DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–5171–N–02]

Federal Housing Administration (FHA) Single Family Mortgage Insurance: Implementation of Risk-Based Premiums

AGENCY: Office of the Assistant Secretary for Housing—Federal Housing Commissioner, HUD.

ACTION: Notice.

SUMMARY: This notice provides for FHA's implementation of risk-based premiums for most of its Title II single family mortgage insurance programs, enabling mortgage lenders to offer borrowers FHA-insured financing with a range of mortgage insurance premiums based on the risk the insurance contract represents. This notice follows a September 20, 2007, notice that solicited public comment on the proposal to implement risk-based premiums. This notice makes certain changes, in response to public comment, to FHA's risk-based premium structure and implements risk-based premiums in accordance with those changes.

DATES: *Effective Date:* July 14, 2008.

FOR FURTHER INFORMATION CONTACT: Margaret E. Burns, Director, Office of Single Family Program Development, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410; telephone number (202) 708–2121 (this is not a toll-free number). Persons with hearing or speech impairments may access this number through TTY by calling the toll-free Federal Information Relay Service at (800) 877–8339.

SUPPLEMENTARY INFORMATION:

I. Background—September 20, 2007, Notice

By notice published by HUD in the **Federal Register** on September 20, 2007 (72 FR 53872), FHA announced its plan to implement risk-based premiums for FHA loans which, under that proposal, would apply to case numbers assigned on or after January 1, 2008. Section 203(c)(2) of the National Housing Act (12 U.S.C. 1709(c)(2)) provides for upfront and annual mortgage insurance premiums for most FHA single family programs. Such upfront and annual insurance premiums are set at levels not to exceed 2.25 percent and 0.50 percent (0.55 percent for mortgages involving an original principal obligation that is greater than 95 percent of the appraised value of the property), respectively, with a discount available on the upfront premiums for some mortgagors who are first-time homebuyers and who successfully complete pre-purchase homeownership counseling approved by the Secretary.

In the September 20, 2007, notice, FHA advised that, by offering a range of premiums based on risk, it would be able to offer options to: (1) Mortgagees serving borrowers who were previously underserved, or not served, by the conventional marketplace; and (2) mortgagees serving those borrowers wishing to lower their premiums by, for example, increasing their downpayment or by improving their credit scores. Additionally, offering a range of premiums based on risk helps to ensure the future financial soundness of FHA programs that are obligations of the Mutual Mortgage Insurance Fund (MMIF or the Fund). The September 20, 2007, notice emphasized that under risk-based premiums, no qualified borrower will be charged by the mortgagee in excess of the current statutory upfront and annual mortgage insurance premium limits.

The September 20, 2007, notice solicited public comment for a period of 30 days. Although, as more fully discussed in Sections III and IV of this notice, a number of public commenters opposed HUD's proposal to implement risk-based premiums but did not fully explain the reasons for the opposition, other commenters raised important issues for HUD's consideration and offered suggestions that HUD should adopt. Therefore, after careful review and consideration of the public comments, HUD will implement risk-based premiums, as provided in this notice, with certain revisions made after consideration of public comments. HUD is proceeding to implement risk-based premiums for the reasons expressed in the September 20, 2007, notice; namely, that such a pricing mechanism will allow FHA to serve a range of borrowers and will help ensure the financial soundness of FHA programs that are obligations of the MMIF. These policy reasons are more fully discussed in Section III of this notice.

II. This Notice—Changes Made After Consideration of Public Comments

After consideration of public comments, this notice makes the following changes to the September 20, 2007, proposal:

- The effective date is changed from January 1, 2008, to July 14, 2008, for FHA loans for which case numbers are assigned on or after that date.
- The classifications used in the upfront premium rate table are changed from minimum downpayment to loan-to-value (LTV) ratio.
- Source of downpayment is eliminated as a factor in determining the borrower's mortgage insurance premium.
- Borrowers with nontraditional credit are eligible for 97 percent LTV financing.
- The September 20, 2007, notice's provision on averaging the borrower's credit scores has been removed and replaced with the lowest-decision credit score.
- A revised matrix shows both upfront and annual premiums for loans with terms in excess of 15 years, and another matrix shows premiums for loans with terms of 15 years or fewer.
- The minimum upfront premium is raised from 75 basis points to 125 basis points for mortgages in excess of 15 years, and from 75 basis points to 100 basis points for mortgages of 15 years or fewer.

III. Overview of Key Public Comment Concerns and the Importance of Implementation of Risk-Based Premiums

At the close of the public comment period on October 22, 2007, HUD received 176 public comments. These public comments came from a variety of sources, including the general public, loan officers, mortgage companies, regional and national banks, state housing finance agencies, various organizations representing the interests of the mortgage lending and home building industries, private mortgage insurers, seller-funded downpayment assistance providers, and companies providing information management systems services.

While many of the commenters opposed risk-based premiums, the majority did not clearly express the basis for their opposition. Some of these commenters stated that risk-based premiums would hurt the very persons FHA was established to serve, but provided no information or explanation to support this claim. One commenter stated that if risk-based premiums are implemented, FHA will offer only more expensive, conventional-type loans and will cease to assist lower-income borrowers who represent the target audience for FHA insurance. Other commenters stated that HUD did not need to implement risk-based premiums and eliminate downpayment assistance; that is, that one or the other should be sufficient to address higher risk mortgages. (These comments and others are more fully addressed in Section IV of this notice.)

FHA is implementing risk-based premiums in support of its mission to promote homeownership among first-time and minority homebuyers. While the conventional market regularly uses risk-based premiums to price insurance risk, FHA, to date, continues to charge a one-size-fits-all premium to mortgagees, resulting in lower-risk borrowers paying a higher premium than necessitated by their risk, and higher-risk borrowers paying a lower premium relative to their risk. The criteria that FHA proposes to use for risk-based premiums—credit scores and LTV ratios—are strongly associated with claim rates and have become the primary risk factors used in conventional market pricing of mortgage credit risk. FHA has a legitimate business basis for charging higher premiums to higher-risk borrowers. Indeed, it has a business imperative, because the current FHA method of average-risk pricing is no longer sustainable.

Risk-based premiums expand FHA's ability to serve borrowers whom it would otherwise have to turn away. By charging them a slightly higher insurance premium, FHA can assist underserved borrowers with fewer monetary resources or impaired credit to become homeowners while protecting the MMIF with the higher premium. Many homebuyers, who were steered to subprime products, paid substantially more for access to homeownership. As the 2004, 2005, and 2006 Home Mortgage Disclosure Act (HMDA) data show, many of these homebuyers were minorities. FHA can potentially lower the cost to borrowers because it is actually less costly for borrowers to pay for their credit risk in a mortgage insurance premium than what is charged to them through a higher subprime mortgage interest rate. For example, if a borrower with imperfect credit used an FHA-insured loan rather than a subprime loan for a $200,000 mortgage used to purchase a $225,000 home, the borrower would typically qualify for a 3 percentage point-lower mortgage interest rate. Assuming a 6.5 percent mortgage interest rate, a 10 percent downpayment, financing of a 1.75 percent upfront mortgage insurance premium, and payment of a 0.50 percent annual premium on the declining principal balance, a borrower would still save nearly $4,000 in monthly payments in the first year alone with an FHA-insured loan compared to a 9.5 percent subprime loan. After 10 years, the borrower would experience a total of nearly $40,000 of savings in monthly payments. Not only would the borrower benefit from lower loan costs with an FHA-insured loan, but FHA requires FHA-approved mortgagees to take measures designed to provide foreclosure alternatives that may not be offered with a subprime loan. FHA requires loan servicers to offer an array of loss mitigation options that may result in defaulting borrowers being able to stay in their homes.

In addition, as the accompanying Appendix chart shows, substantial shares of FHA's lower-income borrowers have FICO [1] scores above 680 and would qualify for premium reductions relative to today's premium levels. In fact, as a result of the predominantly low- and moderate-income character of FHA borrowers, a larger number of low-income borrowers would benefit from premium reductions than would moderate-, middle-, and upper-income borrowers combined. See the Appendix for a chart showing the distribution of FY 2007 homebuyers by FICO category and income group.

Risk-based premiums enable FHA to respond to changes in the market, like the recent implosion of subprime lending, by reaching out to higher-risk borrowers without having to raise premiums for all borrowers. Borrowers are better off, even with higher mortgage insurance premiums, because FHA insurance gives borrowers access to substantially lower interest rates than are charged for subprime loans, thereby lowering borrowers' overall borrowing costs.

Risk-based premiums do not end the cross-subsidization that has always existed within the MMIF programs, but, by implementing risk-based premiums FHA can better manage the cross-subsidization. At present, some segments of the borrowers served by FHA have very high default and foreclosure rates. Ultimately, if FHA did not implement risk-based premiums, FHA would have to raise premiums for all borrowers and impose new underwriting restrictions. Increasing premiums for all borrowers would drive away more of the lower-risk borrowers who are needed to provide cross-subsidies to higher-risk borrowers and would only increase any adverse selection. As a result, FHA would serve fewer borrowers than it does now, and more borrowers would be left with either a higher-cost and higher-risk subprime option, or no access to mortgage credit.

[1] FICO is a credit score developed by Fair Isaac Corporation.

IV. Discussion of Public Comments

Authority to Implement a Credit-Score Based Premium Structure, and Effectiveness of Such Structure in Achieving Stated Goals

Comment—FHA Should Not Be Exercising Risk-Based Premium Authority Now: One commenter challenged the authority of FHA to implement a credit-score premium structure at this point in FHA's history. The commenter stated: ''Congress gave FHA the authority to risk-base price its premium according to the initial LTV of the loan and for the past six and one-half years FHA chose not to exercise that authority.'' The commenter continued, ''However, FHA never fully implemented a risk-based premium based on the initial LTV of the loan and significantly reduced its common up-front premium. The result has been an inadequate premium structure that has contributed to FHA's current financial problems.''

HUD Response: HUD disagrees with the commenter's statement. Inherent in the insurance function is the management of risk. FHA, as a mortgage insurer, is charged with managing risk, and risk-based premiums help FHA manage risk.

FHA is provided with flexible authority in section 203 of the National Housing Act (12 U.S.C. 1709) to charge an upfront premium not exceeding 2.25 percent of the mortgage balance and an annual premium not exceeding 50 basis points on the declining mortgage balance, but not exceeding 55 basis points for mortgages with LTVs greater than 95 percent. This authority has been implemented by HUD through regulations at 24 CFR 203.284 and 203.285. Therefore, HUD has discretion to charge an upfront and an annual insurance premium that are greater than 0 percent but do not exceed the respective statutory limits. The range of insurance premiums in this notice is consistent with, and supported by, the statutory authority in section 203(c)(2) of the National Housing Act (12 U.S.C. 1709(c)(2)). FHA also is authorized to discount the upfront premiums for some mortgagors who are first-time homebuyers and who successfully complete pre-purchase homeownership counseling approved by HUD. Notwithstanding the date of enactment of its statutory authority, FHA is not prohibited from trying new and different approaches from the one originally chosen, consistent with its statutory authority, to improve its financial management and to make its programs more available to the populations they are intended to benefit.

Comment—Over-Reliance on Credit Scores to Assess Risk: With regard to FHA's proposed approach to risk-based premiums, the same commenter above stated that it is concerned that FHA is over-relying on the predictive power of credit scores to pinpoint likely future borrower claims. The commenter said credit scores have proven to have a weak correlation to real risk during periods of economic or housing market stress and, as bank regulators have correctly determined, lenders should not over-rely on credit scores as a substitute for careful analysis of the multiple risk factors associated with mortgage risk. The commenter further stated that the proposed over-reliance on credit scores would lead FHA to repeat the same mistakes now creating major losses throughout the subprime mortgage arena. The commenter elaborated as follows: ''For example, the recent guidance on nontraditional mortgages notes that 'the analysis of repayment capacity should avoid over-reliance on credit scores as a substitute for income verification in the underwriting process'.''

HUD Response: FHA disagrees with this comment. First, FHA is not replacing its strict underwriting criteria. FHA has avoided the major losses now being suffered in the subprime mortgage arena because FHA requires, and will continue to require, full documentation of a borrower's income and credit. Second, FHA recognizes that credit scores matter, but does not intend to over-rely on a borrower's credit score. FHA assesses the borrower's credit using its TOTAL [2] mortgage scorecard that takes into account multiple, statistically significant credit characteristics in approving a borrower's credit or referring the borrower for manual underwriting where the underwriter may determine that compensating factors exist that warrant the borrower's approval for credit. Finally, similar to all other industry organizations, including private mortgage insurers, lenders, and the Federal Reserve, FHA considers credit scores to be highly predictive of borrower performance, even during this period of economic and housing market stress. One demonstration of the predictive power of credit scores comes from the actuarial reviews of the FHA MMIF that are conducted annually by independent contractors for congressional review and are in the public domain. The FY 2006 and FY 2007 actuarial reviews incorporated credit scores as explanatory variables in their loan performance models, which use the most recent 30 years of FHA's actual historical experience and critical economic variables to model loan performance. The correlation between credit scores and loan performance shown by these reviews highlights the importance of credit scores in managing risk. (The FY 2006 actuarial review is available at *http://www.hud.gov/offices/hsg/comp/rpts/actr/2006actr.cfm*. The FY 2007 actuarial review is available at *http://www.hud.gov/offices/hsg/comp/rpts/actr/2007actr.cfm*.)

Comment—Loss of Cross-Subsidization: The same commenter and other commenters expressed the fear that FHA would be prevented by a risk-based premium structure from practicing the cross-subsidization traditionally associated with FHA mortgage insurance programs. For example, one of the commenters stated that there is concern ''that the credit score related portion of the proposed upfront premium as set forth in the proposal will undermine the cross balancing of multiple mortgage risk factors that makes FHA, as a government program, accessible to low and moderate income borrowers and broadly available to areas with large concentrations of minority borrowers.'' Another commenter urged that: ''FHA should consider other premium pricing differentials based on credit risk elements such as mortgage terms and loan-to-value ratios. To the greatest extent possible, the FHA should preserve cross-subsidization of premium pricing in the prime mortgage market. Individual borrower credit scores may be an appropriate element of premium pricing in the subprime market.''

HUD Response: FHA rejects the implication of these comments that FHA is moving away from cross-subsidization. In fact, FHA is seeking to implement risk-based premiums in order to improve its management of cross-subsidization. FHA disagrees with the view that credit scores should be used for establishing premiums in the subprime market but not in the prime market where FHA operates. FHA serves borrowers from the full range of the credit scores. Like any insurance company, FHA must assess and manage its business risk on the basis of the actual characteristics of its borrowers and other factors that have been demonstrated to affect loan performance. In FHA's historical experience, credit scores have proven to be statistically significant indicators of additional risk, while the type of the mortgage—fixed versus adjustable—has not.

FHA's adjustable rate mortgages (ARMs) do not bear the risk characteristics of subprime ARMs because FHA does not permit initial teaser rates, and it underwrites the borrower's credit on the basis of the maximum second-year rate to avoid ''payment shock.'' As a result, the performance of FHA's ARMs does not differ sufficiently from the performance of its fixed-rate mortgages to justify a premium differential.

In managing risk, however, FHA will continue cross-subsidization by charging higher than break-even premiums to borrowers with better credit scores and lower LTVs so that it can serve some borrowers whose premiums do not cover their full risk to the Fund. Such cross-subsidies have been normal and subject to study within the MMIF, and FHA plans to analyze them even more intensely in the future with the implementation of risk-based pricing.

Comment—Fewer Borrowers Would Qualify for FHA-Insured Mortgages: Several commenters cite the June 2007 study of the Government Accountability Office (GAO) on ''Modernization Proposals Would Have Program and Budget Implications and Require Continued Improvements in Risk Management,'' to argue that risk-based pricing would bar an excessive number of borrowers from qualifying for a FHA-insured mortgage. For example, one commenter reprinted Figure 4 from the report and stated: ''As is clearly evidenced above, the imposition of risk-based pricing will arbitrarily redline out 20% of all current FHA users and a full 32% of African-American families and 20% of Latino families currently utilizing FHA.''

HUD Response: FHA provided the data used in the GAO analysis and does not dispute its findings. Some categories of loans have excessively high expected claim rates. While FHA is committed to expanding homeownership, it is also committed to sustainable homeownership. It is FHA's position that expected claim rates above 25 percent are too high, even for a small percentage of borrowers. Consequently, FHA is tightening its underwriting standards resulting in a restriction that requires borrowers with credit scores below 500 to have a 90 percent or lower LTV ratio in order to be eligible for a FHA-insured mortgage.

[2] TOTAL is the acronym for Technology Open to Approved Lenders, which is a mathematical equation to use with an automated underwriting system (AUS). FHA's TOTAL Mortgage Scorecard evaluates the overall creditworthiness of the applicants based on a number of credit variables and, when combined with the functionalities of the AUS, indicates a recommended level of underwriting and documentation to determine a loan's eligibility for insurance by FHA.

While the percentage of borrowers obtaining FHA-insured mortgage financing that will be affected by this restriction is small, this restriction is imposed to serve the public purpose of avoiding excessive foreclosures and to ensure the sustainability of the insurance fund. Due to statutory ceilings, FHA is not authorized to charge premium rates high enough to cover the costs of foreclosures on these loans, and high foreclosure rates adversely impact neighborhoods and communities, as well as the individual families. FHA holds the view that borrowers who lack sufficient credit quality to qualify for immediate homeownership will be best served if they are referred to mortgage counseling, and if they can focus on improving their credit scores or saving for a larger downpayment and, thereby, increase their chances of sustainable homeownership in the future.

Comment—Proposal Will Not Resolve MMIF Solvency Concern: Similar to the preceding comments, two commenters stated that HUD's risk-based premium proposal would not improve the ''financially precarious position'' of the MMIF and would instead negatively impact both the MMIF and the much larger market for prime mortgages, by eliminating the cross-subsidization of premium pricing in the prime mortgage market. One commenter believed it is ''inappropriate for FHA, as a government program, to implement a premium structure that would effectively deny access to low income and minority groups who have traditionally relied on this program.''

HUD Response: HUD disagrees with the commenters' statements. First, as discussed in the response to the previous comment, HUD has documented from its own experience, and using loan-performance forecasts from the annual independent actuarial studies of the MMIF, that this proposal will improve FHA's financial and actuarial solvency. That analysis has been verified by the Office of Management and Budget. Second, HUD is denying access to no one based on income or race. Rather HUD is establishing reasonable parameters for the levels of cross-subsidies that are appropriate within the FHA insurance programs, based on its own historical experience.

By implementing risk-based premiums, HUD is preserving and enhancing its ability to serve low-income and minority groups that represent FHA's traditional borrowers. HUD is doing so by improving its management of—not eliminating—cross-subsidization. Risk-based premiums offer a balanced approach that will permit FHA to reach more potential homebuyers, an objective that is necessary to continue to provide cross-subsidies to targeted groups. Furthermore, because risk-based premiums will also apply to the refinancing of loans, borrowers who improve their creditworthiness through regular mortgage payments or through increases in home value can lower the insurance premiums they pay to FHA, when refinance opportunities present themselves.

Comment—Other and Better Proposals Will Achieve FHA Goals: Two commenters suggested that HUD, instead of implementing risk-based pricing premiums, use other methods for achieving the stated goals of increasing market share, improving competition with the subprime market, and avoiding the need for a credit subsidy. As examples, the commenters cited better marketing of FHA loans and expanded use of loss mitigation.

HUD Response: While serving borrowers who were previously underserved or not served by the conventional market is a goal of this notice, FHA's objectives in implementing risk-based premiums are not to increase market share, nor to compete with the private sector. FHA must engage in a range of appropriate practices that will best serve the needs of homebuyers while protecting the financial soundness of the MMIF. FHA continues to operate its comprehensive loss mitigation program, but these activities do not serve the same objectives as risk-based premiums.

Process for Implementing Risk-Based Premiums

Comment: One commenter stated that HUD failed to follow Administrative Procedure Act (APA) notice and comment rulemaking requirements. The commenter stated that the ''risk-based premium proposal is clearly a ''substantive rule of general applicability''' and, as such, formal rulemaking under the APA is required.

HUD Response: The National Housing Act authorizes FHA to establish mortgage insurance premiums. For FHA single family programs, the National Housing Act directs that the upfront and annual premiums to be established by FHA may not exceed statutorily set maximum levels. The National Housing Act, however, gives FHA flexibility to set premiums within those maximum levels. On the basis of this statutory foundation, FHA may set premiums as it determines to be appropriate within the statutory parameters, to maintain the financial soundness of the MMIF. The September 20, 2007, notice presented FHA's proposal to establish premiums commencing in calendar year 2008 that would maintain the financial soundness of the MMIF.

The key element of APA notice and comment rulemaking is ''notice and comment''; that is, advance notice and the opportunity to comment prior to agency action. HUD has provided such advance notice and opportunity to comment through the September 20, 2007, notice. What HUD has not undertaken at this point is codification, which is not a matter covered by or subject to the APA. Codification presents a convenient organization for rules with some degree of permanence. However, when agencies are charged with setting prices or costs, such as insurance premiums, interest rates, fees or rents, which are based on market or other changing conditions that may necessitate periodic changes, then codification is less convenient. In such cases, what is important is that an agency provides advance notice and the opportunity to comment, and HUD has provided such notice and opportunity for comment in this matter.

Complexity of Proposal

Comment: Three commenters stated that the risk-based premium proposal is too complex and complicated. One commenter specified that the chart outlining the proposed risk-based premiums was ''too complicated and needs to be simplified.'' One commenter noted that HUD should provide, in the final, published notice or in the ensuing mortgagee letter, concrete examples on how to do calculations for determining the borrower's decision credit score and the insured property's base LTV ratio.

HUD Response: In this notice, FHA has made changes that simplify the upfront premium rate table. Moreover, as is FHA's practice, FHA will issue a mortgagee letter that will provide examples of how to perform calculations, as well as additional practical information that may be helpful to assist FHA-approved lenders with risk-based premiums.

Determination of the Borrower's Decision Credit Score

Comment: Several commenters questioned the decision to determine the decision credit score by averaging the scores of multiple borrowers on the loan. The commenters urged FHA to clarify the method of determination or to adopt current industry practice.

HUD Response: FHA agrees with this comment and will determine the decision credit score according to standard industry practice. See footnote

3 of the risk-based premium chart in Section V of this notice for a more detailed description of how decision credit scores for multiple borrowers will be determined.

Multiple Sources of Downpayment

Comment: Two commenters asked FHA to clarify the guidelines for borrowers who receive gifts from multiple sources. One commenter suggested that HUD regulations should either prohibit multiple gifts per loan transaction or permit such multiple gifts and update the TOTAL Scorecard system to accept additional data on the gifts. Another commenter stated that the proposal does not adequately assess and price the risk associated with multiple gift sources depending on the type of mortgage product offered or the type of gift provided (*i.e.*, amortized second mortgage; deferred payment zero-interest; deferred payment loans; seller-funded downpayment assistance, etc.).

HUD Response: FHA will allow all permissible sources of downpayment assistance to be added together to determine the appropriate LTV.

Use of Manual Underwriting

Comment: Some commenters stated that a ''major benefit'' of FHA is the ability to manually review and examine all aspects of a borrower's credit profile. They also stated that the risk-based premiums will only make it harder for individuals to obtain a mortgage with favorable terms. By requiring the use of credit scores, commenters stated that FHA is removing the ability of a trained underwriter to estimate the risk of providing mortgage insurance. One commenter suggested that HUD allow underwriters to exercise discretion when approving a loan with low or no credit scores, and to issue guidance that such loans be underwritten with ''extreme caution and possibly subject to FHA review.''

HUD Response: The risk-based premium structure does not replace FHA's existing underwriting criteria. Eligibility for an FHA-insured loan is first determined by FHA's TOTAL Scorecard, which relies on credit scores, LTV ratio, and several additional factors to determine a borrower's credit quality.

For borrowers that receive a ''Refer'' decision from TOTAL, FHA will continue to require manual underwriting, which allows an underwriter to consider additional compensating factors beyond the credit and application factors considered in TOTAL. Further, FHA may accept loans underwritten using nontraditional credit sources where borrowers have insufficient experience with traditional credit.

FHA has made the decision to establish risk-based premiums using credit scores as a principal determinant because a borrower's credit score provides the most important single measure of the willingness and ability of any single borrower to be successful under the borrower's debt obligations. A home loan is the most significant debt obligation that most households will ever enter into. In statistical models used to predict mortgage performance, credit scores and LTV ratios are the most important determinants. They, therefore, provide the best basis for establishing mortgage insurance premiums.

The premiums charged by FHA are independent of the interest rates charged by lenders on the insured loans. FHA provides lenders with 100 percent insurance on the principal balance of the loan. Therefore, the interest rates charged for FHA-insured loans are very close to those charged for prime, conventional loans purchased by Fannie Mae or Freddie Mac. That would not change regardless of what premiums FHA might charge for the insurance.

Borrowers With Nontraditional Credit

Comment: Several commenters expressed concern about borrowers without credit histories or borrowers with primarily nontraditional credit sources. The commenters stated that, in many instances, such borrowers prove more creditworthy than borrowers with low credit scores. One commenter suggested that the problem lies with HUD's failure to enforce policies requiring sufficient documentation of nontraditional credit sources.

HUD Response: HUD agrees that lenders should be encouraged to underwrite borrowers with no credit histories or borrowers who use nontraditional credit, to determine if such borrowers can qualify for FHA-insured mortgage financing. FHA issued guidance on this subject in Mortgagee Letter 2008–11, which was published on April 29, 2008.

Other Downpayment Concerns

Comment—Provide Zero Downpayment Product: Two commenters noted that the risk-based premium schedule does not allow for the possibility of a ''zero-downpayment'' insured product.

HUD Response: HUD does not currently have the statutory authority to offer a zero-downpayment product to FHA customers.

Comment—State Housing Finance Agencies Should Not Be Categorized as ''Other Sources of Funds'': Several commenters, primarily representing state housing finance agencies (HFAs) and other state and local government entities, expressed concern that the proposal, as published in September 2007, would place downpayment and closing cost assistance packages offered by HFAs in the ''Other Sources of Funds'' category. The commenters stated that this categorization would add 50 basis points to the upfront mortgage insurance premium charged to HFA clients. The commenters stated that there should be an exception in the ''Other Sources of Funds'' category for downpayment assistance programs provided or funded by instrumentalities of state and local government. The commenters cautioned HUD against ''lumping in,'' under the ''Other Sources of Funds'' category, downpayment assistance provided by HFAs and other state and local government entities with seller-funded downpayment assistance, which was categorized, in HUD's final rule published on October 1, 2007, as an impermissible source of downpayment assistance for FHA-insured mortgages. The commenters stated that borrowers receiving downpayment assistance from HFAs and other state or local government entities generally have lower default or delinquency rates than borrowers receiving assistance from other organizations.

HUD Response: HUD agrees and has removed source of downpayment assistance as a basis for premium determination. Whatever downpayment assistance is provided, however, it must be from a permissible source.

Comment—Borrowers with Government-Funded Downpayment Assistance Should Not Be Categorized as ''High Risk'': One commenter noted that most state and local governments and instrumentalities of these governments use, as their source of downpayment assistance to qualified borrowers, funds from various HUD programs designed to increase homeownership opportunities, including the Community Development Block Grant (CDBG) program, HOME program, and American Dream Downpayment Initiative (ADDI). The commenter suggested that classifying borrowers who receive funds from HFAs or instrumentalities of government as ''high risk'' completely contradicts the goals and purposes of programs such as HOME and ADDI.

HUD Response: HUD agrees and has removed source of downpayment as a factor in determining the borrower's mortgage insurance premium.

Comment—LTV, Not Downpayment, Should Be the Benchmark for Risk-

Based Premiums: Several commenters urged FHA to use LTV ratio as the appropriate benchmark for establishing risk-based premiums. One commenter stated that there is a discrepancy between the minimum 3 percent downpayment requirement in the risk-based premium chart in the proposed notice and FHA's current maximum LTV ratios, which are greater than 97 percent. The commenter requested that this discrepancy be addressed.

HUD Response: By law, FHA must require a minimum investment of 3 percent cash in the property in a purchase transaction to be FHA-insured. However, the National Housing Act also permits an LTV that is above 97 percent when the borrower wishes to finance closing costs in the mortgage. To avoid any confusion, HUD is changing the classifications used in the upfront premium rate table from ''downpayment'' to ''LTV,'' as shown in the new risk-based premium chart published herein.

Effective Dates

Comment: Several commenters noted that the proposed effective date for risk-based premiums of January 1, 2008, is not feasible. One commenter stated that compliance with the Sarbanes-Oxley Act necessitates that end-of-year freezes are in place to meet the statute's requirement that internal controls and systems be operating effectively at year end; thus, the commenter's company instituted a policy of not permitting programming changes during the fourth quarter. The commenters also stated that lenders would not be able to update their software systems in time to meet the implementation date of January 1. Various commenters suggested alternative effective dates such as: March 1, 2008; April 1, 2008; June 30, 2008; July 1, 2008; and 12 months from the date the final risk-based premium notice has been published. One commenter suggested that lender systems could be ready for risk-based premium pricing 90 days from the date the mortgagee letter is issued by FHA. Another commenter requested that HUD defer the implementation of risk-based premiums until automated underwriting systems that employ the TOTAL Scorecard, such as Fannie Mae's Desktop Underwriter, are revised to calculate the appropriate risk-based upfront and annual mortgage insurance premiums.

HUD Response: Although most commenters did not oppose the proposed January 1, 2008, implementation date, HUD is nevertheless changing the implementation date from January 1, 2008, to July 14, 2008, for FHA loans for which case numbers have not been assigned. HUD believes that the July 14, 2008, date will provide adequate time for mortgagees to update computer systems to accommodate risk-based premiums. Furthermore, FHA has, in response to public comments, simplified the upfront premium rate table in the notice by eliminating the source of downpayment as a variable in determining the appropriate insurance premium.

Two- to Four-Unit Dwellings

Comment: One commenter stated that the September 20, 2007, notice did not address pricing mechanisms for properties with two- to four-units, even though, historically, two- to four-unit family dwellings have a higher risk for default. The commenter suggested that FHA charge a 25 basis point premium for these properties.

HUD Response: At this time, FHA is not moving to develop risk-based premiums for two- to four-unit dwellings because FHA's overall portfolio includes very few loans secured by multi-unit properties.

Mortgages With 15-Year (or Less) Terms

Comment: Two commenters asked for clarification on how mortgages with 15-year terms or less would be addressed under the proposal. One commenter asked whether such mortgages would be subject to risk-based premiums under the proposal. Another commenter urged HUD to maintain the current practice of waiving the annual premium for loans of 15-year amortizations or less and loans with an LTV ratio of 89.99 percent or less.

HUD Response: FHA is not changing the maximum or minimum annual premiums on 15-year loans at this time. However, 15-year loans with low LTV ratios will have the advantage of the lower upfront premiums as provided in FHA's risk-based premium structure, and as described in Section V of this notice.

Homeownership Counseling

Comment: Two commenters requested that FHA more clearly define ''pre-purchase homeownership counseling acceptable to the Secretary.'' One commenter suggested that *all* homebuyers who complete pre-purchase homeownership counseling should be eligible for the 25 basis point reduction that is currently made available only to first-time homebuyers who would otherwise pay a 225 basis point premium.

HUD Response: Pre-purchase homeownership counseling must be obtained from a HUD-approved housing counseling agency, and must be completed up to one year before the homebuyer signs a purchase agreement for the property. Subsequent to the publication of this final notice, FHA will publish a standard homebuyer counseling certificate that will be used to document the provision of services. The 200 basis point cap on the upfront premium payment for first-time homebuyers is consistent with and reflects the language of section 203(c)(2) of the National Housing Act (12 U.S.C. 1709(c)(2)).

Relationship to FHASecure Temporary Initiative (FHASecure)

Comment: Five commenters suggested that the Department's risk-based premium proposal is inconsistent or incompatible with *FHASecure*, which is designed to help current homeowners avoid foreclosure by refinancing their conventional mortgage with an FHA-insured mortgage. The commenters stated that homeowners who refinance under *FHASecure* should be exempt from the premium pricing schedule outlined in the September 20, 2007, notice.

HUD Response: FHA's risk-based premium proposal is not inconsistent or incompatible with *FHASecure*, and, therefore, an exemption is not needed for *FHASecure* customers. The slightly higher premium for *FHASecure* customers will be more than offset by the substantially reduced mortgage payment they will achieve by refinancing into an FHA-insured mortgage. The slightly higher premium that may be paid by a borrower whose credit score has been impaired by defaulting on the borrower's conventional mortgage will have no effect on the borrower's eligibility for FHA refinancing, pursuant to *FHASecure* underwriting criteria. Furthermore, the difference between the existing 150 basis point upfront premium and the highest proposed upfront premium of 225 basis points for a $150,000 mortgage is approximately $7 per month. Therefore, the proposal should not have a significant impact on those borrowers covered by *FHASecure*.

Other FHA-Insured Programs

Comment: Two commenters noted that other FHA-insured programs, such as for adjustable rate mortgages (ARMs), condominiums, and mortgages insured under section 203(h) of the National Housing Act (12 U.S.C. 1709(h)), were not mentioned in the September 20, 2007, notice. The commenters asked whether these and other FHA-insured programs will be affected by the new risk-based premium pricing structure. One commenter asked whether military impact zones, which currently do not require the payment of an upfront insurance premium, would be included in the risk-based pricing proposal.

HUD Response: The risk-based premium rates apply to those forward mortgages insured under FHA's MMIF, the Section 203(k) rehabilitation mortgage insurance program, and individual condominium units insured under Section 234(c). Risk-based premiums do not apply to reverse mortgages under FHA's Home Equity Conversion Mortgage (HECM) program. Risk-based premiums also do not apply to Section 223(e) (declining neighborhoods), Section 238(c) (military impact areas in Georgia and New York), Section 247 (Hawaiian Homelands), and Section 248 (Indian Reservations).

Upfront Mortgage Insurance Premiums (UFMIPs)

Comment: Six commenters asked whether current policies regarding upfront mortgage insurance premiums would carry over under the new risk-based pricing scheme. For example, one commenter asked whether mortgage insurance premiums could still be financed by the borrower. Two commenters urged HUD to keep the ''78 percent'' and the ''5-year'' rules in effect.

HUD Response: FHA agrees that the existing policies concerning mortgage insurance premium financing, and the 78 percent and 5-year termination of mortgage insurance premiums should continue to apply. FHA will reiterate these policies in a future mortgagee letter.

Annual Mortgage Insurance Premiums

Comment: One commenter asked for HUD to clarify the downpayment thresholds for determining the annual mortgage insurance premiums. The commenter noted that the proposed risk-based premium calculations do not address the annual mortgage insurance premium rates for a downpayment amount other than 3, 5, or 10 percent.

HUD Response: All borrowers qualifying for an FHA-insured mortgage will pay an annual premium rate equal to 50 basis points, unless the LTV is greater than or equal to 95.01 percent. For loans with an LTV of greater than or equal to 95.01 percent, the annual premium rate will be equal to 55 basis points. No borrower who qualifies for an FHA-insured mortgage will pay more than 55 basis points for the annual premium.

V. Risk-Based Premiums—Effective July 14, 2008

This notice replaces FHA's Mortgagee Letter 00–38, which identifies the current mortgage insurance premiums for FHA's single family programs. The risk-based premium structure, as provided in this Section V, is effective for new FHA case number assignments made on or after July 14, 2008.

Risk-based premiums will utilize the following schedule for upfront and annual mortgage insurance premium rates:

FHA Single Family Mortgage Insurance
Upfront and Annual Mortgage Insurance Premiums
(Loan Terms > 15 years)
Effective as of July 14, 2008
All premiums are specified in basis points (0.01%)

	DECISION CREDIT SCORE (FICO)						
LTV	850–680	679–640	639–600	599–560	559–500	499–300	Non-traditional
≤ 90.00	125/50	125/50	125/50	150/50	175/50	175/50	150/50
90.01–95.00	125/50	125/50	150/50	175/50	200/50	n/a	175/50
> 95	125/55	150/55	175/55	200/55	225[a]/55	n/a	200/55

[a] A first-time homebuyer, with HUD-approved counseling, will pay only 200 basis points for the upfront mortgage insurance premiums.

Notes

1. Annual premium rates are: 50 basis points for loans with a loan-to-value (LTV) ratio of less than or equal to 95 percent; and 55 basis points for loans with an LTV ratio of 95.01 percent and higher.

2. The LTV ratio, computed to two decimals (*e.g.*, 95.65) is calculated by dividing the mortgage amount prior to adding on any upfront mortgage insurance premium by the property's sale price or appraised value, whichever is lower.

3. Eligibility for the mortgage insurance premiums listed in the chart above is based on an applicant's decision credit score. A ''decision credit score'' is determined for each applicant according to the following guidelines: when three scores are available (one from each national consumer reporting agency: Equifax, TransUnion, and Experian®), the middle value is used; when only two are available, the lesser of the two is chosen; when only one is available, then that score is used. If more than one individual is applying for the same mortgage, the lender should determine the decision credit score for each individual borrower and then use the lowest score to determine the final decision credit score for the application. That application ''decision'' credit score is then used as part of underwriting to determine if the mortgagor is considered an acceptable risk.

4. Except as provided below, eligibility for these insurance premiums is dependent upon borrower acceptance by TOTAL (Technology Open to Approved Lenders). Therefore, all borrowers with valid credit scores must be scored by TOTAL.

5. Borrowers not scored by TOTAL or with insufficient trade lines to generate credit bureau scores will fall in the ''non-traditional'' column in the premium chart and are priced accordingly. Borrowers falling into cells with no premium price shown are not eligible for FHA-insured financing. Note that a minimum decision credit score of 500 will be required for FHA-insured mortgages with an LTV ratio in excess of 90 percent.

6. If TOTAL refers a loan for manual underwriting and the underwriter deems that there are sufficient compensating factors to create an acceptable risk to FHA, then the upfront insurance premium charge will be as shown on the premium chart.

7. These premiums apply to all purchase loans and to fully underwritten (non-streamline) refinance loans. Cash-out refinance loans must meet a minimum 5 percent equity requirement, based on the appraised value of the property.

8. Streamline refinance of an existing FHA loan for which a case number was assigned prior to July 14, 2008, will have an upfront premium of 100 basis points and an annual premium of 50 basis points.

9. The risk-based premium rates established in this notice apply to those forward mortgages insured under FHA's Mutual Mortgage Insurance (MMI) fund, the Section 203(k) rehabilitation mortgage insurance program, and individual condominium units insured under Section 234(c). Risk-based premiums do not apply to mortgages insured under Title I of the National Housing Act, nor to reverse mortgages under FHA's Home Equity Conversion Mortgage (HECM) program. Risk-based premiums also do not apply to Section 223(e) (declining neighborhoods), Section 238(c) (military impact areas in Georgia and New York), Section 247 (Hawaiian

Homelands), and Section 248 (Indian Reservations).

The following matrix shows upfront and annual mortgage insurance premiums for loan terms with 15 or fewer years.

FHA Single Family Mortgage Insurance
Upfront Mortgage and Annual Mortgage Insurance Premiums
Loan Terms of 15 Years or Fewer
Effective as of July 14, 2008
All premiums are specified in basis points (0.01%)

LTV	DECISION CREDIT SCORE (FICO)						
	850–680	679–640	639–600	599–560	559–500	499–300	Non-traditional
≤ 90.00	100/0	100/0	125/0	150/0	175/0	175/0	150/0
90.01–95.00	100/25	125/25	150/25	175/25	200/25	n/a	175/25
> 95	125/25	150/25	175/25	200/25	200/25	n/a	200/25

VI. Findings and Certifications

Environmental Review

A Finding of No Significant Impact is not required for this notice. Under 24 CFR 50.19(b)(6), the subject matter of this notice is categorically excluded from the requirements of the National Environmental Policy Act (42 U.S.C. 4332 *et seq.*).

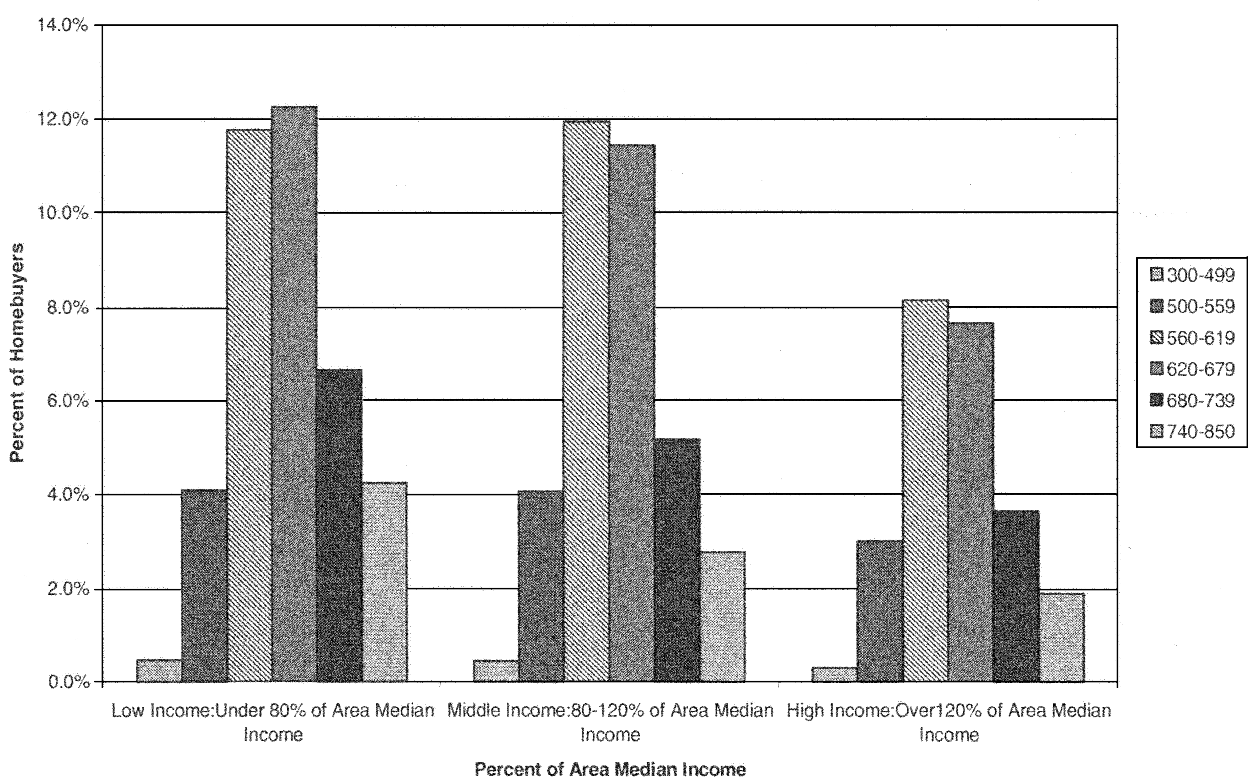
Dated: May 5, 2008.

Brian D. Montgomery,

Assistant Secretary for Housing—Federal Housing Commissioner

Appendix

Distribution of FY 2007 Homebuyers
By FICO Category and Income Group



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