

Legal Update

HUD Update to *Single Family Housing Policy Handbook* Incorporates Dozens of New Policies and Technical Enhancements

Part 1: Changes to Sections I, II and V – Doing Business with FHA, Origination through Post-Closing/Endorsement, Quality Control

On March 27, 2019, the US Department of Housing and Urban Development's ("HUD" or "Department") Federal Housing Administration ("FHA") published the first update to its [Single Family Housing Policy Handbook 4000.1](#) ("SF Handbook") in over two years. The update contains numerous policy changes and technical adjustments of which FHA lenders should be aware. This Legal Update highlights some of the most noteworthy changes that have the potential to impact lender operations.

Background

HUD first released the SF Handbook in September 2014, with an effective date of September 14, 2015. As HUD indicated in its news release at the time ([FHA INFO #15-74](#)), and as stated on its [SF Handbook Information Page](#), HUD's intent was to provide a consolidated, consistent and comprehensive policy source for FHA mortgages. With the release of the SF Handbook, HUD aimed to consolidate the hundreds of FHA Handbooks,

Mortgagee Letters, Housing Notices and other policy documents into a single comprehensive guide for mortgage lenders. HUD hoped to eliminate the need for lenders to wade through thousands of stand-alone documents in search of current requirements and guidelines and to provide a single user-friendly source of information with consistent formatting and terms. The SF Handbook exceeds 1,000 pages and covers almost every aspect of the FHA mortgage insurance program.

Consistent with its goal to maintain a single comprehensive guide, HUD expressed its intent to provide quarterly updates to the SF Handbook whenever possible so that mortgagees and other stakeholders will know what to expect and when ([HUD Office of Housing Counseling Webinar, FHA Info #16-80](#)). However, while HUD updated the SF Handbook a number of times after its initial publication, this most recent update is the first since December 30, 2016. Between then and March 27, 2019, HUD issued 33 Mortgagee

Letters and 22 Housing Notices. (It has issued another two Mortgagee Letters and one Housing Notice since this latest SF Handbook update.) According to HUD ([FHA Info #19-09](#)), with this most recent update, “FHA is recommitting to the industry that it will continue to maintain and enhance the SF Handbook so that it becomes a single, comprehensive source of policy guidance for lenders and other stakeholders doing single family business with FHA.” HUD stated that it “intends to resume regular quarterly SF Handbook updates” and noted that the Home Equity Conversion Mortgage, Title I and Condominium Approval sections of the SF Handbook remain in the development stage.

Handbook Changes

The March 27 update, which did not impact any previously announced effective dates, became effective immediately upon publication. The [Transmittal](#) reflects that HUD made over 60 changes to provisions that cover doing business with FHA, origination through post-closing/endorsement, and quality control, oversight and compliance and over 60 changes to provisions covering servicing, loss mitigation, and claims and disposition, as well as numerous technical changes to wording and source references. The update supersedes 15 Mortgagee Letters in whole and another two Mortgagee Letters in part. The changes, which are marked with color-coded notations throughout the SF Handbook, reflect new policies in many instances and have the potential to impact FHA lenders’ business operations significantly. Below we highlight some of the most noteworthy changes to Section I (Doing Business with FHA), Section II (Origination through Post-Closing/Endorsement) and Section V (Quality Control, Oversight and Compliance).

SECTION I – DOING BUSINESS WITH FHA

HUD made a number of changes to its requirements in the SF Handbook for doing business with FHA.

First, HUD added a requirement pertaining to the legal age of members of a limited liability company (“LLC”) seeking FHA approval. The SF Handbook now provides that members of an LLC must be at least the legal age recognized by the state law of incorporation (HUD Handbook 4000.1 § I.A.3.c.i(A)(2)(b)). This change does not impact LLCs that do not have individual members but does impact any individually owned LLC.

Second, HUD updated the definition of “Vice President” in the section addressing corporate officers of nonsupervised and investing mortgagees to provide that a corporate officer includes a “Vice President in charge of managing or overseeing any aspect of the Mortgagee’s FHA business” (HUD Handbook 4000.1 § I.A.3.c.iv(B)(1)(a)(i)). Years ago, HUD published a reply to a Frequently Asked Question (“FAQ”) regarding which owners and officers a mortgagee must report to FHA, stating that, with respect to corporate officers, a mortgagee must identify only those individuals “who will be directly involved in managing, overseeing, or conducting FHA business.” The new change to the SF Handbook formalizes that guidance and incorporates it into the definition of “Corporate Officer.” The change formally narrows the universe of employees whom a lender must identify as corporate officers to HUD. While a lender may have dozens of employees with the title of Vice President, only a Vice President “in charge of managing or overseeing” FHA business is considered a Corporate Officer for FHA purposes.

Third, HUD no longer requires loan officers to be W-2 employees nor prohibits commissions to servicing personnel. The prior version of the SF Handbook prohibited commissions to employees who perform underwriting, quality

control or servicing functions and required a “mortgagee or its permissible contractor” to “report all employee compensation on IRS Form W-2.” Now, the only employees prohibited from receiving commissions are those who perform underwriting or quality control (HUD Handbook 4000.1 § I.A.3.c.iv(B)(3)). Servicing personnel were removed from the prohibition, which grants mortgagees greater flexibility in determining how to compensate employees involved in servicing activities. This change is also significant because it allows mortgagees to report compensation on any basis that complies with IRS requirements without dictating the use of W-2s or effectively prohibiting compensation of loan officers on a 1099 basis.

That being said, while this change offers greater flexibility to mortgagees in determining how to compensate their employees, it may restrict mortgagees’ ability to use third-party pay structures. In the prior version of the SF Handbook, HUD required a mortgagee *or its permissible contractor* to report income on a W-2 basis. In the updated SF Handbook, HUD has removed the reference to a “permissible contractor” and now requires a mortgagee to report “all employee compensation” (HUD Handbook 4000.1 § I.A.3.c.iv(B)(3)). Removal of the reference to “permissible contractor” raises a question as to how lenders should handle situations where a professional employer organization (“PEO”) or single paymaster is used to handle employee payroll so that a party other than the mortgagee is responsible for reporting employee income.

Fourth, HUD has restricted the circumstances under which a mortgagee may request an extension to submit its annual recertification package. The previous version of the SF Handbook provided: “The Mortgagee may request an extension of its recertification package due date. Extension requests must be

submitted through LEAP at least 45 Days prior to the Mortgagee’s recertification package due date.” Many lenders misunderstood this provision to mean that HUD would grant an extension as long as it was requested at least 45 days in advance. In our experience, however, an extension was never automatic and often was difficult to obtain. HUD now has clarified that it will approve an extension only under very limited circumstances. Specifically, the revised SF Handbook limits a mortgagee’s ability to request an extension to situations where the mortgagee has suffered a disruption to employee or business operations. Specifically, it states: “The Mortgagee may request an extension of its recertification package due date only as the result of a natural or catastrophic event resulting in a disruption of employee or mortgagee business operations. Extension requests must be submitted through LEAP prior to the Mortgagee’s recertification package due date” (HUD Handbook 4000.1 § 1 I.A.8.f).

Fifth, HUD updated its policy for a mortgagee’s voluntary withdrawal of FHA approval. The previous version of the SF Handbook provided: “A Mortgagee that does not wish to retain, *or that is ineligible to retain*, its FHA approval must submit a Change Request for voluntary withdrawal of FHA approval” (emphasis added). The revised SF Handbook states: “A Mortgagee that does not wish to retain its FHA approval must submit a Change Request for voluntary withdrawal of FHA approval” (HUD Handbook 4000.1 § I.A.9). This policy change has the potential for serious consequences. It appears to remove a mortgagee’s ability to seek voluntary withdrawal when it is ineligible to retain its FHA approval, which generally requires submission of a Notice of Material Event within 10 days of the change in circumstance (HUD Handbook § I.A.7.a), limiting voluntary withdrawals to situations where the

mortgagee simply desires to relinquish its FHA approval. HUD's Transmittal notice confirms as much, stating "[i]neligible Mortgagees must notify FHA in accordance with I.A.7."

Sixth, in the section addressing calculation of a mortgagee's annual recertification fee, HUD replaced "annual reporting period" with "Certification Period" as defined in the Glossary. The previous version of the SF Handbook provided that the fee was to be calculated based on the mortgagee's program approval, mortgagee type and number of FHA-approved branch offices as of the last business day of the mortgagee's annual reporting period; a mortgagee terminating a branch had to do so on or before the last business day of the annual reporting period to avoid paying the recertification fee for that branch for the next annual period. The revised SF Handbook provides that the recertification fee will be based on program approvals, mortgagee type and the number of FHA-approved branch offices as of the last business day of the mortgagee's "Certification Period" (as opposed to the annual reporting period); to avoid a recertification fee for a branch office, the mortgagee must terminate that branch on or before the last business day of the "Certification Period" (as opposed to the annual reporting period) (HUD Handbook 4000.1 § I.A.8.c). The Glossary defines "Certification Period" as "the one-year period, beginning on the first day of the Mortgagee's prior fiscal year and ending on the last calendar day thereof."

Seventh, HUD separated its guidance for types of single family nonprofit programs into guidance for purchases at a discounted price and guidance for purchases during an exclusive listing period. The previous version of the SF Handbook provided that "Governmental Entities and HUD-approved Nonprofits are permitted to purchase homes from HUD during the extended listing period, when the homes may be offered at a

discount." The revised SF Handbook provides that "Governmental Entities and HUD-approved Nonprofits are permitted to purchase homes from HUD at a discount" and that "Governmental Entities and HUD-approved Nonprofits are permitted to purchase Properties, without a discount, during the exclusive listing period for owner occupant purchasers" (HUD Handbook 4000.1 § I.B.4.a.i).

Eighth, HUD updated its recertification process for real estate brokers approved to list or sell HUD real-estate owned ("REO") properties. It now requires HUD-registered real estate brokers to be recertified by HUD each year, noting that NAID certifications for brokers are valid only for one year after issuance (HUD Handbook 4000.1 § I.B.5.d).

HUD has made a number of other changes to Section I of the SF Handbook that appear to be an effort to achieve consistency across sources. For example, it updated its adjusted net worth standards for multifamily programs with and without servicing to be consistent with regulatory requirements (HUD Handbook 4000.1 § I.A.3.c.vii(A)(1)(b), 24 C.F.R. §202.5(n)(3)). It also updated its financial requirements for new applicants to require their submission of an adjusted net worth calculation (HUD Handbook 4000.1 § I.A.3.c.vii(C)), although the SF Handbook always has required applicants to submit financials prepared in accordance with the *Consolidated Audit Guide*, which specifically requires an adjusted net worth computation (HUD Handbook 2000.04 REV-2). The changes to Section I further incorporate Mortgagee Letter 2016-21, which clarified various matters related to HUD's test case process, as well as Mortgagee Letter 19-01, which allowed and provided guidance on the use of third-party verification services to verify borrowers' employment, income and asset information.

SECTION II – ORIGINATION THROUGH POST-CLOSING/ENDORSEMENT

In addition to making changes to requirements for doing business with FHA, HUD made numerous changes to FHA loan-level origination requirements.

First, HUD clarified that a subordination agreement is not required for federal tax liens in repayment in order for the borrower to qualify. When determining borrower eligibility, a lender must ensure that the subject property will be free and clear of all liens. However, tax liens may remain unpaid if the borrower has a valid repayment agreement to make regular payments and has made timely payments for at least three months under that agreement. HUD has clarified that, while the tax lien holder also generally must subordinate the tax lien to the FHA loan, federal tax liens in repayment need not be subordinated (HUD Handbook 4000.1 § I.A.1.b.ii.(A)(13)(b)). While this clarification does not reflect an actual change to the prior policy, HUD changed the typeface in an effort to highlight the distinction for federal tax liens.

Second, HUD added discussion of tip income to its income requirements, directing mortgagees to treat tip income the same way they treat overtime or bonus income. For example, tip income may not be included in base income, it must have been received for at least two years and be likely to continue (subject to certain exceptions), and it must be averaged over the prior two years, or the current amount must be used if the income has decreased by 20 percent or more from the prior year (HUD Handbook 4000.1 §§ II.A.3.c.ii(C)(3), II.A.3.c.v., II.A.5.b.ii(C)(3), II.A.5.b.v).

Third, regarding legal restrictions on conveyance, HUD added guidance on determining the “reasonable share of appreciation.” The applicable regulation provides that a mortgage is not eligible for FHA insurance if the property is subject to

legal restrictions on conveyance, subject to certain enumerated exceptions (24 C.F.R. § 203.41(b)). There is a regulatory exception for eligible governmental or nonprofit programs, part of which states that the borrower may be prohibited from selling the property at a price greater than the price permitted under the program, or may be required to pay a portion of the sales proceeds to a governmental body or an eligible nonprofit organization, as long as the borrower is not prohibited from recovering (i) the sum of the borrower’s original purchase price, the reasonable costs of sale, the reasonable costs of improvements made by the borrower and any negative amortization on an insured graduated payment mortgage, and (ii) *a reasonable share, as determined by the Secretary, of the appreciation in value* which shall be the sales price reduced by the sum determined under the foregoing provision (24 C.F.R. § 203.41(d)(1)). The regulation further provides that the purchase price under an option may not be less than the sum of the borrower’s original purchase price, the reasonable costs of sale, the reasonable costs of improvements made by the seller, *and a reasonable share, as determined by the Secretary, of the appreciation in value* (24 C.F.R. § 203.41(d)(4)). In the revised SF Handbook, HUD added a provision stating that “FHA considers a reasonable share of appreciation to be at least 50 percent. HUD does not object to affordable housing programs whereby the homeowner’s share of appreciation is on a sliding scale beginning at zero, provided that within two years the homeowner would be permitted to retain 50 percent of the appreciation. If the program sets a maximum sales price restriction, the Borrower must be permitted to retain 100 percent of the appreciation” (HUD Handbook 4000.1 § II.A.1.b).

Fourth, HUD updated its documentation guidance for evidencing the transfer of gift funds to a borrower or settlement agent.

Specifically, under the previous version of the SF Handbook, when verifying the transfer of gift funds from a donor to the borrower, if the funds were not verified in the borrower's account, the mortgagee had to obtain a copy of the certified check, money order, cashier's check, wire transfer or other official check, along with a bank statement. The new guidance clarifies that the check must evidence payment to the borrower or settlement agent, and that the bank statement must be the donor's bank statement and must evidence sufficient funds for the amount of the gift (HUD Handbook 4000.1 §§ II.A.4.d.iii(F)(3), II.A.5.c.iii(F)(3)). The clarification is significant in that it suggests that a copy of a gift check that does not reflect an actual transfer of funds (i.e., a check that has not been cleared by the bank yet) will be insufficient, as well as indicates that a copy of the borrower's bank statement reflecting the deposit of the funds is insufficient and a copy of the donor's bank statement is required.

Fifth, HUD updated its guidance to distinguish which certifications are required for purchase transactions and which certifications are required for refinance transactions. Specifically, the update clarifies that:

- a) Borrower signatures are required on Form 92900-A for all transactions and on the settlement certification for purchase transactions;
- b) Seller signatures are required on the settlement certification for purchase transactions (except in the case of HUD REOs);
- c) Settlement agent signatures are required on the settlement certification for purchase transactions;
- d) The Closing Disclosure must be signed by all parties; and
- e) No settlement certification is required in refinances.

(HUD Handbook §§ II.A.6.a.vii, II.A.7.b.v).

Sixth, HUD added a definition of "notice of return" in its procedures for FHA insurance endorsement. Specifically, the revised SF Handbook provides that a "Notice of Return (NOR) refers to a notification to the Mortgagee specifying the reason a Mortgage is not currently eligible for endorsement" (HUD Handbook § II.A.7.d.iii.(C)).

Seventh, HUD clarified its policy regarding the exception for non-occupying co-borrowers to hold multiple FHA loans. The previous version of the SF Handbook provided that, as an exception to the general FHA policy limiting the number of mortgages per borrower, "[a] non-occupying co-Borrower on an existing FHA-insured Mortgage may qualify for an FHA-insured Mortgage on a new Property to be their own Principal Residence." The revised SF Handbook adds clarifying language, stating that "[a] non-occupying co-Borrower on an existing FHA-insured Mortgage may qualify for another FHA-insured Mortgage on a new Property to be their own Principal Residence" and that "[a] Borrower with an existing FHA-insured Mortgage on their own Principal Residence may qualify as a non-occupying co-Borrower on other FHA-insured Mortgages" (HUD Handbook 4000.1 § II.A.1.b.iii(A)(2)(c)).

In addition, as it did in Section I, HUD made a number of technical changes to Section II in an effort to achieve consistency across sources and that do not appear to have any substantive impact on FHA requirements or lender practices. For example, it substituted the phrase "Mortgage and Note" for "security instrument" (to provide greater specificity) and the term "project manager" for "general contractor" (to reflect who is actually doing the work in new construction cases). It also included updated numbers for certain Fannie Mae forms and provided updated links to and dates of the current International Energy Conservation Code (HUD Handbook 4000.1 §§ II.A.4.c.xii(I)(2)(c), (I)(3)(c); II.A.4.d.iii(J),

II.A.5.c.iii(F)(3); II.A.5.d.ix(A)(1), II.A.8.a.vi(A)(2)(a), II.A.8.c.iii(B)). HUD also made various technical edits, including to hyperlinks, punctuation, formatting, grammar, spelling and capitalization. HUD further incorporated into Section II:

- a) Mortgagee Letter 16-21, which clarified documentation requirements for final underwriting review decisions;
- b) Mortgagee Letter 17-18, which provided guidance for Property Assessed Clean Energy (“PACE”) obligations;
- c) Mortgagee Letter 19-01, which provided guidance for using third-party verification services to verify borrowers’ employment, income and asset information;
- d) Mortgagee Letter 19-04, which removed the requirement to use an FHA Roster Inspector under various circumstances; and
- e) Mortgagee Letter 19-05, which removed the requirement for a 10-year warranty under various circumstances.

SECTION V – QUALITY CONTROL, OVERSIGHT AND COMPLIANCE

In addition to updating the SF Handbook sections related to doing business with FHA and loan-level origination requirements, HUD updated the provisions addressing quality control, oversight and compliance.

For example, HUD updated its policy regarding field reviews of appraisals. The previous version of the SF Handbook provided that field reviews must be conducted by “licensed” appraisers on FHA’s Roster of Appraisers. The revised SF Handbook removes the term “licensed” to provide that field reviews must be performed by appraisers listed on FHA’s Roster of Appraisers (HUD Handbook 4000.1 § V.A.3.c.ii(C)(1)(b)). In addition, to clarify its role in the appraisal

process, HUD changed the reference to “FHA approved appraisers” to “FHA roster appraisers” in the section noting that FHA may perform periodic reviews of work done by such appraisers to ensure FHA compliance (HUD Handbook 4000.1 § V.D.1). HUD also changed references to “loan officer” to “loan originator” in indicating a mortgagee’s obligation to ensure such participants are not debarred, suspended, under a limited denial of participation or otherwise ineligible to participate in FHA programs (HUD Handbook 4000.1 § V.A.3.f.i(A)). Lastly, HUD incorporated Mortgagee Letter 17-03 into Section V. That Mortgagee Letter provided guidance on HUD’s Loan Review System.

Conclusion

The March 27 update to the SF Handbook is HUD’s first update in over two years. It packs a substantial amount of information into a single resource, much of which may have a significant impact on mortgagees’ FHA lending operations. This Legal Update is intended to highlight some of the most noteworthy changes to FHA participation, origination through post-closing/endorsement and quality control/compliance requirements. However, it does not account for every single change, and it is important that FHA lenders scrutinize all of HUD’s changes carefully to identify whether and how they impact business operations. If you are unsure whether or how the changes impact your operations or any particular transactions, we urge you to consult with counsel or contact HUD. In the coming weeks, we will release Part II, which will address HUD’s changes both to servicing and loss mitigation requirements and to FHA guidelines for claims and disposition.

For more information about the topics raised in this Legal Update, please contact any of the following:

Emily J. B. Dornfeld

202 263 3296

ebdornfeld@mayerbrown.com

Krista Cooley

202 263 3315

kcooley@mayerbrown.com

Phillip L. Schulman

202 263 3021

pschulman@mayerbrown.com

Stacey Riggan

202 263 3362

sriggan@mayerbrown.com

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