

U.S. Structured Finance Newsletter

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ASSESSING THE RISK OF FHA MORTGAGES

Description

In recent years, loans insured by the Federal Housing Administration (FHA) have returned to the market as a home financing option for many first time home buyers and those with less than perfect credit or low income. For these mortgages where claims are reimbursed, the FHA insurance typically covers 100% of the outstanding principal balance and a large portion of the interest. In this newsletter, DBRS provides an overview as to how to assess the credit risk of these mortgages.

Default and Loss Severity Analysis

DBRS's default analysis for FHA loans largely conforms to that of traditional mortgage loans. Various default drivers are considered, including but not limited to credit score, loan-to-value (LTV) ratio, product type, documentation, property type, loan purpose, etc. Due to less than perfect credit, higher LTVs and many other subprime-like collateral qualities, DBRS's analysis of FHA loans generally results in similar default probabilities as subprime pools.

With respect to loss severities, for FHA insured loans where claims are fully reimbursed, the loss severity is equal to the interest payments and foreclosure expenses not covered by the insurance. The claim reimbursements do not include a) interest payments during the first 60 days of delinquency, b) approximately 1/4th to 1/3rd of the foreclosure expenses depending on the Department of Housing and Urban Development's (HUD) servicer ratings and c) the difference between the interest accrued at the mortgage rate and the debenture rate during the liquidation process. In estimating loss severities, DBRS reviews historical servicer trends to stress the liquidation timeline and foreclosure costs. Additionally, debenture rates are stressed based on past debenture rate fluctuations.

Claim Denials and Interest Curtailments

Upon completing the above analysis, DBRS further adjusts the loss severities to incorporate claim denials and interest curtailment rates. HUD can fully deny or curtail FHA claims for different reasons that include missing insurance certificates, excessive damage to properties, title issues, any deviation in practice by the originator or servicer from the program guidelines, late due diligence, late conveyance, late title package, etc. Loss severities for the denied loans are assumed to be similar to that of subprime mortgages with comparable loan characteristics.

Due Diligence Review

For each FHA transaction DBRS rates, it also reviews results from third-party due diligence reviews that include 1) an assessment of the servicer's compliance with minimum standards under the FHA servicing guidelines, 2) a regulatory compliance due diligence on a portion of the mortgage loans and 3) a review on whether a valid FHA insurance is still in place and the Mortgage Insurance Premium (MIP) is current.

DBRS is of the opinion that with increasing claims being conveyed to the HUD, the HUD may increase their scrutiny of claims resulting in higher denial rates than what has been observed in the past. DBRS continues to review servicers' practices and due diligence results and incorporates the most recent FHA claim denial rates into its analytical process.

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