to HUD with the application for approval a commercial credit report on itself and on any corporate parent, and personal residential mortgage credit reports on each officer or individual owner of more than 25% of the entity's stock (or partnership or LLC membership interest). If any of the credit reports show negative items, they must be resolved and fully explained.
- **Office Facilities.** To be approved by HUD, a mortgagee or loan correspondent must have office facilities that meet HUD's requirements. The applicant must provide evidence that its office meets the HUD requirements, with the application for mortgagee approval, by providing pictures of the office facilities and signage, a floor plan of the office space, and a certification that the office meets HUD requirements. Mortgagees that lease space from a real estate agent must assure compliance with RESPA requirements.

The applicant's home office facilities must have adequate office space and equipment for at least two full-time employees to work, must be in a location conducive to mortgage lending, must be located in a commercial space that is separate and apart from any other entity, must be clearly identified to the public so that loan applicants and mortgagors will know, at all

times, exactly with whom they are doing business (this includes a permanently affixed business sign and other common means of identification used by a business entity) and, once approved by HUD, must display a fair housing poster.

- **Quality Control.** All mortgagees and loan correspondents must have and maintain a written quality control plan for the origination and servicing of FHA insured mortgages. The QC Plan must meet HUD/FHA requirements, as detailed in the Mortgagee Approval Handbook, and a copy of the QC Plan must be submitted with the application for approval.
- **Funding Source.** All mortgagees and loan correspondents must have and maintain an acceptable funding source for closing FHA-insured mortgages.

A non-supervised mortgagee must have and maintain a warehouse line of credit adequate to fund the mortgagee's average 60-day origination production pipeline, but not less than a \$1 million.

A loan correspondent must have a letter from, or written agreement with, each of its sponsors indicating that the sponsor will purchase all FHA mortgages that the loan correspondent originates and that the sponsor underwrites.

- **Principal Activity.** Non-supervised mortgagees and loan correspondents must meet HUD's "principal activity" test. That is, each non-supervised applicant must spend a majority of its time and assets in the production of real estate mortgages and in the lending or investment of funds in real estate mortgages. The principal activity must contribute at least one-half of the entity's gross revenues.
- **Loan Correspondent Applicants must be Sponsored.** Each loan correspondent (broker) seeking FHA approval must be sponsored by a fully licensed and FHA approved DE mortgagee who will underwrite all FHA loans originated by the loan correspondent. The applicant must include written statements from the Sponsor indicating that it agrees to sponsor the loan correspondent and will fund loans originated by the loan correspondent.
- **Fidelity Bond.** All supervised and non-supervised mortgagees, except loan correspondents, are required to have and maintain at least \$300,000 fidelity bond and mortgagee's errors & omissions insurance coverage.
- **Partnerships and LLCs.** Partnerships and limited liability companies must provide additional documentation, including the partnership or LLC agreements, which must include HUD-required provisions.

The lender approval and re-certification division at HUD headquarters is responsible for analyzing mortgagee application packages received, approving or disapproving applicants, and maintaining a record of approved mortgagees. HUD will notify the mortgagee of its approval and provide the mortgagee with an FHA mortgagee ID number which must be used in obtaining FHA case number for all future originations of FHA insured mortgages.

Once approved by HUD, supervised and non-supervised mortgagees should contact their regional HUD home ownership center to begin the test case phase for direct endorsement authority. Additionally, all approved mortgagees and loan correspondents must register for an FHA Connection account as soon as they are notified of their approval.

Finally, it is important to note that there are continuing eligibility requirements that must be met, once the mortgagee or loan correspondent has been initially approved by HUD. These include maintaining compliance with HUD's minimum net worth and liquid assets requirements, annually filing the required re-verification reports and annual fees and submitting an annual audited financial statement to HUD within 90 days of the company's fiscal year end. Failing to file the audited financial statement or annual fees or re-verification reports timely may cause HUD to withdraw approval of the mortgagee or loan correspondent.

FHA approved entities also have additional reporting obligations to HUD, including when their net worth drops below minimum required levels or when they suffer an operating loss of 20 percent or more of the entity's net worth, and in the case of material regulatory violations.

Mortgagees and loan correspondents also need to keep in mind that HUD regularly audits the performance of mortgages originated by FHA approved entities. If the delinquency and default ratios of those loans gets too high, HUD will terminate the lender's ability to originate new FHA-insured loans. HUD personnel also conduct periodic on-site audits of approved mortgagee's originations and servicing activities.

FHA lending presents mortgage companies with a great opportunity, but in originating and servicing these loans, it's "FHA's way or the highway."

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For assistance on FHA Approval issues, Credit Watch terminations and Audit and Enforcement issues, contact Weiner Brodsky Sidman Kider PC at 202-628-2000.