



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT  
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-  
FEDERAL HOUSING COMMISSIONER

**July 21, 2004**

**MORTGAGEE LETTER 2004-28**

**TO: ALL APPROVED MORTGAGEES**

**SUBJECT: Credit Policy Issues**

This Mortgagee Letter provides additional guidance to mortgage lenders regarding Federal Housing Administration (FHA) policy for accurately estimating property taxes on newly constructed homes, the correct manner of completing form HUD-92900-PUR when building a home on land already owned by the borrower, gift funds documentation, interest rate buydowns, and use of hybrid adjustable rate mortgages for streamline refinance transactions. Unless otherwise described, these policies are effective with all mortgage applications signed on or after 30 calendar days from the date of this mortgagee letter.

**Property Tax Estimates for Underwriting**

Direct Endorsement (DE) underwriters must use accurate estimates of monthly property tax escrows in qualifying borrowers. HUD has discovered a number of instances where underwriters, usually on new construction transactions, failed to consider the property taxes once the improvements are valued by the taxing authority and reassessed. The underwriters instead grossly underestimated taxes by using only the appraiser's estimate of the vacant land. Often unaware of the increased mortgage payment that awaited them, some borrowers were unable to absorb the payment shock once the servicing lender analyzed the tax escrows and adjusted the monthly mortgage payment. Therefore, when qualifying borrowers, DE underwriters must use realistic estimates of the property taxes that reflect the value of the improvements once they are assessed by the units of government to which those taxes are paid. Such estimates may be obtained from reliable sources such as the appraiser, comparable sales data, or the assessor's office.

Please note that projecting tax payments and collecting those funds, as a portion of the monthly escrow account payment, does not violate RESPA (Real Estate Settlement Procedures Act). RESPA requires that the borrower receive an initial escrow account statement at settlement or within 45 days. In conducting this analysis, RESPA permits lenders and mortgage servicers to project the disbursements for real estate taxes for the ensuing twelve months and

collect funds based on this projection. When the annual escrow analysis is completed, refunds are issued or shortages are collected, depending on the results of that analysis. In any event, lenders must not predicate the borrower's monthly escrow payments on the value of the vacant land when tax authority reassessments are likely to occur within 12 months of mortgage loan closing.

### **Interest Rate Buydown Accounts**

Similar to HUD's risk-management efforts regarding inaccurate estimates of property taxes, the Department is concerned with the use of temporary interest rate buydown accounts on fixed-rate mortgages and the ensuing payment shock. Interest rate buydowns, although a small percentage of FHA's insured mortgage portfolio, have not performed as well as those mortgages made without buydowns. Consequently, FHA will no longer permit *underwriting* at the buydown rate on fixed-rate mortgages. Builders and sellers *may still offer* buydowns but the borrower must qualify at the *note rate*.

Since the borrower must qualify at the rate exclusive of the payment reduction provided by the buydown account, the underwriting requirements described in handbook HUD-4155.1 REV-5, paragraph 2-14B2(a) through (d) no longer apply. All other programmatic instructions for temporary buydowns, including the buydown agreement requirements, remain in effect.

### **Building On Own Land**

The Department's instructions regarding borrowers building homes on land they own (see handbook 4155.1 REV-5, 1-8 D) permit the *value* of the land, if owned by the borrower more than six months, to be used in calculating the mortgage amount and as part or all of the equity needed for the transaction. However, in reviewing numerous such cases submitted to FHA for insurance endorsement, HUD has determined that additional clarification was needed to bring about consistency in underwriting such transactions.

Henceforth, all such mortgage transactions will be summarized using only form HUD-92900-PUR, Mortgage Credit Analysis Worksheet-Purchase Money Mortgages. Line 10a of this form, "contract sales price", will consist of the sum total of the *documented* acquisition cost of the property, including: (a) the builder's price, or the sum of all subcontractor costs, materials, etc.; (b) cost of the land or, if owned more than six months or was received as an acceptable gift, its appraised value; (c) interest and other costs associated with any construction loan obtained by the borrower to fund construction of the property; (d) the closing costs to be paid by the borrower; and (e) reasonable discount points.

This clarification will make it easier to determine if the borrower has made the required three percent cash (or its equivalent in land equity) investment into the transaction. Further, the calculated loan-to-value ratio shown on line 16a (which is to be the same value used when

seeking a risk classification from FHA's TOTAL (Technology Open To Approved Lenders) Mortgage Scorecard) will reflect the lesser of the sales price or the appraiser's value estimate, as it does on other purchase transactions.

### **Gift Funds Documentation Requirements**

Handbook HUD-4155.1 REV-5 sets forth the documentation requirements for showing the transfer of gift funds (see paragraph 2-10 C). The instructions also state that "[W]hen the transfer occurs at closing, the lender remains responsible for obtaining verification that the closing agent received funds from the donor for the amount of the purported gift and that those funds came from an acceptable source."

Our Quality Assurance Division (QAD) has advised us that some lenders are failing to adequately document this transfer at closing and that in some cases, there is a question as to whether the purported downpayment funds were actually provided by a legitimate source such as a charitable organization. Since most transfers of downpayment funds from charities are by means of wire transfers, when that situation occurs, the lender must obtain and keep the documentation of the wire transfer in its mortgage loan application binder. While that document need not be provided in the insurance binder, it must be available for inspection by QAD when that office conducts its on-site review of lenders.

### **Streamline Refinance to a Hybrid Adjustable Rate Mortgage (ARM) (Non-Credit Qualifying)**

HUD's hybrid ARM product offerings were not available when the current mortgage credit analysis handbook (HUD-4155.1 REV-5) was issued. Consequently, it does not have instructions on the use of 3-, 5-, 7- and 10-year ARMs under the streamline refinance program. Since these product offerings provide for a minimum of three years of fixed mortgage payments, FHA will treat fixed rate-to-hybrid ARM as well as ARM (1-year or hybrid)-to-hybrid ARM in the same manner, i.e., the streamline refinance need only result in an immediate payment reduction to the borrower to be eligible. All other handbook instructions (section 1-12) remain in effect. Additionally, ARMs may only be used to finance owner-occupied properties. Lenders should be mindful of the anti-churning provisions previously stated in Mortgagee Letter 90-20. These programmatic instructions for hybrid ARMs are effective immediately.

If you have any questions regarding this Mortgagee Letter, please contact your Homeownership Center (HOC) in Atlanta (888-696-4687), Denver (800-543-9378), Philadelphia (800-440-8647), or Santa Ana (888-827-5605).

Sincerely,

John C. Weicher  
Assistant Secretary for Housing-  
Federal Housing Commissioner