



To Originate FHA Loans or Not to Originate FHA Loans: That is the Question

A Benefit-Cost Analysis of Originating/ Funding FHA Mortgage Loans

By Scott Dodson, CEO & President, *Federal Mortgage Licensing, Inc.*

REPRINTED FROM SCOTSMAN GUIDE RESIDENTIAL EDITION, MAY 2004

(None of the information contained in this article should be construed as legal advice or a legal opinion. All information should be verified by researching the applicable state or federal regulations or by contacting the applicable state or federal regulatory agency.)

In order to originate or fund FHA insured mortgage loans, your mortgage company must first secure approval as a Loan Correspondent Mortgagee (broker) or a Non-Supervised Mortgagee (lender) from the U.S. Department of Housing & Urban Development (HUD). If your company is not HUD Approved, you must turn away FHA leads or refer the potential borrower to a HUD Approved Mortgagee for no compensation. As it is illegal to pay or receive referral fees under RESPA, your company must be HUD Approved to legally participate in the origination of FHA loans.

Unfortunately, operating as a net branch of a HUD Approved Mortgagee is generally not a viable option. Most net branch arrangements do not meet the strict guidelines set forth by HUD and are, therefore, prohibited arrangements in terms of enabling the branch to legally originate FHA loans. A net branch arrangement is not permissible under HUD guidelines unless the HUD Approved Mortgagee pays all of the operating expenses of the net branch including, but not limited to, employee compensation, equipment and furniture expenses, office rent, and other similar expenses incurred in

the operation of a mortgage business. Even if a net branch arrangement is permissible under HUD guidelines, if the office does not meet HUD requirements for operating as a satellite office, then the HUD Approved Mortgagee must obtain a HUD Branch Approval for the net branch office. A separate state branch office license for the net branch in the name of the HUD Approved Mortgagee may be required as well under the regulations of the state where the net branch is located. Recognizing that, if you wish to originate/fund FHA loans, with very few exceptions, your company must first secure HUD Approval. What benefits can you expect to derive from obtaining a HUD Approval? What costs will you incur to obtain and retain your HUD Approval?

BENEFITS:

Large Market –The most obvious benefit of obtaining HUD Approval is that the approval will enable your company to tap into the large FHA mortgage market. According to the February 2004 issue of *U.S. Housing Market Conditions* published by HUD's Office of Policy Development and Research, HUD endorsed a total of 1,382,570 FHA 1-4 Family mortgages in the year 2003. Although individual FHA mortgage loan limits vary by county based upon the cost of housing, we can estimate the average amount of all FHA mortgages based on the ranges in loan limits. For instance,

FHA mortgage loan limits range from \$160,176 to \$290,319 for 1-Family mortgages up to a range of \$307,992 to \$558,236 for 4-Family mortgages (there are separate limits for 2-Family and 3-Family mortgages as well). Based upon the range of loan limits for FHA 1-4 Family mortgages, a relatively conservative estimate of the average dollar amount of FHA 1-4 Family mortgages is \$200,000. If \$200,000 is multiplied by the number of mortgages endorsed by HUD in 2003, the total dollar amount of all FHA 1-4 Family mortgages originated in 2003 was roughly \$276.5 billion. Although the \$276.5 billion figure is only an estimate, it reveals that the FHA mortgage market is enormous.

Rising Interest Rates – In addition to being an enormous market, the FHA mortgage market has proven to be fairly resilient in the face of rising interest rates. According to the Federal Reserve, since 1972, the average 30-year conventional mortgage interest rate has increased over the previous year's average rate on ten separate occasions. Despite those rate increases, the total number of FHA 1-4 Family mortgages endorsed by HUD *actually increased along with the interest rates* on four separate occasions. This trend appears to be growing stronger as increases in average annual rates have resulted in positive increases in the number of FHA-1-4 Family mortgages endorsed

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by HUD in three out of the last four rising rate periods.

The phenomenon of somewhat regular increases in HUD endorsements in the face of rising interest rates makes sense. Typically, borrowers can only afford to pay a relatively fixed amount toward a monthly mortgage payment. As interest rates rise, borrowers must purchase lower priced houses in order to attain the same monthly payment they would have obtained before the rate increase. As a result, a significant number of borrowers who would have purchased houses priced in excess of FHA mortgage loan limits can only afford houses priced under the loan limits at the higher interest rate. As more borrowers are forced to consider houses priced under the FHA mortgage loan limits, the FHA mortgage market naturally expands.

Best Brokers Demand HUD Approval

– An often overlooked benefit to obtaining HUD Approval is that HUD Approved companies attract and retain the most talented brokers. Because brokers can generally earn more points on FHA loans than conventional loans, it is in their best interest to work with HUD Approved companies. Furthermore, brokers do not want to miss out on any opportunities to close loans. If your company is not HUD Approved, your brokers will fail to close a loan every time a borrower fails to qualify for a conventional loan – even if the borrower could qualify for a FHA loan. Smart brokers know that they can make more money brokering for a company that is HUD Approved and offers FHA loans; consequently, many of the best brokers simply refuse to broker for a company that is not HUD Approved.

Customers for Life – One of the keys to long-term success in the mortgage

industry is acquiring repeat business from existing customers. Obtaining HUD Approval will allow you to start building relationships with a significant segment of the market. Given that a large number of borrowers who secure FHA mortgage loans are first-time home purchasers, if you cannot offer FHA mortgage loans, you may lose more than a single loan; you may lose the opportunity to land a customer for life and give that opportunity to one of your competitors. Other candidates for FHA Mortgages (lower credit scores, less cash available for a down payment) likewise will have to turn to a HUD Approved competitor if you cannot get them into a conventional mortgage. As a result, failing to obtain HUD approval can cost you present and future business and may contribute to the success of your competitors.

Selling Loans in Secondary Market

– For lenders, obtaining HUD Approval will enable you to sell certain mortgage loans in the secondary market. Under the Secondary Mortgage Market Enhancement Act (SMMEA), in order to obtain certain exemptions under the securities laws, mortgage loans originated for sale into Mortgage Backed Securities must be originated by: 1) a savings and loan association, savings bank, commercial bank, credit union, insurance company or similar banking institution which is supervised by a federal or state authority; **or** 2) a HUD Approved Mortgagee. Certain major financial institutions, like GMAC Residential Funding, for example, will purchase Jumbo or Expanded Criteria loans only from HUD Approved Non-Supervised Mortgagees.

State Licensing Benefits – Securing HUD Approval for your company may enable your company to obtain or more easily obtain certain state

mortgage licenses. For example, in order to obtain a California Residential Mortgage Lender license, the applicant must be a HUD Approved Non-Supervised Mortgagee or be an approved lender for the Veterans Administration, Farmers Home Administration, Ginnie Mae, Fannie Mae, or Freddie Mac. Another example is that, in order to obtain a Pennsylvania First Mortgage Banker license, the applicant must be approved by or meet the criteria for approval of Fannie Mae, Freddie Mac, or FHA (i.e. HUD Approved Non-Supervised Mortgagee). Your HUD Approval as a Non-Supervised Mortgagee will remove any doubt as to whether your company meets the criteria for approval.

Even if a federal approval is not a requirement for obtaining a mortgage license from a particular state, nearly all state mortgage license applications require the applicant to list all federal approvals held by the company. The examiners at state licensing agencies look very favorably upon applicants with federal approval(s) because they know that the applicant has already made it through a stringent approval process and has been operating under the supervision of the applicable federal agency or agencies. Although the same should be true for other state licenses held by your company, licenses from other states do not carry nearly as much weight as a federal approval. Nothing says “big time mortgage company” like a federal approval.

State Licensing Exemptions – Both Loan Correspondent Mortgagees and Non-Supervised Mortgagees meeting certain criteria may be exempt or partially exempt from state licensing requirements in AL, HI, IN, KY,

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MO, MS, and TN. Non-Supervised Mortgagees with Direct Endorsement authority are exempt from state licensing requirements in TX as well. Although it is important to research and understand each state's procedural requirements for operating under a HUD Approval exemption, proper execution of the required procedures can enable Loan Correspondent Mortgagees and Non-Supervised Mortgagees to expand their geographic market without having to first obtain additional state licenses.

COSTS:

In weighing the benefits of obtaining HUD Approval to originate/fund FHA loans against the costs of obtaining HUD Approval, it is important to include initial costs, recurring costs, and opportunity costs. All of these costs are detailed in the following capsules:

Processing Fees – The application processing fee payable to HUD for both Loan Correspondent Mortgagees and Non-Supervised Mortgagees is \$1,000. There is also an additional fee of \$300 for each Branch Office Approval application filed.

Application Preparation Service – Paying a professional to prepare your HUD Approval application is an optional cost; however, it is an expenditure that will more than pay for itself. The standard application available from HUD provides wholly inadequate directions for compiling an application package and does not include some of the major components that must be included with the application (such as the required Quality Control Plan). Sponsoring lenders will provide assistance to Loan Correspondents, but a lender's expertise is in funding mortgage loans and not in preparing HUD Approval applications. With or

without the assistance of a sponsoring lender, you or someone in your organization will have to invest considerable time and effort to prepare a HUD Approval application. Moreover, due to a lack of pertinent information available, your application package is almost certain to contain errors or omissions that will lead to costly delays in the approval process. Considering that the profits from closing a single FHA loan will easily cover the cost of utilizing a professional application preparation service, it is far more costly, in terms of actual costs and opportunity costs, to forego utilizing such a service.

Audited Financial Statements – All companies applying for a HUD Approval must submit Certified Public Accountant prepared audited financial statements demonstrating that the company meets the applicable net worth requirement. The prices of audited financial statements vary considerably depending on how long you have been in business and depending on the size and complexity of your business operations and business structure. Although the price may range from \$1,000 to \$20,000 or more, it is likely that 95% of mortgage companies can purchase audited financial statements for \$1,000 to \$5,000. Additionally, HUD Approved Mortgagees are required to file audited financial statements on an annual basis. As such, paying for audited financial statements will be an annually recurring cost that is likely to rise, to a certain extent, as your business grows. For most mortgage companies, however, this cost will be covered by closing one or two FHA loans.

Meeting & Maintaining Required Net Worth – Loan Correspondent Mortgagees must maintain an adjusted

net worth of at least \$63,000 plus an additional \$25,000 for each Branch Office Approval up to a maximum required net worth of \$250,000. Non-Supervised Mortgagees must maintain an adjusted net worth of at least \$250,000. All HUD Approved Mortgagees must maintain liquid assets (cash, cash equivalents or readily convertible instruments) equal to at least 20 percent of their net worth up to a maximum amount of \$100,000. Technically, there is no cost to maintain the minimum net worth; however, a considerable amount of company assets will be tied up. In order to maintain the minimum net worth, you will be unable to spend or distribute a certain amount of cash or assets without replacing them with cash or assets of an equal amount. Technicalities aside, maintaining the minimum net worth will certainly feel like a cost to some companies.

Quality Control Plan and Compliance – All applicants must submit a Quality Control Plan (QCP) with their application package in order to obtain HUD Approval. If you do not utilize a professional HUD application preparation service that provides you with the required QCP, you will have to purchase a QCP that meets all HUD requirements. HUD QCPs are available from various sources at prices ranging from \$400 to \$1,000. An additional cost to consider is that, after obtaining HUD Approval, you will be responsible for complying with your HUD QCP. In order to comply with your HUD QCP, a post-closing review of 10% of all FHA loans closed each month must be conducted by personnel that are not involved in the loan origination process. You can outsource the reviews

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to a quality control services company at prices ranging from \$125 to \$200 per loan file reviewed. Alternatively, you can hire and train your own staff to conduct the reviews. Considering training and labor costs, as well as the potential costs relating to compliance violations, it is probably more cost effective to outsource the post-closing reviews to a quality control services company that already possesses the necessary expertise.

Insurance Policies – Non-Supervised Mortgagees are required to obtain a Fidelity Bond (employee dishonesty insurance policy) with coverage of at least \$300,000 and an Errors & Omissions insurance policy with coverage of at least \$300,000. The combined total annual premiums for the two policies

will be different for every company; however, most companies will pay total annual premiums ranging from \$4,000 to \$7,000. You will probably have to close two to three FHA loans to cover these premiums. Note that these insurance premium costs do not apply to Loan Correspondent Mortgagees.

BENEFITS VS. COSTS:

It is clear that great benefits can be derived by obtaining a HUD Approval to originate/fund FHA loans. It is equally clear that there are some costs associated with obtaining and retaining a HUD Approval. Some companies derive benefits from a HUD Approval in excess of the costs without closing a single FHA loan. For most companies, however, it all boils down to

the number of FHA loans you think your company can close. Taking into account all of the benefits and all of the costs, if your company can close 6-12 FHA loans per year, the benefits of obtaining a HUD Approval probably outweigh the costs by a significant margin.

Scott Dodson is CEO and President of Federal Mortgage Licensing, Inc., a company providing consulting and expedited application preparation services to mortgage brokers and lenders seeking a HUD Approval (apply online at www.federalmortgagelicensing.com). Mr. Dodson is a MBA, Juris Doctor, and member of the State Bar of TX. He also has over four years of state and federal mortgage licensing experience. He may be reached by phone at 214-760-9922 or by email at sdodson@federalmortgagelicensing.com. ♦