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Supplementing the Compare Ratio: An Important Step toward Opening the FHA Credit Box

By Laurie Goodman

Credit availability remains restricted, a challenge from which even the Federal Housing Administration (FHA), the lender of last resort for many borrowers, is not immune. The proportion of FHA borrowers with credit scores (as measured by FICO) under 640 has gone from 47 percent in 2001 to less than 3 percent today. One of the reasons for this is that strategies adopted to deal with past credit excesses, such as multiple quality assurance guides and the Lender Compare Ratio, are today incenting lenders to impose credit overlays that lead them to lend only to a fraction of those who actually qualify for FHA lending. My colleague Jim Parrott, in an early March commentary, described how FHA Commissioner Carol Galante has held meetings with numerous lenders, both large and small, to better understand the uncertainties that drive them to add credit overlays to their FHA loans. In that commentary, he also went through some of the steps the FHA is thinking about to try to get lenders to correct these overlays.

On Tuesday, May 14, the same morning as Federal Housing Finance Agency (FHFA) Director Mel Watt's maiden speech (which got all the press attention), the FHA introduced some of these credit expansion initiatives. In particular, the FHA announced both quality assurance initiatives and the Homeowners Armed with Knowledge (HAWK) program, in which borrowers who commit to housing counseling will get a discount on both their upfront and annual FHA mortgage insurance premium (MIP). The quality assurance actions include three major steps: rewriting the FHA handbook to bring more than 900 mortgagee letters and other policy guidance into a single coordinated document; undertaking a loan quality assessment that will classify manufacturing defects into categories and defining what the remediation will be for each of these categories of defects; and performing quality reviews earlier in the process to provide lenders with clearer pictures of how the FHA is interpreting the guidelines. Together these steps should resolve some of the uncertainty over how their underwriting rules are to be applied, which should in turn relieve pressure on lenders to apply overlays in their FHA lending.

Finally, the FHA proposes to supplement the Lender Compare Ratio, a part of the Credit Watch Termination Initiative that is very inflexible, with a supplemental performance metric. While the FHA is statutorily required to retain the Lender Compare Ratio, the addition of a supplemental metric should result in more flexibility and a willingness of lenders to take on higher-risk borrowers who meet FHA underwriting requirements.

These FHA actions are significant, and complement the actions the FHFA is taking to open the credit box. In this commentary, we focus on the Lender Compare Ratio, its strengths and weaknesses, and the need for a supplemental performance metric. While we applaud the FHA staff for proposing the new metric because it is the right kind of solution to a significant impediment to access to credit, we believe a slight variation, will make the metric even more effective. This is not a matter of technical niceties; the new metric has major policy implications. The Lender Compare Ratio is often the first step in the determination of whether a lender's authority to originate loans should be

terminated. It is also used to determine if a lender is eligible for Lender Insurance (LI) authority, which provides the lender with more delegated authority to approve FHA insurance on loans that the lender originates.

The Lender Compare Ratio

The Lender Compare Ratio is calculated by comparing the rate of serious delinquencies (SDQs) for a lender in the first year and first two years after a loan's origination to the SDQ rate for all lenders in the same geographic area. This calculation makes no allowance for the riskiness of the lender's book of business, and, as such, discourages lenders from having a book of business that, while still consistent with FHA underwriting guidelines, is significantly riskier than the FHA book as a whole. The FHA evaluates all lenders with a Compare Ratio of 150 or higher, and may propose termination of a lender's ability to originate FHA loans if (1) the Compare Ratio is 200 or higher, and (2) the lender's claim and default rate exceed the FHA national average. The FHA also reserves the right to terminate a lender's LI authority if the Compare Ratio exceeds 150.

This ratio limits lenders' willingness to serve borrowers who lie within the FHA credit box but have a higher-than-average default rate. Note that the FHA is not compelled to take action in the event of high Compare Ratios, but has the option to do so. However, the existence of this option makes lenders uncomfortable. Moreover, the Compare Ratios are very public numbers, giving lenders pause on "reputational risk" issues. Finally, warehouse facilities often terminate lender relationships if the Compare Ratio is too high.

Given that the Lender Compare Ratio is very inflexible, and does not take account of the fact that different lenders will have a different mix of business, why not just change it? Unfortunately, it is written into legislation. The 1987 Housing and Community Development Act includes provisions directing the FHA to take actions to reduce losses, including an annual review of the rates of "early serious default and claims," and mandated lenders with higher than normal rates to explain the reasons for this and develop a corrective action plan. It also authorized suspension from the program if no plan was submitted or corrective action was not completed in a timely manner. The US Department of Housing and Urban Development (HUD) first promulgated regulations on this in 1990, and revised them in 1992–93. Those revisions, implemented in 1995, introduced Credit Watch Termination actions, including the 200 percent threshold for termination of originator approval. Part 202.3 of 24 CFR reads:

> (ii) ***Credit Watch Status.*** Mortgagees are responsible for monitoring their default and claim rate performance. A mortgagee is considered to be on Credit Watch Status if, at any time, the mortgagee has a rate of defaults and claims on insured mortgages originated, underwritten, or both, in an area which exceeds 150 percent of the normal rate and its origination approval agreement has not been terminated.
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> (iii) ***Notice of termination.***
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> (A) ***Notice of termination of origination approval agreement.*** The Secretary may notify a mortgagee that its origination approval agreement will terminate 60 days after notice is given, if the mortgagee had a rate of defaults and claims on insured mortgages originated in an area which exceeded 200 percent of the normal rate and exceeded the national default and claim rate for insured mortgages.
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> (B) ***Notice of termination of direct endorsement approval.*** The Secretary may notify a mortgagee that its direct endorsement approval under 24 CFR part 203 will terminate 60 days after notice is given, if the mortgagee had a rate of defaults and claims on insured mortgages underwritten in an area which exceeded 200 percent of the normal rate and exceeded the national default and claim rate for insured mortgages. The termination of a mortgagee's direct endorsement approval pursuant to this section is separate and apart from the termination of a mortgagee's

direct endorsement approval under 24 CFR part 203.

The Credit Watch Termination Regulations were challenged in court in 1999, and HUD prevailed after appeal. In 2001, Section 533 of the National Housing Act of 1934 was amended to include these provisions.

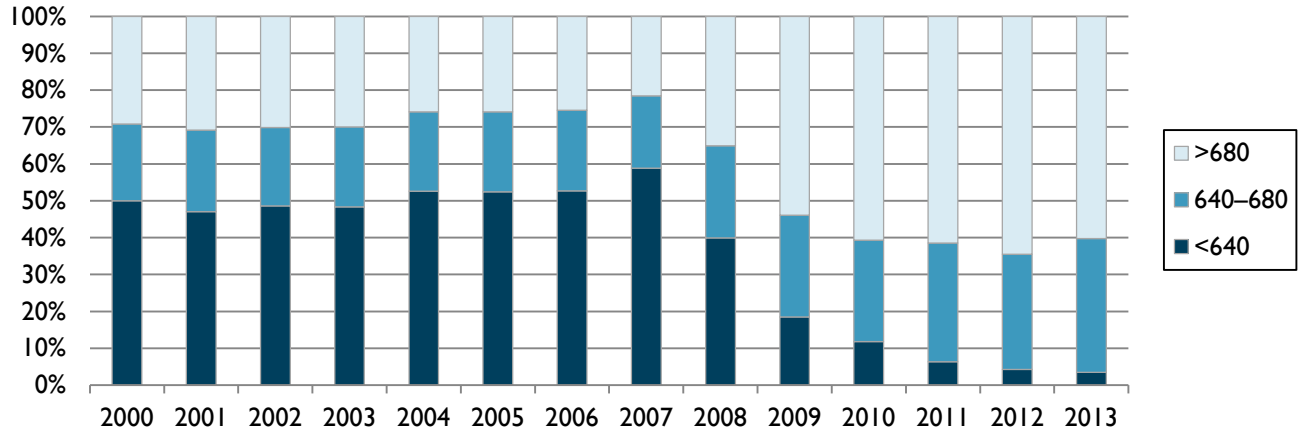
For most of the life of the rules, the FHA book of business was broad enough that the inflexibility of the Compare Ratio has not been an issue. However, as figure 1 shows, since 2009, the book of business has been characterized by loans with very high FICO scores and very low default rates. In 2001, 47 percent of FHA loans had FICO scores of less than 640; by 2013, that number was 3 percent. Loans with FICOs greater than 680 constituted 31 percent of the 2001 book of business, but 60 percent of the 2013 book of business. This has improved the normal rate of default and claims so considerably that lenders are reluctant to deviate significantly from the average FHA book of business by lending to the full FHA credit box. Their concern is that loans to lower credit borrowers, even within FHA underwriting standards, usually have higher default rates, and are thus likely to cause the lender's default and claim rate to exceed the area and national FHA rates. This is exactly the behavior the FHA wants to alter.

The FHA is trying to obtain the necessary legislative authority to change the Compare Ratio. However, given that the ratio cannot be changed in the near term, the FHA has proposed a supplemental performance metric to give lenders assurance that a broader business mix is encouraged. The FHA is looking for feedback on this proposal. This article contains our feedback; we hope others will also provide thoughts on this important initiative.

Relationship between Compare Ratio and Supplemental Performance Metric

The relationship between the Compare Ratio and the Supplemental Performance Metric can best be explained by hypothetical examples, given in table 1; the first 3 sections are drawn from the FHA's document in which this metric is proposed. For a given geographic area, assume the FHA book of business is comprised of 9 percent loans with FICOs less than 640, 38 percent with FICOs between 640 and 680, and 53 percent with FICO scores greater than 680. The three groups have serious delinquency rates of 2.6 percent, 1.5 percent, and 0.4 percent, respectively. Thus, the SDQ rate for the FHA portfolio is 1.02 percent. Lender 1 has a mix of business that is very heavily weighted to lower FICO loans. Thirty percent of Lender 1's portfolio is in loans to borrowers with FICOs less than 640, 60 percent to borrowers with FICOs of 640 to 680, and 10 percent to borrowers with FICOs greater than 680. The serious delinquency rates for this lender are 2.9 percent, 1.6 percent, and 0.6 percent,

Figure 1: FICO Score at Origination for All FHA Loans



Source: Corelogic Prime Servicing as of March 2014.

Table 1: Supplemental Performance Metric as Proposed Versus Alternative

		<640	640–680	>680	Weighted SDQ Rate	Compare Ratio	FHA Proposed Supplemental Performance Metric	Mix-Adjusted Supplemental Performance Metric	Mix-Adjusted SDQ Rate
Target Portfolio	Mix	25%	50%	25%	1.60%				
	SDQ Rate	3.00%	1.50%	0.40%					
FHA Portfolio	Mix	9%	38%	53%	1.02%				
	SDQ Rate	2.60%	1.50%	0.40%					
Lender 1	Mix	30%	60%	10%	1.89%	186	118	110	1.72%
	SDQ Rate	2.90%	1.60%	0.60%					
Lender 2	Mix	30%	60%	10%	1.72%	169	108	100	1.72%
	SDQ Rate	2.60%	1.50%	0.40%					
Lender 3	Mix	25%	50%	25%	1.95%	192	122	130	1.50%
	SDQ Rate	3.80%	1.70%	0.60%					
Lender 4	Mix	17%	38%	45%	1.93%	190	121	162	1.19%
	SDQ Rate	5.00%	2.25%	0.50%					
Lender 5	Mix	60%	30%	10%	2.05%	202	128	100	2.05%
	SDQ Rate	2.60%	1.50%	0.40%					
Lender 6	Mix	90%	5%	5%	2.07%	204	129	85	2.44%
	SDQ Rate	2.21%	1.28%	0.34%					

Source: Urban Institute.

Note: Lenders are hypothetical examples.

respectively. As a result, the serious delinquency rate for the portfolio is 1.89 percent. The Compare Ratio is simply the lender's SDQ rate divided by that for the area; Lender 1 would have a Compare Ratio of 186 ([1.89/1.02] × 100). This is mostly due to Lender 1's mix of business and less due to higher-than-average delinquency. Observe that Lender 2 in table 1 has the same business mix as Lender 1, but also serious delinquencies that mirrored the FHA market as a whole for each FICO band, and a resulting Compare Ratio of 169, still tripping the 150 trigger.

The Supplemental Performance Metric is intended to provide some relief for FHA lenders who concentrate their business at the lower end of the credit spectrum. The FHA would consider this additional metric before taking action under the Credit Watch Termination Initiative. The Supplemental Performance Metric uses as its "target portfolio" a book of business that (1) is different from the total FHA book of business in that it is more heavily weighted toward loans with lower FICO scores and (2) assumes that loans with lower FICO scores will default at a higher rate than the average FHA loan in that FICO band. Thus, as shown in table 1, the target portfolio under the Supplemental Performance Metric is made up of 25 percent loans with FICO scores less than 640, 50 percent with FICO scores between 640 and 680, and 25 percent loans with FICO scores greater than 680.

The assumed base serious delinquencies are 3.0 percent, 1.5 percent, and 0.4 percent, respectively (versus 2.6 percent, 1.5 percent, and 0.4 percent, respectively, on the total FHA book of business). Thus, the target portfolio assumes a default rate on the lowest FICO bucket that is higher than that on the average FHA book of business; the default rates on the other FICO buckets are equal to the FHA average. The weighted average SDQ rate of the target portfolio is 1.60 percent, compared with 1.02 percent for the total FHA portfolio. The Supplemental Performance Metric is the ratio of the lender's SDQ rate to that of the target portfolio. For Lender 1, it is ([1.89/1.60] × 100) or 118. Under the proposal, if a lender had a high Compare Ratio, but the Supplemental Performance Metric was less than 125, the FHA would be less likely to take further action, as is the case with Lender 1 in our example. If the

Supplemental Performance Metric was more than 125, it would suggest further action is likely.

Any system that has bright lines can be gamed, and indeed there is a history of the FHA being subject to such strategies. As the rule is proposed, lenders would look for 639 FICO scores, at the top of the bottom (less than 640) bucket. A lender that held only 639 FICOs would likely have fewer SDQs than a lender with a diversified mix of below-640 assets. Similarly, 679 and 680 FICO scores would also be coveted, because they are at the top of the 640 to 680 bucket. We suggest the potential for gaming would be lower with more FICO categories, and urge the FHA to introduce more FICO buckets if it goes forward with the addition of the Supplemental Performance Metric as proposed.

An Alternative Form of the Supplemental Performance Metric

There is a slightly different way to implement the Supplemental Performance Metric, which we recommend the FHA consider. This would eliminate the target portfolio, and instead measure each lender's SDQ rate relative to that lender's actual mix of business. More specifically, one would calculate for each lender, based on their business mix, and the SDQ rate for all FHA business in the relevant area, a "lender mix-expected SDQ rate." The lender's actual SDQ rate would then be compared to the "lender mix-expected SDQ rate" to get the lender's mix-adjusted Supplemental Performance Metric. Thus, in the case of Lender 1, the actual SDQ rate is 1.89 percent, the mix-expected SDQ rate is 1.72 percent, for a mix-adjusted Supplemental Performance Metric of 110 ([1.89/1.72] × 100). This is lower than the 118 Supplemental Performance Metric under the current proposal. But the outcome would be the same—no action. Lender 2 is identical to Lender 1 in terms of origination mix, but has exactly average losses. Lender 2's Compare Ratio is 169, while the Supplemental Performance Metric equals 108. Lender 2's mix-adjusted Supplemental Performance Metric would be 100, because the lender, by definition, has an average SDQ rate.

Let us consider several circumstances where there could be different outcomes. Lender 3 holds exactly the target book of business, but has higher-than-average delinquencies. Lender 3's Compare Ratio is high, 195, owing to both the lender's mix of business and the loss rate. The Supplemental Performance Metric, at 122, is under the level where action is required, but the mix-adjusted metric, at 130, suggests that action would be taken against this lender. Even more extreme, Lender 4 holds a book of business that is more pristine than the target, but less pristine than the average. This lender has a very high SDQ rate. He skates by on the FHA Supplemental Performance Metric (121), but is clearly flagged on the mix-adjusted Supplemental Performance Metric (162).

Lender 5 has the opposite issue than Lenders 3 and 4; it caters to a higher-risk clientele (60 percent of the borrowers with less than a 640 FICO), but its SDQ rate, by design, is exactly on the FHA average. This lender has a very high Compare Ratio (202). And since the lender's book of business is so much riskier than the FHA average (more low FICO borrowers who default at a higher rate), the Supplemental Performance Metric at 128 would be flagged, and the lender could lose its license or its LI authority. In contrast, the mix-adjusted metric would be exactly 100. Thus, if a mix-adjusted Supplemental Performance Metric were used, Lender 5, who serves an FHA-eligible but higher-risk population in an average manner, would not be flagged. The high SDQ rate for this lender comes entirely from its mix of business, not from its SDQ performance, and a lender should not be penalized for its mix of business as long as it is consistent with FHA underwriting standards.

Lender 6 is even more extreme. This lender caters almost exclusively to a higher-risk clientele, with 90 percent of its book of business to borrower with FICO scores below 640, and the balance split equally among the other two FICO buckets (640–680 and > 680). Even with an SDQ rate that is 15 percent below the FHA average for each FICO bucket (SDQ rates of 2.21, 1.28, and 0.34, versus FHA average SDQ rates of 2.6, 1.5, and 0.4 for each of the three buckets, respectively), this lender would have a Compare Ratio of 207. The FHA-proposed Supplemental Performance Metric at 129 is also over the limit. However, on a mix-adjusted basis, this lender is doing a great job, achieving

delinquencies 15 percent under the FHA average in each bucket. This is reflected in the mix-adjusted metric of 85.

The differences basically present policymakers with a choice: penalize the lender for doing too much risky lending (90 percent versus 25 percent) or reward this lender for producing better-than-average performance on the risky loans. We would vote for the latter, as this gives the widest possible latitude to the lender to determine risk mix, while providing significant protection to the FHA to take action against poorly performing servicers.

Conclusion

The proposed Supplemental Performance Metric is a welcome addition to the FHA tool kit, because it allows the FHA to see that a high Compare Ratio may just indicate a riskier-than-average book of business, but a book still well within FHA underwriting standards. However, as proposed, the Supplemental Performance Metric does not completely account for the differences in mix among lenders. In our view, the new metric could be improved by relying on a lender-specific mix-adjusted methodology. This would allow the lender complete discretion to choose his business mix, consistent with FHA standards. Lenders would be judged on how well they performed given their mix of business, thereby encouraging them to open up the credit box to the full range of FHA-eligible borrowers.

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