

RD AN No. 4435 (1980-D)  
April 30, 2009

TO: State Directors  
Rural Development

ATTENTION: Rural Housing Program Directors,  
Guaranteed Rural Housing Specialists,  
Area Directors and Area Specialists

FROM: James C. Alsop (*Signed by James C. Alsop*)  
Acting Administrator  
Housing and Community Facilities Programs

SUBJECT: Single Family Housing Guaranteed Loan Program  
Debt Ratio Waivers and Payment Shock

**PURPOSE/INTENDED OUTCOME:**

The purpose of this Administrative Notice (AN) is to clarify RD Instruction 1980-D and provide guidance on the use of debt ratio waivers and compensating factors when approving loan guarantees and to reiterate Agency methodology for evaluating “payment shock.” This guidance applies to manually underwritten loan files and Guaranteed Underwriting System (GUS) files that receive an underwriting recommendation of “Refer” or “Refer with Caution.”

**COMPARISON WITH PREVIOUS AN:**

This AN replaces AN 4366 dated May 31, 2009.

EXPIRATION DATE:  
May 31, 2010

FILING INSTRUCTIONS:  
Preceding RD Instruction 1980-D

## **BACKGROUND:**

The National Office receives inquiries from both lenders and Agency staff regarding debt ratio waivers, compensating factors, and payment shock. Common questions include:

- How does payment shock factor into manually underwritten loan decisions?
- What are strong compensating factors lenders may document to demonstrate the strength of a loan application?
- How high can debt ratios be exceeded?

Rural Development guarantees underwritten loan packages submitted by approved lenders. The agency recognizes that each loan applicant is unique and may require flexibility in underwriting when supported, in order to assist them in achieving successful homeownership. Single Family Housing Guaranteed Loan Program (SFHGLP) loans are designed to accommodate the varying needs of each applicant. RD Instruction 1980-D outlines many of the underwriting issues which are addressed in further detail by this AN.

## **IMPLEMENTATION RESPONSIBILITIES:**

Approved lenders, whom have executed a Lenders Agreement, are responsible for underwriting the mortgage loan request. The approved lender may utilize the services of a non-approved lender for originating the loan; however, the approved lender is responsible for loan underwriting and obtaining the conditional commitment. State Directors will advise lenders about the need to:

- underwrite loans according to Agency regulations;
- process and approve loans in accordance with program instructions;
- review loan applications for accuracy and completeness;
- ensure applicants have adequate loan repayment ability;
- verify acceptable credit histories; and,
- check, on a regular basis, the Rural Development's website for new issuances related to program requirements.

## **DEBT RATIO WAIVERS:**

### **Requested by the lender, approved by Rural Development**

In the guaranteed loan program, an applicant meets agency requirements for repayment ability if their **Principal, Interest, Real Estate Taxes, and Homeowners Insurance (PITI)** debt ratio is 29 percent or less, and the **Total Debt Ratio (TD)** (the PITI plus any additional monthly debt obligations combined) is 41 percent or less.

It is common for underwriters and Rural Development to allow exceptions to both the PITI and TD ratio requirements. There is not a maximum amount that the ratio standards may be exceeded. Strong compensating factors documented by the underwriter will assist Rural Development in approving ratio waiver requests.

Requests to exceed the standard ratio thresholds must be **submitted in writing** to Rural Development and include the documentation of appropriate compensating factors to support sound underwriting judgment. The lender's permanent case file must include the compensating factors identified and the documentation to support their recommendation.

There is no minimum credit score required to be eligible for a debt ratio waiver request. It is possible that a credit score is not indicative of an applicant's true credit risk. Underwriters are encouraged to evaluate credit, capacity, and collateral when considering any applicant for a debt ratio waiver.

The National Office supports and encourages granting ratio waiver requests for applicants with legitimate compensating factors such as those listed below and in 1980.345(c)(5) which include but are not limited to:

- Credit score of 660 or higher. Credit scores of 660 and higher can be documented as a stand alone compensating factor for a debt ratio waiver request, **if** no additional risk layers are present (i.e. adverse credit, payment shock, etc.).
- No or low "payment shock:" a minimal increase in housing expenses, or current rent is comparable to proposed PITI (100 percent increase in payment or less).
- Conservative attitude toward the use of credit and ability to accumulate savings with regular deposits.
- Previous credit history verifies the applicant has the ability to devote a greater portion of income to housing expense. Many low income or high cost area applicants currently pay a substantial amount for rent or housing and are successful.

- Employment history: 2 or more years in current position is an excellent compensating factor; however, underwriters should consider applicants who change positions frequently to better their financial position. Underwriters should give more credence to a history of continuous employment (no gaps due to multiple separations, etc.).
- Additional compensation/income: Public benefits, food stamps, potential commissions, bonus payouts, and additional part time employment that lack a stable history may not be reflected in the repayment income, yet this additional income will have a direct effect on the ability to successfully repay the mortgage obligation.
- Cash reserves available post closing.
- Potential for increased earnings and career advancement, as indicated by job training or education in the applicant's profession.
- Trailing spouse income: Home is being purchased as the result of relocation of the primary wage-earner. The secondary wage earner has an established history of employment and is currently seeking or expects to return to work and there are reasonable prospects for securing employment in a similar occupation within the new area.
- Low TD: A low TD by itself does not compensate for a high PITI ratio; however, when other strong compensating factors are present, a low TD ratio should be viewed as a positive mitigating factor.

If requested by a lender, Agency staff may assist lenders in identifying compensating factors associated with guaranteed loan applications to make a preliminary determination of the appropriateness of a ratio exception. Rural Development can not approve or deny guaranteed debt ratio waiver requests without a complete underwritten loan package provided by the approved lender. Denial of a lender's request for a ratio waiver is not an appealable decision; however, this adverse action may be reviewed if and when the guaranteed loan is denied for lack of repayment ability.

It is recommended that the lender record their request for a ratio waiver in the comment section of Fannie Mae (FNMA) Form 1008/ Freddie Mac (FHLMC) Form 1077, Uniform Underwriting Transmittal Summary, or similar underwriting analysis form.

Ratio waivers require a written response from Rural Development which must be retained in the lender's permanent case file.

## **PAYMENT SHOCK:**

### **Approved by the lender**

Analysis of early delinquency loans guaranteed under the SFHGLP has indicated that payment shock is a delinquency factor, **IF** additional risk layers are present (risk layering). The presence of payment shock is especially significant when the applicant's credit history contains derogatory information.

The term "payment shock" signifies the increase in housing expenses experienced by an applicant. Payment shock is defined as a percentage and calculated using the following formula:

New PITI (principal, interest, taxes and insurance) ÷ Current housing expense – 1.

The following examples illustrate payment shock as a percentage.

A. New PITI: \$850      Current Rent: \$550  
 $850.00 \div 550.00 = 1.54 - 1 = .54$  or 54 percent

The payment shock in this example is 54 percent.

***The payment shock for this example is below 100 percent and therefore not a risk factor.***

B. New PITI: \$1,500      Current rent: \$650  
 $1,500.00 \div 650.00 = 2.30 - 1 = 1.30$  or 130 percent

The payment shock in this example is 130 percent.

***The payment shock for this example is above 100percent and therefore is a risk factor.***

C. New PITI: \$750      Current rent: \$0 (lives rent free)

***The payment shock in this example can not be measured and therefore is a risk factor.***

In cases where the applicant does not have prior experience in meeting rent or housing expense obligations, payment shock can not be measured as a percentage.

When payment shock is 100 percent or higher, or the applicant has no previous rent or housing expenses, no additional risk layering (such as adverse credit waivers approved by the lender), debt ratio waivers (approved by Rural Development), or temporary buy-downs should be allowed without strong compensating factors such as those listed above.

The presence of payment shock alone, without any additional risk layering, is not considered a risk factor.

It is recommended that the lender record their waiver of payment shock on the comment section of FNMA Form 1008/ FHLMC 1077, Uniform Underwriting Transmittal Summary, or similar underwriting analysis form.

## **ENSURING QUALITY UNDERWRITING:**

The Agency is not responsible for underwriting individual Single Family Housing Guaranteed Loans. Approved lenders will periodically be monitored for SFHGLP underwriting compliance. Existing lenders that exhibit high early delinquencies, or high loan losses, will be subject to quality control reviews to ensure that agency underwriting standards are followed. Newly approved lenders are subject to underwriting reviews based upon the criteria outlined in RD Instruction 1980-D, Section 1980.309(g)(1). States will perform reviews of new lenders to confirm the approved lender's comprehension and compliance with Agency regulations.

Questions concerning this AN should be addressed to Kristina Zehr at (309) 452-0830 ext. 111, or Joaquin Tremols at (202) 720-1465. Their respective email addresses are [kristina.zehr@wdc.usda.gov](mailto:kristina.zehr@wdc.usda.gov) and [joaquin.tremols@wdc.usda.gov](mailto:joaquin.tremols@wdc.usda.gov).