Section C. Borrower Credit Analysis

Overview

In This Section

This section contains the topics listed in the table below.

1. General Guidelines for Analyzing Borrower Credit

Introduction

This topic contains information on the general guidelines for analyzing borrower credit, including

- past credit performance
- analyzing credit history
- documenting analysis of delinquent accounts
- lack of established credit history
- verifying and documenting non-traditional credit providers, and
- non-traditional mortgage credit report (NTMCR).

Change Date

March 1, 2011

4155.1 4.C.1.a Past Credit Performance

Past credit performance is the most useful guide to

- determining a borrower's attitude toward credit obligations, and
- predicting a borrower's future actions.

Borrowers who have made payments on previous and current obligations in a timely manner represent a reduced risk. Conversely, if a borrower's credit history, despite adequate income to support obligations, reflects continuous slow payments, judgments, and delinquent accounts, significant compensating factors will be necessary to approve the loan.

4155.1 4.C.1.b Analyzing Credit History

When analyzing a borrower's credit history, the underwriter must examine the overall pattern of credit behavior, not just isolated occurrences of unsatisfactory or slow payments.

A period of past financial difficulty does not necessarily make the risk unacceptable, if the borrower has maintained a good payment record for a considerable time period since the financial difficulty occurred.

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1. General Guidelines for Analyzing Borrower Credit, Continued

4155.1 4.C.1.c Documenting an Analysis of Delinquent Accounts

The lender *must* document the analysis of delinquent accounts, including whether late payments were based on

- a disregard for financial obligations
- an inability to manage debt, or
- factors beyond the borrower's control, such as
  - delayed mail delivery, or
  - disputes with creditors.

Minor derogatory information occurring two or more years in the past does not require an explanation. Major indications of derogatory credit, such as judgments, collections, and other recent credit problems, require sufficient written explanation from the borrower. The explanation must make sense, and be consistent with other credit information in the file.

TOTAL Scorecard Accept/Approve or Refer Recommendations
If the loan receives an Accept/Approve recommendation from the Technology Open To Approved Lenders (TOTAL) Scorecard, the borrower need not provide an explanation for adverse credit or other derogatory information. There must, however, be evidence of payoffs for any outstanding judgments shown on the credit report.

The TOTAL Scorecard Refer recommendation requires the borrower to provide an explanation for major indications of derogatory credit, such as judgments and collections, and any minor indications within the past two years.

Reference: For more information on the TOTAL Scorecard recommendations, see the *TOTAL Mortgage Scorecard User Guide*.

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1. General Guidelines for Analyzing Borrower Credit, Continued

4155.1 4.C.1.d Lack of Established Credit History

The lack of a credit history, or the borrower's decision to not use credit, may *not* be used as the basis for rejecting the loan application.

Some prospective borrowers may not have an established credit history. For these borrowers, including those who do not use traditional credit, the lender must obtain a non-traditional merged credit report (NTMCR) from a credit reporting company, or develop a credit history from

- utility payment records
- rental payments
- automobile insurance payments, and
- other means of direct access from the credit provider, as described in HUD 4155.1 4.C.1.e.

TOTAL Scorecard Accept/Approve Recommendation
If TOTAL Scorecard has issued an Accept/Approve recommendation, additional development of a credit history is *not* required.

References: For more information on
- the TOTAL Scorecard recommendations, see the *TOTAL Mortgage Scorecard User Guide*
- NTMCR requirements, see HUD 4155.1 1.C.5, and
- evaluating non-traditional credit and insufficient credit, see HUD 4155.1 4.C.3.

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1. General Guidelines for Analyzing Borrower Credit, Continued

4155.1 4.C.1.e Verifying and Documenting Non-Traditional Credit Providers

Only if a NTMCR does not exist, or such a service is unavailable, may a lender choose to obtain independent verification of credit references. Lenders must document that the providers of non-traditional credit do exist, and verify the credit information. Documents confirming the existence of a non-traditional credit provider may include

- public records from the state, county, or city, or
- other documents providing a similar level of objective information.

To verify credit information, lenders must use a published address or telephone number for the credit provider and not rely solely on information provided by the applicant.

If a method other than NTMCR is used to verify credit information or rental references, all references obtained from individuals should be backed up with the most recent 12 months of cancelled checks.

A rental reference from a management company with payment history for the most recent 12 months may be used in lieu of 12 months of cancelled checks.

References: For more information on
- NTMCR requirements, see HUD 4155.1 1. C.5, and
- evaluating non-traditional credit and insufficient credit, see HUD 4155.1 4.C.3.

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1. General Guidelines for Analyzing Borrower Credit, Continued

4155.1 4.C.1.f Non-Traditional Mortgage Credit Report (NTMCR)

Lenders may use a NTMCR developed by a credit reporting agency as an alternative method for developing a credit history. Use of this type of report requires that the credit reporting agency has verified

- the existence of the credit providers
- that the credit was actually extended to the borrower, and
- the creditor has a published address or telephone number.

Reference: For more information on NTMCR requirements, see HUD 4155.1 1.C.5.

2. Guidelines for Credit Report Review

Introduction

This topic contains information on the credit report items that lenders must review, including

- hierarchy of credit review
- reviewing previous rental or mortgage payment history
- recent and/or undisclosed debts and inquiries
- collections and judgments
- paying off collections and judgments
- previous mortgage foreclosure
- Chapter 7 bankruptcy
- Chapter 13 bankruptcy
- consumer credit counseling payment plans
- truncated Social Security Numbers on credit reports
- evaluating non-traditional/insufficient credit (reference), and
- short sales.

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March 1, 2011

4155.1 4.C.2.a Hierarchy of Credit Review

Evaluating credit involves reviewing payment histories in the following order:

- first: previous housing expenses, including utilities,
- second: installment debts,
- third: revolving accounts.

Generally, a borrower is considered to have an acceptable credit history if he/she does not have late housing or installment debt payments, unless there is major derogatory credit on his/her revolving accounts.

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2. Guidelines for Credit Report Review, Continued

4155.1 4.C.2.b Reviewing Previous Rental or Mortgage Payment History

The borrower's housing obligation payment history holds significant importance when evaluating credit. The lender must determine the borrower's housing obligation payment history through the

- credit report
- verification of rent received directly from the landlord (for landlords with no identity-of-interest with the borrower)
- verification of mortgage received directly from the mortgage servicer, or
- review of canceled checks that cover the most recent 12-month period.

Note: The lender must verify and document the previous 12 months' housing history even if the borrower states he/she was living rent-free.

TOTAL Scorecard Accept/Approve Recommendation
If the loan receives an Accept/Approve recommendation from the Technology Open To Approved Lenders (TOTAL) Scorecard, the housing/rental history requirement stated above is waived.

Reference: For more information on the TOTAL Scorecard recommendations, see the *TOTAL Mortgage Scorecard User Guide*.

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2. Guidelines for Credit Report Review, Continued

4155.1 4.C.2.c Recent and/ or Undisclosed Debts and Inquiries

Lenders *must* determine the purpose of any recent debts, as the borrower may have incurred the indebtedness to obtain the required cash investment.

A borrower *must* provide a satisfactory explanation for any significant debt that is shown on the credit report but not listed on the loan application. Written explanation is required for all inquiries shown on the credit report for the last 90 days.

TOTAL Scorecard Accept/Approve Recommendation

- Verify the actual monthly payment amount of any undisclosed indebtedness.
- Include the monthly payment amount and resubmit the loan if the liability is greater than $100 per month.
- Determine that any funds borrowed were not/will not be used for the borrower's cash investment in the transaction.
- Explanation is not required for inquiries.

Reference: For more information on the TOTAL Scorecard recommendations, see the *TOTAL Mortgage Scorecard User Guide*.

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2. Guidelines for Credit Report Review, Continued

4155.1 4.C.2.d Collections and Judgments

Collections and judgments indicate a borrower's regard for credit obligations, and *must* be considered in the creditworthiness analysis.

The lender must document reasons for approving a mortgage when the borrower has collection accounts or judgments. The borrower *must* explain, in writing, all collections and judgments.

Note*:* Compliance with the requirements specified in HUD 4155.1 4.C.2.e is applicable to judgments.

TOTAL Scorecard Accept/Approve Recommendation
Collection accounts trigger neither an explanation requirement nor a hypothetical monthly payment to be used in qualifying borrowers.
The presence of collection accounts in the borrower's credit history already result in lowering the credit bureau scores used in TOTAL and, thus, no further information need be provided by the borrower.

References: For information on
- paying off collections and judgments, see HUD 4155.1 4.C.2.e and
- the TOTAL Scorecard recommendations, see the *TOTAL Mortgage Scorecard User Guide*.

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2. Guidelines for Credit Report Review, Continued

4155.1 4.C.2.e Paying off Collections and Judgments

FHA does *not* require that collection accounts be paid off as a condition of mortgage approval. However, court-ordered judgments *must* be paid off before the mortgage loan is eligible for FHA insurance endorsement.

Exception: An exception to the payoff of a court-ordered judgment may be made if the borrower has

- an agreement with the creditor to make regular and timely payments, and
- provided documentation indicating that payments have been made according to the agreement.

TOTAL Scorecard Accept/Approve and Refer Recommendations
TOTAL Scorecard Accept/Approve and Refer recommendations require that the lender obtain evidence of payoffs for any outstanding judgments shown on the credit report.

Reference: For more information on the TOTAL Scorecard recommendations, see the *TOTAL Mortgage Scorecard User Guide*.

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2. Guidelines for Credit Report Review, Continued

4155.1 4.C.2.f Previous Mortgage Foreclosure

A borrower is generally *not* eligible for a new FHA-insured mortgage if, during the previous three years

- his/her previous principal residence or other real property was foreclosed, or
- he/she gave a deed-in-lieu of foreclosure.

Exception: The lender may grant an exception to the three-year requirement if the foreclosure was the result of documented extenuating circumstances that were beyond the control of the borrower, such as a serious illness or death of a wage earner, and the borrower has re-established good credit since the foreclosure.

Divorce is *not* considered an extenuating circumstance. An exception may, however, be granted where a borrower's loan was current at the time of his/her divorce, the ex-spouse received the property, and the loan was later foreclosed.

Note: The inability to sell the property due to a job transfer or relocation to another area does not qualify as an extenuating circumstance.

4155.1 4.C.2.g Chapter 7 Bankruptcy

A Chapter 7 bankruptcy (liquidation) does not disqualify a borrower from obtaining an FHA-insured mortgage if at least two years have elapsed since the date of the discharge of the bankruptcy. During this time, the borrower must have

- re-established good credit, or
- chosen not to incur new credit obligations.

An elapsed period of less than two years, but not less than 12 months, may be acceptable for an FHA-insured mortgage, if the borrower

- can show that the bankruptcy was caused by extenuating circumstances beyond his/her control, and
- has since exhibited a documented ability to manage his/her financial affairs in a responsible manner.

Note: The lender must document that the borrower's current situation indicates that the events which led to the bankruptcy are not likely to recur.

Continued on next page

2. Guidelines for Credit Report Review, Continued

4155.1 4.C.2.h Chapter 13 Bankruptcy

A Chapter 13 bankruptcy does not disqualify a borrower from obtaining an FHA-insured mortgage, provided that the lender documents that

- one year of the pay-out period under the bankruptcy has elapsed
- the borrower's payment performance has been satisfactory and all required payments have been made on time, and
- the borrower has received written permission from bankruptcy court to enter into the mortgage transaction.

TOTAL Scorecard Accept/Approve Recommendation
Lender documentation must show two years from the discharge date of a Chapter 13 bankruptcy. If the Chapter 13 bankruptcy has not been discharged for a minimum period of two years, the loan must be downgraded to a Refer and evaluated by a Direct Endorsement (DE) underwriter.

Reference: For more information on the TOTAL Scorecard recommendations, see the *TOTAL Mortgage Scorecard User Guide*.

4155.1 4.C.2.i Consumer Credit Counseling Payment Plans

Participating in a consumer credit counseling program does not disqualify a borrower from obtaining an FHA-insured mortgage, provided the lender documents that

- one year of the pay-out period has elapsed under the plan
- the borrower's payment performance has been satisfactory and all required payments have been made on time, and
- the borrower has received written permission from the counseling agency to enter into the mortgage transaction.

TOTAL Scorecard Accept/Approve Recommendation
The borrower's decision to participate in consumer credit counseling does not trigger a requirement for additional documentation, as the credit scores already reflect the degradation in credit history. No explanation or other documentation is needed.

Reference: For more information on the TOTAL Scorecard recommendations, see the *TOTAL Mortgage Scorecard User Guide*.

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2. Guidelines for Credit Report Review, Continued

4155.1 4.C.2.j Truncated Social Security Numbers on Credit Reports

In an effort to reduce the risk of identity theft and other forms of financial fraud, some providers of consumer credit reports use a truncated version of an individual's Social Security Number (SSN) on the credit report.

A truncated SSN, which may contain as few as the last four digits of a borrower's full number, is acceptable for FHA mortgage insurance purposes provided that the

- loan application captures the full 9-digit SSN, and
- borrower's name, SSN and date of birth are validated through the FHA Connection (FHAC) or its functional equivalent.

4155.1 4.C.2.k Evaluating Non-Traditional or Insufficient Credit (Reference)

For guidelines on evaluating borrowers with non-traditional or insufficient credit histories, see HUD 4155.1 4.C.3.

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2. Guidelines for Credit Report Review, Continued

4155.1 4.C.2.l Short Sales

A borrower is not eligible for a new FHA-insured mortgage if he/she pursued a short sale agreement on his/her principal residence simply to

- take advantage of declining market conditions, and
- purchase a similar or superior property within a reasonable commuting distance at a reduced price as compared to current market value.

Borrower Current at the time of Short Sale
A borrower is considered eligible for a new FHA-insured mortgage if, from the date of loan application for the new mortgage, all

- mortgage payments on the prior mortgage were made within the month due for the 12-month period preceding the short sale, and
- installment debt payments for the same time period were also made within the month due.

Borrower in Default at the time of Short Sale
A borrower in default on his/her mortgage at the time of the short sale (or pre-foreclosure sale) is not eligible for a new FHA-insured mortgage for three years from the date of the pre-foreclosure sale.

Note: A borrower who sold his/her property under FHA's pre-foreclosure sale program is not eligible for a new FHA-insured mortgage from the date that FHA *paid the claim* associated with the pre-foreclosure sale.

Exception: A lender may make an exception to this rule for a borrower in default on his/her mortgage at the time of the short sale if the

- default was due to circumstances beyond the borrower's control, such as death of primary wage earner or long-term uninsured illness, and
- a review of the credit report indicates satisfactory credit prior to the circumstances beyond the borrower's control that caused the default.

References:
- For detailed information on converting existing principal residences into rental properties, see HUD 4155.1 4.E.4.g.
- For information on short payoffs, see HUD 4155.1 3.B.1.f.

3. Evaluating Non-Traditional Credit and Insufficient Credit

Introduction

This topic contains information on evaluating non-traditional credit and insufficient credit, including

- evaluating borrowers with non-traditional credit
- evaluating borrowers with insufficient credit
- qualifying ratios for borrowers with insufficient credit, and
- cash reserves for borrowers with insufficient credit.

Change Date

March 1, 2011

4155.1 4.C.3.a Evaluating Non-Traditional Credit

When evaluating a borrower with non-traditional credit history, a satisfactory credit history, at least 12 months in duration, must include

- no history of delinquency on rental housing payments
- no more than one 30-day delinquency on payments due to other creditors, and
- no collection accounts/court records reporting (other than medical) filed within the past 12 months.

Important: Borrowers with non-traditional or insufficient credit are eligible for maximum financing, but must meet the all underwriting guidance provided in HUD 4155.1 4.C.3.

4155.1 4.C.3.b Evaluating Borrowers With Insufficient Credit

When evaluating a borrower with no credit references, or only Group II references as outlined in HUD 4155.1 1.C.5.f, a satisfactory credit history, at least 12 months in duration, must include

- no more than one 30-day delinquency on payments due to any Group II reference, and
- no collection accounts/court records reporting (other than medical) filed within the past 12 months.

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3. Evaluating Non-Traditional Credit and Insufficient Credit, Continued

4155.1 4.C.3.c Qualifying Ratios for Borrowers With Insufficient Credit

To enhance the sustainability of homeownership for borrowers with insufficient credit histories, the qualifying ratios

- are computed *only* on those borrowers occupying the property and obligated on the loan. Non-occupant coborrowers may not be included.
- may not exceed 31% for the payment-to-income ratio and 43% for the total debt-to-income (DTI) ratio.

Important: Compensating factors are *not* applicable for borrowers with insufficient credit references.

4155.1 4.C.3.d Cash Reserve Requirement for Borrowers with Insufficient Credit

Borrowers should have two months of cash reserves following mortgage loan settlement from their own funds. No cash gifts from any source should be counted in the cash reserves for borrowers with insufficient credit histories.

4. Borrower Liabilities: Recurring Obligations

Introduction

This topic contains information on the borrower's recurring obligations, including

- types of recurring obligations
- recurring obligations in debt-to-income ratio calculation
- revolving account minimum monthly payment, and
- alimony payments in qualifying ratio calculations.

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March 1, 2011

4155.1 4.C.4.a Types of Recurring Obligations

Recurring obligations include

- all installment loans
- revolving charge accounts
- real estate loans
- alimony
- child support, and
- other continuing obligations.

Continued on next page

4. Borrower Liabilities: Recurring Obligations, Continued

4155.1 4.C.4.b Recurring Obligations in Debt to Income Ratio Calculation

When computing the debt-to-income (DTI) ratio, the lender must include the following recurring obligations:

- monthly housing expense, and
- additional recurring charges extending ten months or more, such as
  - payments on installment accounts
  - child support or separate maintenance payments
  - revolving accounts, and
  - alimony.

Debts lasting *less* than ten months *must* be included if the amount of the debt will affect the borrower's ability to pay the mortgage during the months immediately after loan closing, especially if the borrower will have limited or no cash assets after loan closing.

***Note*:** Monthly payments on revolving or open-ended accounts, regardless of their balances, are counted as liabilities for qualifying purposes even if the accounts appear likely to be paid off within ten months or less.

Reference: For more information on calculating ratios, see HUD 4155.1 4.F.2.a.

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4. Borrower Liabilities: Recurring Obligations, Continued

4155.1 4.C.4.c Revolving Account Minimum Monthly Payment

If the credit report shows a revolving account with an outstanding balance but no specific minimum monthly payment, the payment must be calculated as the greater of

- 5% of the outstanding balance, or
- $10.

Note*:* If the actual monthly payment is documented from the creditor or the lender obtains a copy of the current statement reflecting the monthly payment, that amount may be used for qualifying purposes.

4155.1 4.C.4.d Alimony Payments in Qualifying Ratio Calculations

Since there are tax consequences of alimony payments, the lender may choose to treat the monthly alimony obligation as a reduction from the borrower's gross income, rather than treating it as a monthly obligation when calculating qualifying ratios.

5. Borrower Liabilities: Contingent Liability

Introduction

This topic contains information on the borrower's contingent liabilities, including

- definition of "contingent liability"
- application of contingent liability policies
- contingent liability on mortgage assumptions
- exemption from contingent liability on mortgage assumptions, and
- contingent liability on cosigned obligations.

Change Date

March 1, 2011

4155.1 4.C.5.a Definition: Contingent Liability

A ***contingent liability*** exists when an individual is held responsible for payment of a debt if another party, jointly or severally obligated, defaults on the payment.

4155.1 4.C.5.b Application of Contingent Liability Policies

The contingent liability policies described in this topic apply *unless* the borrower can provide conclusive evidence from the debt holder that there is no possibility that the debt holder will pursue debt collection against him/her should the other party default.

4155.1 4.C.5.c Contingent Liability on Mortgage Assumptions

The underwriter must consider a contingent liability when the borrower remains obligated on an outstanding FHA-insured, VA-guaranteed, or conventional mortgage secured by property that he/she

- has sold or traded within the last 12 months without a release of liability, or
- is about to sell on assumption without a release of liability being obtained.

Reference: For exceptions to this policy, see HUD 4155.1 4.C.5.d.

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5. Borrower Liabilities: Contingent Liability, Continued

4155.1 4.C.5.d Exemption From Contingent Liability on Mortgage Assumptions

When a mortgage is assumed, contingent liabilities need *not* be considered if

- the originating lender of the mortgage being underwritten obtains, from the servicer of the assumed loan, a payment history showing that the mortgage has been current during the previous 12 months, or
- the value of the property, as established by an appraisal or the sales price on the HUD-1, *Settlement Statement* from the sale of the property, minus the upfront mortgage insurance premium (UFMIP), results in an loan-to-value (LTV) ratio of 75% or less.

TOTAL Scorecard Accept/Approve Recommendation
If the loan receives an Accept/Approve recommendation from the Technology Open To Approved Lenders (TOTAL) Scorecard, the lender must obtain either

- a copy of the divorce decree ordering the spouse to make payments, or
- the assumption agreement and deed showing transfer of title out of the borrower's name. (***Note***: A 12 month history is *not* required.)

References: For more information on
- the TOTAL Scorecard recommendations, see the *TOTAL Mortgage Scorecard User Guide*, and
- UFMIP amounts, see HUD 4155.2 7.2.a.

4155.1 4.C.5.e Contingent Liability on Cosigned Obligations

Contingent liability applies, and the debt must be included in the underwriting analysis, if an individual applying for an FHA-insured mortgage is a cosigner/co-obligor on a

- car loan
- student loan
- mortgage, or
- any other obligation.

If the lender obtains documented proof that the primary obligor has been making regular payments during the previous 12 months, and does not have a history of delinquent payments on the loan during that time, the payment does not have to be included in the borrower's monthly obligations.

6. Borrower Liabilities: Projected Obligations and Obligations Not Considered Debt

Introduction

This topic contains information on borrower

- projected obligations, and
- obligations not considered debt.

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4155.1 4.C.6.a Projected Obligations

Debt payments such as a student loan or balloon note scheduled to begin or come due within 12 months of the mortgage loan closing must be included by the lender as anticipated monthly obligations during the underwriting analysis.

Debt payments do not have to be classified as projected obligations if the borrower provides written evidence that the debt will be deferred to a period outside the 12-month timeframe.

4155.1 4.C.6.b Obligations Not Considered Debts

Obligations not considered debt, and therefore not subtracted from gross income, include

- Federal, state, and local taxes
- Federal Insurance Contributions Act (FICA) or other retirement contributions, such as 401(k) accounts (including repayment of debt secured by these funds)
- commuting costs
- union dues
- open accounts with zero balances
- automatic deductions to savings accounts
- child care, and
- voluntary deductions.