August 13, 2008
Announcement 08-16: *Bankruptcy, Foreclosure, and Conversion of Principal Residence Policy Changes; and Revised Property Value Representation and Warranty Requirements*
Frequently Asked Questions

Bankruptcy and Foreclosure Policy Changes

Q1. What is the difference between a Chapter 13 bankruptcy and Chapter 7 bankruptcy and the difference between a Chapter 13 dismissal and a Chapter 13 discharge?
Chapter 13 permits borrowers with regular income to propose a plan to repay some or all of their obligations over a period of up to five years. A borrower who files a Chapter 13 bankruptcy case can dismiss the case at any time (voluntary dismissal) or the case may be dismissed by the court based upon the borrower's failure to comply with the requirements of the Bankruptcy Code or to make required payments.

If a borrower who files a Chapter 13 case makes all of the payments required by the plan, the borrower receives a discharge at the end of the plan. A borrower who does not make all of the payments required by the plan may still receive a discharge if the court finds, among other things, that the borrower made a certain amount of payments and the borrower's failure to make all of the payments was due to circumstances beyond the borrower's control.

The distinction between a Chapter 13 dismissal and a Chapter 13 discharge is important because a discharge indicates a reestablishment of credit by the borrower by meeting (in whole or in part) the terms of the repayment plan.

Chapter 7 permits a borrower to retain exempt assets and receive a discharge of the borrower's debts. It is a relatively quick liquidation process that is generally completed within 120 days. Chapter 7 cases are rarely dismissed.

Q2. How are preforeclosure sales and deed-in-lieu of foreclosure actions identified on a credit report?
Because there is no standard reporting for a preforeclosure sale or deed-in-lieu, the lender is responsible for reviewing the credit report, loan application, and any other information supplied by the borrower to determine whether such an action has been completed. Preforeclosure sales may be reported as "paid in full" with a "settled for less than owed" remarks code, and the mortgage tradeline would indicate recent delinquency. A deed-in-lieu action may be reported by a remarks code indicating such, and the lender can refer to the loan application (borrower declarations) to further determine whether the borrower has a deed-in-lieu in their credit history.

For reporting these actions on Fannie Mae loans, we require that servicers report to one of the major credit reporting agencies, but it is our policy not to direct specifically how to report various actions.

Q3. Why do the additional requirements for foreclosures in Announcement 08-16 only apply from five to seven years following the completion date?

In accordance with our existing policy in Part X, Section 103 of the *Selling Guide*, we require only a seven-year history to be reviewed for all credit and public record information. The seven-year timeframe also aligns with the information provided by the borrower on the loan application (Declaration C) relative to disclosure of a past foreclosure action.

Q4. Do the bankruptcy and foreclosure policy changes specified in Announcement 08-16 apply to loan casefiles underwritten with Desktop Underwriter® (DU®)?

Regarding the bankruptcy policy:

The bankruptcy policy changes specified in the Announcement are not applicable to loan casefiles underwritten with DU. The following bankruptcy policies continue to apply to DU loan casefiles:

- No bankruptcy can be filed within the 24-month period prior to the credit report date.
- All bankruptcies must be discharged at the time of the loan application.

Regarding the foreclosure policy:

DU Version 7.0 incorporated the five-year time period requirement from the credit report date to the date the foreclosure was reported. The additional foreclosure requirements specified in the Announcement are not applicable to loan casefiles underwritten with DU.

Regarding the requirements for foreclosure-related extenuating circumstances, deed-in-lieu, and preforeclosure sale:

DU is unable to determine the existence of extenuating circumstances that resulted in the foreclosure, or if the foreclosure was actually a deed-in-lieu or pre-foreclosure sale. If a lender has the appropriate documentation that these events occurred, and the applicable minimum time period has elapsed, lenders can manually underwrite loans that otherwise received a Refer with Caution/IV recommendation due to the five-year time period requirement for prior foreclosures. The loan must meet all requirements of the *Selling Guide* (as amended by this and prior Announcements) that pertain to manually underwritten loans, including full documentation, minimum credit scores, maximum loan-to-value (LTV) ratios, etc.

Q5. Announcement 08-16 states that DU will be updated in a future release to incorporate some or all of the changes specified in the Announcement. What changes will be made to DU regarding the bankruptcy and foreclosure policy changes, and when will these changes be made in DU?

Potential changes to DU regarding the updated bankruptcy and foreclosure policy specified in this Announcement are currently under review.

Q6. Is a preforeclosure the same as a short sale?

No, not necessarily, although historically the terms have been used interchangeably. For Fannie Mae's purposes, a preforeclosure assumes that the borrower has been delinquent in paying his or her mortgage and the servicer/investor agrees to accept a lesser amount to avoid the time and expense of a foreclosure action. A short-sale, however, can refer to situations in which the servicer/investor of the mortgage agrees to a payoff of a lesser amount than is actually owed, even on a current mortgage, to facilitate the sale of the property to a third party.

Q7. If a borrower has completed a short sale and was never delinquent on that mortgage and is now attempting to purchase a new primary residence, will Fannie Mae purchase the loan?

If the borrower is purchasing a new property and the previous mortgage history complies with our excessive prior mortgage delinquency policy and does not have one or more 60-, 90-, 120-, or 150-day delinquencies reported within the 12 months prior to the credit report date, the loan is eligible for delivery to Fannie Mae, provided the lender or servicer who completed the short sale has not entered into any agreement that obligates the borrower to repay any amounts associated with the short sale, including a deficiency judgment.

Conversion of Principal Residence to Second Home or Investment Property

Q8. Announcement 08-16 states that with the exception of the additional reserve requirements, all other requirements regarding primary residence conversions must also be applied to loan casefiles underwritten with DU. How should lenders apply these requirements to DU loan casefiles?

When the borrower's current principal residence is pending sale, but the transaction will not close prior to the closing of the new loan transaction, the lender must make sure that DU is using both the current and the proposed mortgage payments when calculating the total expense ratio. This is done by ensuring that the current principal residence mortgage is *not* marked "paid by close" or "omit" in the liabilities section of the online loan application.

When the borrower is converting a primary residence to a second home, lenders should make sure the associated mortgage is *not* marked "paid by close" or "omit" in the liabilities section of the online loan application, so the mortgage payment will be included in the total expense ratio.

When the borrower is converting a primary residence to an investment property, the lender must document the following items:

- Equity in the existing property of at least 30 percent;
- A copy of the fully executed lease agreement; and
- The receipt of a security deposit from the tenant and deposit into the borrower's account.

If this documentation can be provided, the lender may enter a net rental income amount in the income section of the online loan application equal to 75 percent of the total rental income amount. DU will use this income amount when calculating the total expense ratio.

If this documentation cannot be provided, the lender must ensure that DU is using both the current and the proposed mortgage payments when calculating the total expense ratio. If the mortgage is identified in the online loan application as one associated with the rental property, the lender must enter a negative net rental income amount equal to the current residence payment (for example, net rental income is entered as "–$1,000" when the current residence payment is $1,000). If the mortgage is not identified as one associated with a rental property, the lender must make sure the associated mortgage is *not* marked "paid by close" or "omit" in the liabilities section of the online loan application in order to ensure DU includes the payment in the total expense ratio.

Q9. Announcement 08-16 states that the additional reserve requirement for primary residence conversions does not apply to loan casefiles underwritten with DU. Will DU be updated so the message that states the amount of assets that must be verified includes the additional two months or six months of reserves on these transactions?

Because DU is not able to determine if a second home or rental property was previously the borrower's primary residence, it would not be able to determine additional reserve requirements for that characteristic. DU continues to require the amount of assets to be verified based on the overall risk assessment of the loan casefile. Lenders may continue to follow the asset verification requirements specified in the DU Underwriting Findings report, and will not be required to verify additional reserves outside of DU for primary-to-investor or second home conversion transactions.

Q10. Why is Fannie Mae requiring valuation of a property that is not the subject property for the loan? Won't that be costly to lenders/borrowers?

Fannie Mae understands that this requirement is an additional burden to lenders and borrowers, but we are committed to sustainable homeownership. As our "National Down Payment Policy" indicates – equity matters. Lenders may choose not to pursue the value of the current primary residence, but additional qualifying criteria for the new property must be applied if the lender chooses that option.

Q11. Is it up to the lender to decide when to use a full appraisal rather than an automated valuation model (AVM) or broker price opinion (BPO)? What happens if the property is a multi-unit investment property or there is some other higher-risk situation?

It would be within the lender's discretion to determine the appropriate valuation method based on each case scenario and the overall risk factors of the loan. If a higher review level is warranted, a lender should use more prudent underwriting and secure a higher level of appraisal field work.

Q12. Does Fannie Mae continue to allow a bridge loan that is collateralized by the borrower's current principal residence?

Yes, as long as the bridge financing meets the requirements in Part X, Section 702.2 (E) of the *Selling Guide*. That provision states that the payments on the current primary residence do not need to be included in the borrower's total expense ratio as long as:

- The lender obtains a copy of the executed sales contract for the current principal residence;
- All financing contingencies, if any, have been cleared; and
- The borrower has reserves equal to six months of payments for any outstanding liens against the property, in addition to any other reserves that are otherwise required in connection with the borrower's purchase of the new home.

Revised Property Value Representation and Warranty

Q13. How does the new representation and warranty that property value has not declined for loans sold to Fannie Mae more than six months from closing apply to construction-to-permanent (C to P) transactions?

Fannie Mae did not make any changes to the C to P guidelines for the value used to support the terms of the transaction. The six-month period for measuring the new representation and warranty begins at the time the permanent financing is closed (separate closing or modification). The lender may deliver loans from the date of closing for up to and including six months with no required representation and warranty that value has not declined. Only if the loan is sold to Fannie Mae more than six months from the closing/modification date of the permanent financing does the representation and warranty become applicable.

Q14. What if the loan is sold to Fannie Mae more than six months after closing and the lender verifies that the value has declined, but the new value does not impact the original eligibility for the loan – i.e., level of mortgage insurance, maximum LTV/CLTV, etc.? Is the loan still eligible for delivery to Fannie Mae on a flow basis?

If the lender cannot provide the representation and warranty that the property value has not declined, regardless of whether the loan is still eligible based on a lower value, the loan may not be delivered as flow business and must be submitted as part of a bulk transaction. The bulk process involves additional due diligence to assess eligibility and price the loan accordingly.