FALCON CAPITAL ADVISORS

CLIN 0003 Report

Capital and Financial Requirements for Non-Regulated Lenders

Contract # AG-31ME-C-16-0006

GAO Risk Management Audit and Credit Committee Procedures

Submitted to

Single Family Housing Guaranteed Loan Program, USDA

October 14, 2016

Table of Contents

Introduction

Falcon Capital Advisors ("FCA") was tasked by the U.S. Department of Agriculture ("USDA") to assist with the implementation of recommendations by the Government Accountability Office ("GAO") for improvements in the Single Family Housing Guaranteed Loan Program ("SFHGLP")[1]. The purpose of the recommendations is to bring the SFHGLP into full alignment with the federal standards contained in OMB Circular A-129, *Policies for Federal Credit Programs and Non-Tax Receivables* ("A-129"). This report contains FCA's analysis and recommendation for adopting capital and financial requirements for SFHGLP lenders that are not regulated by a Federal Financial Institution Regulatory Agency.

1. CLIN 0003. Develop Capital and Financial Requirements for Guarantee Program Lenders that are not Regulated by a Federal Financial Institution Regulatory Agency

CLIN 0003 of the contract (AG-31ME-C-16-0006) states:

> *The contractor will develop capital and financial requirements for guarantee program lenders that are not regulated by a federal financial institution regulatory agency. In doing so, the contractor will examine the requirements of federal financial institution regulatory agencies, as well as similar requirements in other housing agencies or branches of the government. The contractor will then determine if the requirement of any single agency or branch would best meet the program's needs, or if different requirements would be more appropriate.*

2. GAO Recommendation

The GAO Report recommends that the Rural Housing Service ("RHS"), "develop and publish in the Federal Register capital and financial requirements for guarantee program lenders that are not regulated by a federal financial institution regulatory agency."[2]

The GAO Report observes that "RHS officials said they effectively relied on the requirements of other mortgage institutions, such as FHA and VA, because approval by these institutions is generally the means by which non-supervised lenders become eligible to participate in the guarantee program." GAO expressed caution about this approach and stated that the "FHA's and VA's requirements differ and may not be well-suited for RHS's program." Further, The GAO report explains that "by not specifying its own requirements, RHS increases the potential that entities that originate and service RHS-guaranteed mortgages may lack the experience and financial soundness to perform these functions in a manner that protects RHS's financial interests or lack the ability to cover any liability for violations of RHS requirements." However,

[1] "Rural Housing Service: Actions needed to Strengthen Management of the Single Family Mortgage Guarantee Program" GAO-16-193 (March 2016), herein after referred to as "GAO Report".

[2] Page 38 of GAO Report.

the GAO Report leaves open the possibility that the current approach may be sufficient, stating that "while it is possible that detailed analysis of FHA and VA requirements would find them sufficient for RHS's program, RHS did not provide any evidence that it had conducted such an analysis."

3. Standards and Methodology

OMB Circular A-129 prescribes policies and procedures for justifying, designing, and managing Federal credit programs. Part III(C), *Management of Guaranteed Loan Lenders and Servicers, of the Circular* contains the following standard:

"1) Lender and Servicer Eligibility

a) *Participation Criteria*. Federal credit granting agencies shall establish and publish in the Federal Register specific eligibility criteria for lender or servicer participation in Federal credit programs. These criteria should include:

(iv) Financial and capital requirements for lenders not regulated by a Federal financial institution regulatory agency, including minimum net worth requirements based on business volume".

Our methodology for preparing the deliverables required by CLIN 0003 includes the following:

- Review relevant sources of standards and best practices, including:
  - OMB Circular A-129, and related interpretations and guidance;
  - GAO Reports and testimony, including GAO-16-193 and GAO-15-625T; and
  - Best practice recommendations of associations and standard setting-bodies.
- Review relevant RHS documentation, including rules and regulations, handbooks, guidelines, and reports.
- Interview RHS senior managers and personnel in order to gain a clear practical understanding of how to interpret program regulation and policies.
- Review examples of the policies and procedures of similar committees in the federal government and at commercial organizations.
- Analyze SFHGLP data, reports and analytics.

4. Current Capital and Financial Requirements of the SFHGLP

Under RHS regulation[3] and policy, a lender is eligible to make and/or service SFHGLP loans if it can validate that it has the demonstrated ability to do so. A lender can demonstrate this ability by submitting or evidencing documentation that it has received approval from another recognized source to participate in that source's program.

[3] 7 C.F.R. 3551.51

RHS regulations have established nine categories of recognized sources, or eligibility designations, for a lender to choose from when applying to participate in the SFHGLP. The nine recognized sources are:

1. Fannie Mae, when the lender is approved for single-family loan activities;
2. Freddie Mac, when the lender is approved for single-family loan activities;
3. HUD-FHA, when the lender is approved as a supervised or non-supervised mortgagee with direct endorsement authority for title II lending activity;
4. VA, when the lender is a supervised or non-supervised mortgagee with authority to close loans under VA's automatic guarantee procedure;
5. State housing finance agency;
6. Farm Credit System lenders with direct lending authority;
7. Lenders participating in other Rural Development or Farm Service Agency guaranteed loan programs;
8. Supervised lenders, meaning depository institutions that are regulated by one of the following federal regulatory agencies:
    a. The Federal Reserve System ("FRS")
    b. The Office of the Comptroller of the Currency ("OCC")
    c. The Federal Deposit Insurance Corporation ("FDIC")
    d. The National Credit Union Administration ("NCUA")
    e. The Federal Housing Finance Board[4] ("FHFB"); and
9. Demonstrated ability[5].

Table 1 contains a list of the eligibility designations and summarizes the capital/net worth requirements that are associated with the designation. The chart also indicates the level of loan guarantee associated with the loan program, where applicable, and the number of lenders that have been approved to participate in the SFHGLP leveraging that eligibility designation.

Table 1: Current Capital and Financial Requirements for SFHGLP Lenders

Eligibility Designations	Capital & Financial Requirements	Guarantee
Fannie Mae	Net worth of at least \$2.5 million, plus a dollar amount that represents 0.25% of the unpaid principal balance of any Fannie Mae portfolio it is servicing. If Serious Delinquency Rate is less than or equal to 6%, the minimum liquidity requirement is 0.035% of the UPB of the seller/servicer's portfolio.	100% of Unpaid Principal Balance & Interest

[4] While the Federal Housing Finance Board has been abolished and its responsibilities have been placed under the Federal Housing Finance Agency, the designation continues to refer to depository institutions that are members of the Farm Home Loan Bank System.
[5] This is an eligibility designation that will permit a lender to participate in the SFHGLP if the qualitative criteria are met.

	If greater than 6%, then 0.035% of the UPB of the seller/servicer's portfolio; plus 200 basis points of the UPB of the Serious Delinquency Rate over 6%.	
Freddie Mac	Net worth of at least $2.5 million, plus a dollar amount that represents 0.25% of the unpaid principal balance of any Freddie portfolio it is servicing. If Serious Delinquency Rate is less than or equal to 6%, the minimum liquidity requirement is 0.035% of the UPB of the seller/servicer's portfolio. If greater than 6%, then 0.035% of the UPB of the seller/servicer's portfolio; plus 200 basis points of the UPB of the Serious Delinquency Rate over 6%.	100% of Unpaid Principal Balance & Interest
HUD-FHA Originators Servicers (Ginnie Mae Requirement)	Minimum adjusted net worth of $1,000,000 plus 1% of the total volume in excess of $25,000,000 of FHA Single Family Mortgages originated, underwritten, serviced, and/or purchased during the prior fiscal year, up to a maximum required adjusted net worth of $2,500,000. Mortgagee must hold no less than 20% of its required adjusted net worth in liquid assets. Lender must maintain a line of credit of at least $1 million. $2,500,000 minimum base net worth; liquid assets of at least $1,000,000; and institution-wide capital equal to at least 6% of total adjusted net worth.	100% of Unpaid Principal Balance & Interest
VA	Minimum adjusted net worth of $250,000 or at least $50,000 in working capital. Lender must maintain a line of credit of at least $1 million.	25% - 50% Varies by Location of Property
State Housing Finance Agencies	Varies by State.	Varies by State
Farm Credit System	8% total risk based capital ratio.	100% of Unpaid Principal Balance & Interest
Lenders participating in USDA Guaranteed Loan Programs	Varies by Program.	Varies by Program
Supervised Lenders	FRS: 8% total risk based capital ratio OCC: 8% total risk based capital ratio FDIC: 8% total risk based capital ratio NCUA: 8% total risk based capital ratio FHFB: Minimum stock investment requirement varies by FHLBank.	N/A
Demonstrated Ability	None	N/A

As shown in **Table 1** above, the VA's maximum guarantee varies depending on the location of the property. While VA does not have a maximum loan amount, there are effective "loan limits" for high-cost counties. The limits are derived by considering both the median home price for a county and the Freddie Mac conforming loan limit. To aid lenders in determining the maximum guarantee in high-cost counties, VA has created a Loan Limit chart (**Table 2)** that is updated annually.

Table 2: VA Loan Limit Chart[6]

Loan Amount	Maximum Potential Guaranty	Special Provisions
Up to $45,000	50 percent of the loan amount.	Minimum guaranty of 25 percent on IRRRLs.
$45,001 to $56,250	$22,500	Minimum guaranty of 25 percent on IRRRLs.
$56,251 to $144,000	40 percent of the loan amount, with a maximum of $36,000.	Minimum guaranty of 25 percent on IRRRLs.
$144,001 to $417,000	25 percent of the loan amount	Minimum guaranty of 25 percent on IRRRLs.
Greater than $417,000	The lesser of: • 25 percent of the VA county loan limit, or • 25 percent of the loan amount	Minimum guaranty of 25 percent on IRRRLs

5. Analysis

As **Table 1** illustrates, there is a wide variation in the amount of capital a non-regulated lender must maintain in order to participate in the SFHGLP. The range extends from $2,500,000 for a Fannie Mae or Freddie Mac lender, to a no minimum requirement for a lender that is approved under the Demonstrated Ability eligibility designation. Given this disparity, the SFHGLP would clearly benefit from adopting a minimum capital requirement that covered all non-supervised lenders. The factors to consider in developing a minimum capital requirement are discussed below.

Purpose. The primary purpose of eligibility criteria for lender participation in a credit program is to ensure that the lenders are technically capable, financially sound, reliable, and trust-worthy. Such a purpose enables RHS to enlist sound and lasting lending partners who will contribute to the success of the SFHGLP.[7] The purpose of the eligibility criteria should be distinguished from other risk management policies of federal credit programs. For instance, the primary purpose of insurance premiums and guarantee fees is to protect against loan losses, ensure the solvency of the insurance program, and thus protect taxpayers against losses. Insurance premiums are set without regard to the eligibility category of the lender or how much capital the lender maintains.

[6] VA Lender's Handbook: *VA Pamphlet 26-7, Chapter 3: The VA Loan and Guaranty, Section 4. Maximum Guaranty on VA Loans*

[7] There is an element of credit risk management in the capital requirements, since lenders may be required to repurchase improperly originated loans. However, the capital requirements of other programs are not set at a level that would realistically cover any significant potential repurchase liability.

RHS and other credit programs have detailed credit subsidy models for setting insurance premiums at the appropriate level.[8]

Mission Impact. Capital requirements for program lenders must balance counterparty risk against mission success. OMB Circular A-129 expects departments and agencies to manage credit programs "in a manner that most effectively and efficiently achieves policy goals while minimizing taxpayer risk."[9]

The SFHGLP is by statute designed to assist and serve rural communities. Many of the program's lenders are small financial institutions serving only their local rural communities. In 2015, 524 lenders, or 32.1% of all lenders originated fewer than 10 SFHGLP loans. RHS should be cautious about setting a uniform capital requirement at a level that serves as a financial disincentive for small lenders to participate in the program, with a potential negative impact on the success of the program.

Loan Guarantee Levels. Of the four large loan programs, the VA has the lowest minimum capital requirement, set at an adjusted net worth of $250,000 or at least $50,000 in working capital. GAO recognized that this lower VA capital requirement (relative to the FHA and the GSEs) may be appropriate given that the VA guarantee covers only 25% - 50% of lender loss. The lower guarantee level puts VA originators and investors at a higher risk of loss, and thus incentivizes better originations. By comparison, the FHA program covers 100% of lender loss and the capital requirement for lenders is four times the level of the VA, plus a volume-based supplement (a total cap of $2,500,000). The SFHGLP guarantee covers a maximum of 90% of the loss[10] and the program serves an exclusively rural constituency that differentiates the SFHGLP from other government loan guarantee programs.

Loan Origination Quality and Risk Management. Mortgage loan originators, whether in connection with a private transaction or a Government mortgage loan guarantee program, are generally required to indemnify guarantors/investors for loan losses in cases where the originator made errors in the origination of the loan. Fannie Mae and Freddie Mac will enforce this indemnity by requiring lenders to repurchase loans with origination errors even in cases where the loan is performing. Since the GSEs use the loans as collateral for their insured mortgage backed securities, the GSEs have a strong incentive for exercising their indemnification claims as early as possible. Their repurchase demands can only be satisfied if the lender has sufficient resources to buy back the loan. The GSEs are vulnerable to absorbing loan losses from underwriting errors if the lender is unable to repurchase the mortgage. That is why the GSEs have the highest capital requirements for non-supervised lenders listed in **Table 1**.

[8] See OMB Circular No. A-11 (2016).
[9] OMB Circular No. A-129, page 2.
[10] RHS guarantees the loan at 100% of the loss for the first 35% of the original loan amount and the remaining 65% of the loan amount at 85% of the loss. The maximum loss payable by the RHS cannot exceed 90% of the original loan amount.

In contrast to the GSEs, the SFHGLP does not guarantee the MBS that are backed by pools of SFHGLP mortgages. That guarantee is provided by Ginnie Mae, and Ginnie Mae has its own program for managing the risk associated with its MBS guarantee program. The SFHGLP also differs from the GSEs on how lender indemnification is administered. The SFHGLP does not incur loan losses until a claim has been filed by the servicer and paid. At the time the claim is filed, the SFHGLP will review the loan file for origination errors. If errors are found, the SFHGLP may deny the claim. This approach protects the SFHGLP from losses that would result from a failure by an insolvent lender to reimburse the program for underwriting errors.

SFHGLP lenders also have strong motivation to properly underwrite the program's loans because of their credit risk exposure. The SFHGLP only guarantees 90% of the losses, while the lender retains risk for 10% of the losses.

There is also a significant difference in how SFHGLP loans are originated when compared to the FHA and VA loan programs. The SFHGLP reviews and approves every loan that is guaranteed. This allows the program to exercise a level of quality control that is different from FHA delegated underwriting approval and the VA automatic guarantee procedure.

Overall, the SFHGLP's approach to managing origination risk provides a strong incentive for originators to adhere to the program's underwriting guidelines. Claims data from the SFHGLP indicate that during the five-year period from 2011 - 2015 (inclusive), the program identified origination errors that resulted in claim denials in only 110 insurance claims out of 61,781 processed.

There is utility in performing a comparative analysis of default rates across the different government loan programs for determining capital requirements; however, we concluded that such an analysis would have limited value. There is insufficient data to establish a strong nexus between default rates and origination quality. There can be some correlation, but even the most properly originated loan can and does default due to factors unrelated to the origination process, such as a change in borrower circumstances or certain underwriting policies.

6. Recommendations

Given the above analysis and the requirements of A-129, we recommend that the SFHGLP adopt an FHA/VA hybrid approach for capital requirements. The standard would utilize the VA base requirement, and add the volume component of the FHA standard. The volume requirement would be structured and capped following the FHA model. The regulatory provision could define key terms, such as "adjusted net worth" and "working capital", or the SFHGLP could provide those details in its handbook or other documentation. The later might be preferable since it would allow SFHGLP to make technical adjustments to the definitions and calculations over time without the need to engage in a formal rulemaking.

In addition, both the VA and FHA have a line of credit component to their financial requirements for non-supervised lenders. We recommend that the SFHGLP also adopt such a requirement. A warehouse line of credit is essential to sound mortgage banking and risk management. The credit facility ensures that the lender will have a reliable means to fund mortgage originations. The VA standard requires that the lender maintain an unrestricted line of credit of at least $1 million. The HUD standard requires that the lender maintain a warehouse line of credit that is adequate to fund the lender's average 60-day origination operations, but in any event the line of credit cannot fall below $1 million. We recommend the simpler approach utilized by the VA.

In order to implement our recommendation, we suggest that the SFHGLP amend the relevant Program regulation at 7 C.F.R. 3551.51 *Lender Eligibility,* by adding a new subsection "(c)" at the end to read as follows:

> (c). *Financial Requirements for Non-Supervised Lenders.* In addition to the participation requirements of subsection (b), all lenders not covered by paragraph (a)(8) must maintain:
>
> (1) a minimum adjusted net worth of $250,000 or at least $50,000 in working capital, plus 1% of the total volume in excess of $25,000,000 of SFHGLP mortgages originated, underwritten, serviced, and/or purchased during the prior fiscal year, up to a maximum required adjusted net worth of $2,500,000; and
> (2) one or more lines of credit aggregating at least $1 million. The line of credit must be unrestricted, meaning that funds are available upon demand to close loans and are not dependent on prior investor approval."

We also recommend that the SFHGLP periodically review the impact and adequacy of the new requirements. With the appropriate data and metrics, SFHGLP could then determine whether any adjustments are advisable.