Development Act of 1992 (12 U.S.C. 1715z–13a), except for mortgage transactions exempted under § 203.19(c)(2), is a safe harbor qualified mortgage that meets the ability-to-repay requirements in 15 U.S.C. 1639c(a).

PART 1007—SECTION 184A LOAN GUARANTEES FOR NATIVE HAWAIIAN HOUSING

■ 7. The authority citation for part 1007 is revised to read as follows:

Authority: 12 U.S.C. 1715z–13b; 15 U.S.C. 1639c; 42 U.S.C. 3535(d).

■ 8. A new § 1007.80 is added to read as follows:

§ 1007.80 Qualified mortgage.

A mortgage guaranteed under section 184A of the Housing and Community Development Act of 1992 (1715z–13b), except for mortgage transactions exempted under § 203.19(c)(2), is a safe harbor qualified mortgage that meets the ability-to-repay requirements in 15 U.S.C. 1639c(a).

Dated: December 5, 2013.

Shaun Donovan,

Secretary.

[FR Doc. 2013–29482 Filed 12–10–13; 8:45 am]

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DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

24 CFR Chapter II

[Docket No. FR–5595–N–01]

RIN 2502–AJ07

Federal Housing Administration (FHA) Risk Management Initiatives: New Manual Underwriting Requirements

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

ACTION: Final notice of new manual underwriting requirements.

SUMMARY: On July 15, 2010, HUD issued a document seeking comment on three initiatives that HUD proposed would contribute to the restoration of the Mutual Mortgage Insurance Fund capital reserve account. This document implements one of these proposals. Specifically, through this document, FHA is providing more definitive underwriting standards for mortgage loan transactions that are manually underwritten.

DATES: *Effective date:* This document will be effective for FHA case numbers assigned on or after a date to be established by Mortgagee Letter following publication of this document. The effective date shall be no earlier March 11, 2014. HUD will publish a document in the **Federal Register** announcing the effective date. *Comment due date:* February 10, 2014.

ADDRESSES: Interested persons are invited to submit comments regarding the revised credit score threshold for use of compensating factors to the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 7th Street SW., Room 10276, Washington, DC 20410–0500. Communications must refer to the above docket number and title. There are two methods for submitting public comments. All submissions must refer to the above docket number and title.

1. *Submission of Comments by Mail.* Comments may be submitted by mail to the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 7th Street SW., Room 10276, Washington, DC 20410–0500.

2. *Electronic Submission of Comments.* Interested persons may submit comments electronically through the Federal eRulemaking Portal at *www.regulations.gov.* HUD strongly encourages commenters to submit comments electronically. Electronic submission of comments allows the commenter maximum time to prepare and submit a comment, ensures timely receipt by HUD, and enables HUD to make them immediately available to the public. Comments submitted electronically through the *www.regulations.gov* Web site can be viewed by other commenters and interested members of the public. Commenters should follow the instructions provided on that site to submit comments electronically.

Note: To receive consideration as public comments, comments must be submitted through one of the two methods specified above. Again, all submissions must refer to the docket number and title of the rule.

No Facsimile Comments. Facsimile (FAX) comments are not acceptable.

Public Inspection of Public Comments. All properly submitted comments and communications submitted to HUD will be available for public inspection and copying between 8 a.m. and 5 p.m. weekdays at the above address. Due to security measures at the HUD Headquarters building, an appointment to review the public comments must be scheduled in advance by calling the Regulations Division at 202–708–3055 (this is not a toll-free number). Individuals with speech or hearing impairments may access this number via TTY by calling the Federal Relay Service at 800–877–8339. Copies of all comments submitted are available for inspection and downloading at *www.regulations.gov.*

FOR FURTHER INFORMATION CONTACT: Karin Hill, Director, Office of Single Family Program Development, Office of Housing, Department of Housing and Urban Development, 451 7th Street SW., Room 9278, 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 Relay Service at 800–877–8339.

SUPPLEMENTARY INFORMATION:

I. Executive Summary

A. Purpose and Legal Authority

Under the National Housing Act (12 U.S.C. 1701 *et seq.*), which authorizes Federal Housing Administration (FHA) mortgage insurance, HUD has a responsibility to ensure that the Mutual Mortgage Insurance Fund (MMIF) remains financially sound. During times of economic volatility, FHA has maintained its countercyclical influence, supporting the private sector when access to housing finance capital is otherwise constrained. FHA played this role in the recent housing crisis, and the volume of FHA insurance increased rapidly as private sources of mortgage finance retreated from the market. However, the growth in the MMIF portfolio over such a short period of time contributed significantly to the projected losses to, and financial soundness of, the Fund.[1] Consistent with the Secretary's responsibility under the National Housing Act to ensure that the MMIF remains financially sound, FHA has taken steps to improve the health of the Fund. Therefore, HUD published a July 15, 2010, notice, and sought public comment on three proposals designed to address features of FHA mortgage insurance that have resulted in high mortgage insurance claim rates and risk of loss to FHA.

At the close of the public comment period on August 16, 2010, HUD received 902 public comments in response to the July 15, 2010, notice. The majority of the public comments focused on the proposal to reduce allowable seller concessions. In order to provide itself with the necessary additional time to consider the issues

[1] U.S. Department of Housing and Urban Development, Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund, Fiscal Year 2012. See *http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf.*

raised by the commenters, HUD decided to separately implement the proposals contained in the July 15, 2010, notice.

B. Summary of Major Changes

This final document implements the revised manual underwriting requirements, and takes into consideration the public comments received on this proposal. Through this final document, FHA is providing more definitive underwriting standards for mortgage loan transactions that are manually underwritten. In response to comment, HUD has made five changes to the proposed manual underwriting requirements at this stage. First, HUD has taken the opportunity to address the issue of borrowers who exceed the 31 percent housing-to-income ratio, yet carry little or no discretionary debt and, therefore, do not exceed the maximum 43 percent debt-to-income ratio. Second, HUD has addressed the relationship between compensating factors and ''stretch ratios'' that permit borrowers to exceed the housing payment and total debt-to-income ratios under certain FHA mortgage insurance programs. Third, this document establishes additional compensating factors that can be used to qualify borrowers who exceed FHA's standard housing payment and debt to income ratios. Fourth, HUD has reduced the credit score (from 620 to 580) below which compensating factors may not be cited and the standard ratio guidelines may not be exceeded. Fifth, HUD has extended the applicability of these underwriting policies to FHA-to-FHA rate and term refinance transactions (no cash-out) and credit-qualifying FHA streamline refinance transactions.

Manually underwritten loans are required to have reserves equal to at least one full monthly mortgage payment (1–2 unit properties) or three full monthly mortgage payments (3–4 unit properties). FHA currently has standard guidelines for the debt-to-income ratios. The mortgage payment-to-income ratio (the front-end ratio) may not exceed 31 percent, and the total fixed payment-to-income ratio (the back-end ratio) may not exceed 43 percent. Either or both of these ratios may be exceeded provided that there are compensating factors. This document establishes for manually underwritten loans a maximum front ratio and a maximum back ratio that may not be exceeded based on the borrower's credit score. Borrowers with no credit score [2] or with credit scores below 580 may not exceed the standard 31/43 ratios. Borrowers with credit scores of 580 or higher may be approved for ratios as high as 37/47 with one compensating factor, and 40/50 with two compensating factors. In addition, the final document restricts the use of compensating factors to borrowers with credit scores of 580 or higher. Borrowers not meeting this standard are limited to maximum ratios of 31/43 unless they meet the Energy Efficient Mortgage requirements which provide maximum stretch ratios of 33/45.

The manual underwriting requirements are applicable for purchase transactions and all credit qualifying FHA refinance transactions

C. Requests for Comments on Credit Score Threshold for Use of Compensating Factors

As noted above, and discussed in more detail in the response to comments that follows, HUD has reduced the credit score (from 620 to 580) below which compensating factors may not be cited and the standard ratio guidelines may not be exceeded. This change will expand the pool of eligible borrowers who may qualify for the use of such compensating factors. Although this document is being issued for effect, HUD nonetheless invites public comment on this one change. HUD is not soliciting comments on other aspects of the document. Comments on the revised credit score threshold for use of compensating factors are due on or before February 10, 2014, and submitted in accordance with the procedures described in the **ADDRESSES** section of this document. HUD will publish a follow-up document addressing the comments received on the revised credit score threshold.

D. Benefits and Costs

The effect of the document is to reduce underwriting losses by strengthening manual underwriting guidelines and thereby increase revenue per loan for FHA as a result of more rigorous underwriting practices that reduce the number of claims. FHA can control costs through risk management practices. The lower costs are a gain to FHA. The target of the document is low net-revenue loans, which have higher claim rates and higher loss rates. HUD expects the net revenue per loan to increase by $2,300 (discounted at 3 percent) primarily because the expected claim amount falls. At a 7 percent discount rate, the increase in net revenue per loan is $1,900. Any gain to the FHA is a transfer. Whether there are net transfers to FHA depends on the impact of the rule on volume and thus the proportion of the current borrowers excluded from receiving a loan. When 10 percent of applicants are excluded, the gain (transfer) to FHA ranges from $35 to $42 million. Under certain circumstances, reducing the riskiest of loans will allow FHA to return additional revenues to the U.S. Treasury.

The new underwriting guidelines will postpone (perhaps indefinitely for some) the purchase of a home or the refinancing of a loan until the excluded households can satisfy more specific requirements. As noted by many of the public commenters on the July 15, 2010, notice, the policy changes being made by FHA have already been adopted by the private mortgage lending industry. Accordingly, the borrowers excluded by the document would not be able to purchase mortgage insurance from a private mortgage insurance company.

Many of the borrowers who would not qualify under the underwriting requirements may adjust their financial situation in order to meet the requirements. If the front-end ratio is the disqualifying factor, then a borrower could adjust by purchasing a less expensive home. Longer term solutions include saving to build reserves and repaying non-housing debt to meet the back-end ratio. A household could work to repair their credit score which would raise the allowable debt ratios. Once the borrower reaches a credit score of 580 or greater, compensating factors such as 3 months of reserves or the purchase of an energy-efficient home will raise the qualifying ratios even further. Thus, not all of the 16,000–19,000 borrowers affected by the document will be excluded from an FHA loan. Some will be able to adjust immediately and others within a year or two.

Another consideration in measuring the costs of the document is that by excluding potential borrowers from the benefits of an FHA loan guarantee, the new manual underwriting requirements may lead to a reduction in the social benefits of homeownership. HUD assumed two potential outcomes: that homeownership has positive net public benefits or that there are no public benefits of homeownership. The first scenario is motivated by economic theory and the second by recent empirical evidence. One study estimated the public benefits of homeownership to be $443 ($341 adjusted to the 2013 price level). Assuming that homeowners leave their current homes every seven years, the annualized benefit per loan is $70 (at a 3 percent discount rate) or $80 (at a 7 percent discount rate). The exclusion of

[2] For manually underwritten loans with insufficient credit references and with greater than 31/43 ratios, HUD currently does not to allow for compensating factors. Under this document, HUD will continue not to allow for compensating factors for these borrowers.

homeowners may reduce these public benefits of homeownership. However, HUD also notes that some studies find that a negative social effect of home ownership is reduced mobility, which leads to rigidity in the labor market and thus lengthens economic downturns. In addition, a full analysis of the expected cost to society of excluding a household from homeownership would account for the expected social costs of foreclosure for every homeowner created.

The aggregate economic impact of the document is found by examining the aggregate changes to FHA's net revenue, the total impact on consumers (rejected applicants and accepted borrowers), and the public benefits of homeownership. HUD quantifies the revenue impacts and discusses qualitatively the impacts on consumers and social benefits. The pre-document number of loans is estimated to be 18,000. HUD assumes that some proportion of those loans will be excluded as a direct result of the document. The implications of raising the number of loans that cannot make the transition into higher quality loans are that the gain to the FHA will decline and the total cost to borrowers will rise (since the loss due to exclusion is assumed to be greater than the loss due to compliance). As long as not more than 13 percent of applications are excluded, the net transfers to FHA outweigh the burdens of the document regardless of the discount rate.

The aggregate revenue impacts of the document for a variety of assumptions concerning key parameters are summarized in the table below.

ANNUAL AGGREGATE IMPACTS OF THE FINAL DOCUMENT

[In millions of dollars]

Category	0% of loans excluded		10% of loans excluded		20% of loans excluded		100% of loans excluded	
	discount rate of		discount rate of		discount rate of		discount rate	
	3%	7%	3%	7%	3%	7%	3%	7%
Transfers								
FHA Gain	+42	+35	+20	+16	−17	−3	−176	−156

II. Background

On July 15, 2010, at 75 FR 41217, HUD submitted for public comment three policy changes that HUD proposed would contribute to the restoration of the MMIF capital reserve account. The volume of FHA insurance has increased rapidly as private sources of mortgage finance retreated from the market. FHA's share of the single-family mortgage market was estimated at 17 percent (33 percent for home purchase mortgages) in Fiscal Year (FY) 2010, up from 3.4 percent in FY 2007, and the dollar volume of insurance written has jumped from the $77 billion issued in FY 2007 to $319 billion in FY 2010. The growth in the MMIF portfolio over such a short period of time coincided with worsening economic conditions that have seen high levels of defaults and foreclosures, and consequently FHA has had to balance its social mission, which includes meeting the needs of homebuyers with low down payments and first time homebuyers, with the risk of incurring unexpected losses that could deplete capital reserves in the MMIF.[3] The National Housing Act, which authorizes FHA mortgage insurance, envisions that FHA will adjust program standards and practices, as necessary, to operate the MMIF, on a financially sound basis.

Consistent with HUD's responsibility under the National Housing Act to ensure that the MMIF remains financially sound, HUD published the July 15, 2010, notice and sought public comment on three proposals designed to address features of FHA mortgage insurance that have resulted in high mortgage insurance claim rates and risk of loss to FHA. Specifically, HUD proposed to reduce the amount of closing costs a seller may pay on behalf of a homebuyer purchasing a home with FHA-insured mortgage financing for the purposes of calculating the maximum mortgage amount; to introduce a credit score threshold as well as reduce the maximum loan-to-value (LTV) for borrowers with lower credit scores who represent a higher risk of default and mortgage insurance claim; and to provide more definitive underwriting standards for mortgage loan transactions that are manually underwritten.

The proposed changes were developed to preserve both the historical role of the FHA in providing a home financing vehicle during periods of economic volatility and HUD's social mission of helping underserved borrowers. Interested readers are referred to the July 15, 2010, notice for details regarding the proposed changes to FHA requirements.

At the close of the public comment period on August 16, 2010, HUD received 902 public comments in response to the July 15, 2010, notice. The majority of the public comments focused on the reduction in seller concessions and revised manual underwriting requirements. In order to provide itself with the necessary additional time to consider the issues raised by the commenters on these two issues, HUD decided to separately implement the proposals contained in the July 15, 2010, notice. On September 10, 2010, HUD published a final rule, at 75 FR 54020, implementing a credit score threshold and reducing the maximum LTV for borrowers with lower credit scores.

III. This Document—Implementation of Revised Manual Underwriting Requirements; Additional Compensating Factors

This document implements the revised manual underwriting requirements, and takes into consideration the public comments received on this proposal. The new manual underwriting requirements will reduce the risk to the MMIF by reducing the probability of default and protecting consumers from predatory, irresponsible lending practices.

Section III of this document discusses the significant issues raised by the public comments regarding the new manual underwriting requirements, as well as HUD's responses to these issues. Section IV of this document implements the new manual underwriting

[3] While the Federal Credit Reform Act of 1990 requires that FHA (and all other government credit agencies) estimate and budget for the anticipated cost of mortgage loan guarantees, the National Housing Act imposes a special requirement that the MMIF hold an additional amount of funds in reserve to cover unexpected losses. FHA maintains the MMIF capital reserve in a special reserve account, which the National Housing Act mandates maintain a 2 percent ratio of reserve relative to the amount of outstanding insurance in force. The capital ratio generally reflects the reserves available (net of expected claims and expenses) as a percentage of the current portfolio, to address unexpected losses.

requirements. HUD will also issue additional guidance through Mortgagee Letter to assist in implementation of these new requirements.

As discussed in the July 15, 2010, notice, the purpose of mortgage underwriting is to determine a borrower's ability and willingness to repay the debt and to limit the probability of default. An underwriter must consider the borrower's credit history, evaluate their capacity to repay the loan based on income, assets and current debt, determine if cash to be used for closing is sufficient and from an acceptable source, determine if the value of the collateral is adequate security for the amount being borrowed and reserves are adequate. In cases where mortgage loans cannot be rated by FHA's TOTAL Mortgage Scorecard, the loan is referred by TOTAL, or the loan is manually downgraded the loan must be manually underwritten. Where FHA's standard qualifying ratios for total mortgage payment-to-income and total fixed payment-to-income are exceeded, lenders must cite at least one compensating factor. Under FHA's current manual underwriting standards, there is no limit on the maximum debt to income ratios a lender may approve nor does FHA define which or how many compensating factors must be cited to exceed FHA's standard qualifying ratio guidelines [4] FHA has determined that factors concerning housing and debt-to-income ratios, along with cash reserves, are particularly good predictive indicators as to the sustainability of the mortgage. Through this document, FHA is implementing additional requirements for consideration of these factors for manually underwritten mortgage loans. These additional requirements will consider the borrower's credit history, LTV percentage, housing/debt ratios, reserves, and compensating factors.

In response to comment, HUD has made five changes to the proposed manual underwriting requirements at this stage. First, HUD has taken the opportunity to address the issue of borrowers who exceed the 31 percent housing-to-income ratio, yet carry little or no discretionary debt and, therefore, do not exceed the maximum 43 percent debt-to-income ratio. Second, HUD has addressed the relationship between compensating factors and ''stretch ratios'' that permit borrowers to exceed the housing payment and total debt-to-income ratios under certain FHA mortgage insurance programs. Third, this document establishes additional compensating factors that can be used to qualify borrowers who exceed FHA's standard housing payment and debt to income ratios. Fourth, HUD has reduced the credit score (from 620 to 580) below which compensating factors may not be cited and the standard ratio guidelines may not be exceeded. Fifth, the manual underwriting requirements are applicable to all purchase loans and all credit qualifying refinance loans, including FHA-to-FHA rate and term refinance transactions (no cash out) and credit qualifying FHA streamline refinance transactions.

[4] The manual underwriting procedures are detailed in HUD Handbook 4155.1 ''Mortgage Credit Analysis for Mortgage Insurance.'' The handbook may be downloaded at: *http://www.hud.gov/offices/adm/hudclips/handbooks/hsgh/4155.1/41551HSGH.pdf.*

IV. Discussion of the Public Comments Regarding Proposed Revisions to Manual Underwriting Requirements

Comment: Support for revised manual underwriting requirements. The majority of the commenters submitting comments on the revised manual underwriting requirements wrote to express support for the new policy. The commenters agreed that clarifying the underwriting standards for manually underwritten loans would reduce risks to the FHA MMIF and help to stem the tide of home foreclosures. Moreover, these commenters wrote that the new manual underwriting standards would protect consumers from predatory and irresponsible lending practices, thereby assisting in stabilizing the housing industry.

HUD Response. HUD appreciates the support expressed by these commenters, and agrees that the changes will reduce the risk to the MMIF and help ensure that homebuyers are offered FHA-insured mortgage loans that are sustainable.

Comment: Opposition to revised manual underwriting guidelines. Several commenters opposed the proposed manual underwriting standards. Some of these commenters questioned the need for the proposed changes. These commenters wrote that lenders have voluntarily implemented stricter underwriting standards to help ensure borrowers are financially capable of meeting their loan obligations. Other commenters focused on the potential impacts of the new standards on low- and moderate-income homebuyers. The commenters wrote that borrowers are already facing limited access to credit as a result of stricter underwriting standards being adopted by lenders, and that the standards proposed by FHA would further restrict the ability of these homebuyers to obtain financing for the purchase of a home.

HUD Response. HUD has considered these comments and as a result, revised its proposal to reduce the credit score requirement for the use of compensating factors from 620 to 580, thereby expanding the pool of eligible borrowers who may qualify for the use of such factors. In addition to expanding access to compensating factors, the new threshold provides for the more precise and historically accurate use of credit scores. The formerly proposed thresholds would have grouped borrowers with non-traditional/insufficient credit together all borrowers with credit scores up to 619. Such a grouping would have been overly broad. The new threshold recognizes that the loan performance of FHA borrowers with non-traditional/insufficient credit is comparable to that of borrowers with credit scores of 579 or lower. Moreover, the use of the credit score of 580 is consistent with HUD's recent guidance on manual underwriting contained in Mortgagee Letter 2013–05 (January 31, 2013).[5]

In response to these comments, HUD is also providing more flexible front-end and back-end ratios. The document also establishes better defined compensating factors, and provides that HUD may establish additional compensating factors through Mortgagee Letter, thereby enabling HUD to more promptly address changes in market conditions and the population of borrowers being served by the FHA programs. While HUD does not presently anticipate the need for issuing such a Mortgage Letter, HUD emphasizes that the purpose of any such issuance would be to add to, but not subtract from, the list of compensating factors established in this document.

HUD believes that these changes strike the appropriate balance between fulfilling the Department's historical and social mission as well as its statutory duty to preserve the financial health of the MMIF. Moreover, sustainable homeownership is essential to a healthy and well-functioning housing market. These changes will promote that goal by helping to ensure that homeowners are able to afford their FHA-insured mortgage loans.

The preamble to the July 15, 2010, notice specifically solicited public comment on acceptable compensating factors and, in particular, on how FHA could serve borrowers with housing ratios above the proposed threshold and debt-to-income ratios below the threshold (see 75 FR 41222). These borrowers, while having established

[5] *http://portal.hud.gov/hudportal/documents/huddoc?id=13-05ml.pdf.*

credit lines, traditionally do not use credit to finance purchases over a period of several months or years or pay them off within the billing cycle. Therefore, they have a history of carrying little to no discretionary debt. While the housing debt assumed by such a borrower may be higher than the housing ratios established by this document, their overall debt-to-income ratios fall within acceptable underwriting levels and reflect a record of responsible credit. To address this issue, HUD has established an additional ''compensating factor'' that would allow such borrowers to qualify for FHA mortgage insurance. Specifically, a borrower will be permitted to exceed the housing and debt-to-income ratios, if the borrower has access to credit but carries no discretionary debt. For example, the borrower's monthly housing expense is the only open installment debt with an outstanding balance and revolving debt is paid off every month.

HUD also agrees that borrowers are already facing limited access to credit as a result of stricter underwriting standards being adopted by mortgagees. To provide additional consideration for manually evaluating the borrower for expanded ratios, HUD has included a residual income compensating factor that can be used to determine if the borrower has sufficient income after making their monthly mortgage payment, including taxes and insurance, to meet their needs for food, utilities, clothing, transportation, work-related expenses, and other essentials. HUD will permit the use of a compensating factor modeled on the Department of Veteran's Affairs (VA) residual income requirements (codified in regulation at 38 CFR 36.4340). Under the VA regulations, residual income is calculated by determining the borrower's gross monthly income, then deducting the borrower's monthly expenses from the total gross monthly income. The balance remaining is ''residual income'' and the mortgagee can determine if the mortgagor meets the applicable residual income requirements, which vary based on family size, region, and loan amount as described in tables codified in the VA regulations. If the mortgagor meets the residual income test, the mortgagee can use residual income as a compensating factor.[6]

Second, HUD has clarified the relationship between the compensating factors and the ''stretch ratios'' provided for under certain FHA mortgage insurance programs that authorize borrowers to exceed qualifying housing and debt-to-income ratios. For example, as noted in the preamble to the July 15, 2010, notice, borrowers using FHA energy efficient mortgage insurance may have stretch ratios of 33/45 if the homes are built or retrofitted to exceed the applicable International Energy Conservation Code (IECC) standard. HUD has taken the opportunity afforded by this document to clarify that, although such borrowers may not be subject to the 31/43 percent qualifying ratios established by this document, these borrowers may not exceed the 33/45 percent upper limit for stretch ratios established by the document unless they qualify for higher ratios based on credit score and additional compensating factors.

Comment: Hold underwriters to a higher standard. Several commenters suggested that, in addition to the proposed manual underwriting requirements, HUD should hold underwriters themselves to a higher standard. The commenters recommended that HUD require underwriters to absorb a higher percentage of the risk associated with manual underwriting. For example, one of the commenters recommended that HUD suspend lenders with high default rates on their manually underwritten loans.

HUD Response. HUD has not revised its proposal based on these comments. The Department has already implemented the types of action recommended by the commenters. Mortgagee Letter 2010–03, issued on January 21, 2010, announced several steps undertaken by HUD to enhance its authority to address deficiencies in a lender's performance, focusing on all underwriting decisions, not just those that were manually underwritten.[7] Specifically, Mortgagee Letter 2010–03 advised that every three months, HUD reviews the rates of default and claims on all FHA-insured single family loans. This review analyzes the performance of every participating lender based on its area of operation. HUD may terminate an underwriting lender's approval to underwrite FHA-insured loans in an area where the lender's default and claim rate exceeds the established Credit Watch Termination thresholds.

Comment: Clarify what are acceptable compensating factors in underwriting guidelines. Several commenters, while expressing support of the proposed changes to the manual underwriting requirements, also suggested that HUD simplify the acceptable compensating factors. For example, one commenter recommended that FHA develop a list or chart that more clearly identifies the relationship between the compensating factors and the acceptable housing and debt to income ratios. Another commenter suggested that FHA more specifically define the compensating factors.

HUD Response. As noted above, HUD has, in response to these comments, made changes to clarify the compensating factors and their relationship to the qualifying housing and debt-to-income ratios. In addition, HUD is providing a matrix outlining credit score, front-end ratios, back-end ratios, cash reserves, acceptable compensating factors, and criteria for stretch ratios.

V. Establishment of Revised Manual Underwriting Requirements

Commencing on the effective date:

Manual Underwriting. On manually underwritten mortgage loans, borrowers are required to have minimum cash reserves equal to one monthly mortgage payment for one- and two-unit properties, and 3 months for three- and four-unit properties, which includes principal, interest, taxes, and insurance. For borrowers with credit scores of 500 to 579 or non-traditional credit the maximum housing and debt-to-income ratios for manually underwritten loans are set at 31 percent and 43 percent, respectively, unless the borrower qualifies for 33/45 stretch ratios available for manually underwritten borrowers with homes built or retrofitted to exceed the applicable IECC standard including Energy Efficient Mortgages. For borrowers with credit scores of 580 or higher the maximum housing and debt-to-income ratios for manually underwritten loans are set at 31 percent and 43 percent, respectively, unless the borrower (1) qualifies for 33/45 stretch ratios available for manually underwritten borrowers with homes built or retrofitted to exceed the applicable IECC standard including Energy Efficient Mortgages or (2) meets the compensating factors criteria in the matrix below. To exceed 31/43 ratios or, in the case of homes built or retrofitted to exceed the applicable IECC standard including Energy Efficient Mortgages, the 33/45 stretch ratios, not to exceed 37/47 percent, borrowers must meet *at least* one of the acceptable compensating factors. To exceed the qualifying ratios of 37/47 percent, not to exceed 40/50 percent, borrowers must

[6] For more details on the VA residual income requirements, please refer to Chapter 4 of VA Pamphlet 26–7, ''Lenders Handbook,'' available at *http://www.benefits.va.gov/warms/pam26_7.asp.*

[7] Mortgagee Letter 2010–03 is available for download at: *http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/10-03ml.pdf.*

meet at least *two* of the acceptable compensating factors. These minimum cash reserve and maximum qualifying ratio requirements are applicable for purchase transactions and all credit-qualifying FHA refinance transactions, where the loan received a REFER scoring recommendation from TOTAL, where TOTAL cannot score the loan (non-traditional credit) or where the TOTAL Scorecard scoring recommendation is Accept, but the underwriter manually downgrades it to Refer. These maximum front and back ratios requirements and reserve requirements are not applicable for non-credit qualifying FHA streamline refinance transactions and Home Equity Conversion Mortgage transactions.

Credit score	Maximum front and back ratios	Acceptable compensating factors (Note: HUD may establish additional compensating factors through Mortgagee Letter)
500–579 or Non-traditional/ Insufficient Credit.	31/43	Not applicable. Borrowers with credit scores below 580 or with Non-traditional/insufficient credit may not exceed 31/43 ratios.
580 and above	31/43	No compensating factors required.
580 and above	37/47	One of the following: • Verified and documented liquid cash reserves equal to at least three total monthly mortgage payments (1–2 units) or six total monthly mortgage payments (3–4 units). • New total monthly mortgage payment is not more than $100 or 5% higher than previous total monthly housing payment, whichever is less; and verified and documented twelve month housing payment history (1X30 only). • Sufficient Residual Income as calculated per VA requirements
580 and above	40/40	Borrower with established credit and open credit lines carries no discretionary debt. Monthly housing payment is only open installment account and revolving credit is paid off monthly.
580 and above	40/50	Two of the following: • Verified and documented liquid cash reserves equal to at least three total monthly mortgage payments (1–2 units) or six total monthly mortgage payments (3–4 units). • New total monthly mortgage payment is not more than $100 or 5% higher than previous total monthly housing payment, whichever is less; and verified and documented twelve month housing payment history (1X30 only). • Sufficient Residual Income as calculated per VA requirements. • Verified and documented additional income that is not considered effective income. Overtime and bonus income can be cited as a compensating factor if the mortgagee verifies and documents that the borrower has received this income for at least one year but less than two years, and it will likely continue. Part-time and seasonal income can be cited as a compensating factor if the mortgagee verifies and documents that the borrower has worked the part-time or seasonal job uninterrupted for at least one year but less than two years, and plans to continue.

Note: Maximum ratios for manually underwritten borrowers with homes built or retrofitted to exceed the applicable IECC standard including Energy Efficient Mortgages are eligible for stretch ratios of 33/45 regardless of credit score or Nontraditional credit, but must meet the minimum required reserve requirement for manually underwritten loans (1 month for 1–2 units, 3 months for 3–4 units). These transactions may also be eligible for higher ratios if they meet additional criteria, i.e. minimum 580 FICO and one or more additional compensating factors.

VI. Findings and Certification

Regulatory Review—Executive Orders 12866 and 13563

Under Executive Order 12866 (Regulatory Planning and Review), a determination must be made whether a regulatory action is significant and therefore, subject to review by the Office of Management and Budget (OMB) in accordance with the requirements of the order. Executive Order 13563 (Improving Regulations and Regulatory Review) directs executive agencies to analyze regulations that are ''outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them in accordance with what has been learned. Executive Order 13563 also directs that, where relevant, feasible, and consistent with regulatory objectives, and to the extent permitted by law, agencies are to identify and consider regulatory approaches that reduce burdens and maintain flexibility and freedom of choice for the public. This document was determined to be a ''significant regulatory action'' as defined in section 3(f) of Executive Order (although not an economically significant regulatory action, as provided under section 3(f)(1) of the Executive Order).

As noted above, this document implements one of the three initiatives announced in HUD's July 15, 2010, notice to aid in the restoration of the MMIF capital reserve account. Specifically, this document provides more definitive underwriting standards for mortgage loan transactions that are manually underwritten to overcome lender uncertainty and resistance to manually underwritten, credit-worthy FHA borrowers in this time of tighter mortgage credit. The benefit of the document is to reduce underwriting losses by strengthening manual underwriting requirements and thereby increase net revenue to the FHA. Whether there are net transfers to FHA depends on what proportion of the current borrowers is excluded from receiving a loan. As long as not more than 13 percent are excluded, the net transfer to FHA is positive. When 10 percent of applicants are excluded, the gain (transfer) to FHA ranges from $35 million to $42 million. HUD has prepared an economic analysis assessing costs and benefits of the new manual underwriting requirements. HUD's full analysis can be found at *www.regulations.gov*. A summary of HUD's analysis follows:

A. *Transfers/Revenue Effects.* The broader purpose of the policy change is to reduce the risk to the MMIF so that FHA can continue to provide mortgage loans. Facilitating the provision of credit during a liquidity crisis is a welfare-enhancing activity, and FHA provides such a public benefit.

A government agency's increase in net revenue is usually treated as a transfer because governments traditionally raise revenue through taxes and fees. In the case of the manual underwriting document, the increase in FHA revenue occurs as the result of more rigorous underwriting practices that reduce the number of claims. FHA can control its costs through risk management practices. The lower costs are a gain to

FHA. When 10 percent of applicants are excluded, HUD's estimate of the expected net gain to the FHA (and subsequent transfer to the U.S. Treasury) ranges from $35 million to $42 million depending upon the discount rate. Any gain to the FHA is an eventual transfer to others. Under certain circumstances, reducing the riskiest of loans will allow FHA to return excess revenues to the U.S. Treasury.

HUD expects a reduction in the number of loans but also a reduction in the number of claims. The target of the document is low net-revenue loans, which have higher claim rates and higher loss rates. HUD expects the net revenue per loan to increase by $2,300 (discounted at 3 percent) primarily because the expected claim amount. At a 7 percent discount rate, the increase in net revenue per loan is $1,900.

B. *Benefits/Costs.* The new underwriting guidelines will postpone (perhaps indefinitely for some) the purchase of a home or the refinancing of a loan until the excluded households can satisfy more specific requirements. As noted by many of the public commenters on the July 15, 2010, notice, the policy changes being made by FHA have already been adopted by the private mortgage lending industry. Accordingly, the borrowers excluded by the document would not be able to purchase mortgage insurance from a private mortgage insurance company. The only choice for a rejected applicant would be to improve the strength of their financial position. A few analytical options exist for estimating the magnitude of the cost of being excluded from homeownership. The costs are: the direct private costs of meeting the new requirements, the private costs of delaying the loan, and the public costs of delay.

Many of the borrowers who would not qualify under the underwriting requirements may adjust their financial situation in order to meet the requirements. If the front-end ratio is the disqualifying factor, then a borrower could adjust by purchasing a less expensive home. Longer term solutions include saving to build reserves and repaying non-housing debt to meet the back-end ratio. A household could work to repair their credit score which would raise the allowable debt ratios. Most of the negatives will be removed from a credit report after 7 years, and it is possible to increase credit scores significantly after 3 years by better managing consumer debt. Once the borrower reaches a credit score of 580 or greater, compensating factors such as 3 months of reserves or the purchase of an energy-efficient home will raise the qualifying ratios even further. Thus, not all of the 16,000–19,000 borrowers affected by the document will be excluded from an FHA loan. Some will be able to adjust immediately and others within a year or two.

Another consideration in measuring the costs of the document is that by excluding potential borrowers from the benefits of an FHA loan guarantee, the new manual underwriting requirements may lead to a reduction in the social benefits of homeownership. HUD assumed two potential outcomes: that homeownership has positive net public benefits or that there are no public benefits of homeownership. The first scenario is motivated by economic theory and the second by recent empirical evidence. One study estimated the public benefits of homeownership to be $443 ($341 adjusted to the 2013 price level). Assuming that homeowners leave their current homes every seven years, the annualized benefit per loan is $70 (at a 3 percent discount rate) or $80 (at a 7 percent discount rate). The exclusion of homeowners may reduce these public benefits of homeownership. However, HUD also notes that some studies find that a negative social effect of home ownership is reduced mobility, which leads to rigidity in the labor market and thus lengthens economic downturns. In addition, a full analysis of the expected cost to society of excluding a household from homeownership would account for the expected social costs of foreclosure for every homeowner created.

C. *Aggregate costs and benefits.* The aggregate economic impact of the document is found by examining the aggregate changes to FHA's net revenue, the total impact on consumers (rejected applicants and accepted borrowers), and the public benefits of homeownership. HUD quantifies the revenue impacts and discusses qualitatively the impacts on consumers and social benefits. The pre-document number of loans is estimated to be 18,000. HUD assumes that some proportion of those loans will be excluded as a direct result of the document. The implications of raising the number of loans that cannot make the transition into higher quality loans are that the gain to the FHA will decline and the total cost to borrowers will rise (since the loss due to exclusion is assumed to be greater than the loss due to compliance).

The aggregate revenue impacts of the document for a variety of assumptions concerning key parameters are summarized in the table below.

ANNUAL AGGREGATE IMPACTS OF THE FINAL DOCUMENT

[In millions of dollars]

Category	0% of loans excluded		10% of loans excluded		20% of loans excluded		100% of loans excluded	
	discount rate of		discount rate of		discount rate of		discount rate	
	3%	7%	3%	7%	3%	7%	3%	7%
Transfers								
FHA Gain	+42	+35	+20	+16	−17	−3	−176	−156

As long as not more than 13 percent of applications are excluded, the net transfers to FHA outweigh the burden of the document regardless of the discount rate.

The docket file is available for public inspection in the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 7th Street SW., Room 10276, Washington, DC 20410–0500. Due to security measures at the HUD Headquarters building, please schedule an appointment to review the docket file by calling the Regulations Division at 202–402–3055 (this is not a toll-free number). Individuals with speech or hearing impairments may access this number via TTY by calling the Federal Information Service at 800–877–8339.

Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) (5 U.S.C. 601 *et seq.*), generally requires an agency to conduct a regulatory flexibility analysis of any document subject to notice and comment rulemaking requirements unless the agency certifies that the document will not have a significant economic impact on a substantial number of small entities. The document does not establish new and unfamiliar regulatory requirements on FHA-approved mortgage lenders. Rather, the document builds on existing requirements and procedures that are familiar to lenders. Specifically, the document tightening portions of FHA's current underwriting guidelines that present an excessive level of risk to both homeowners and FHA. The benefit of the set of actions to regulated lending institutions will be to reduce the risk to the MMIF so that FHA can continue to insure mortgage loans originated and serviced by these lenders.

As noted in the economic analysis for the document, relative to the total FHA portfolio, few borrowers are served in the categories that would be excluded under the new policies, relative to the total FHA portfolio. Further, as noted by many of the public commenters on the July 15, 2010, notice, the policy changes being made by FHA have already been adopted by the private mortgage lending industry. The impact of the policy changes will, therefore, largely be limited to conforming FHA standards to widespread industry practice. Accordingly, to the extent this document has any economic impact on the minority of lenders that have not already adopted such stricter underwriting standards; they will be minimal, encompassing a relatively small proportion of their FHA business activities.

Environmental Impact

A Finding of No Significant Impact (FONSI) with respect to the environment has been made in accordance with HUD regulations at 24 CFR part 50, which implement section 102(2)(C) of the National Environmental Policy Act of 1969 (42 U.S.C. 4332(2)(C)). The Finding of No Significant Impact is available for public inspection between the hours of 8 a.m. and 5 p.m. weekdays in the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 7th Street SW., Room 10276, Washington, DC 20410. Due to security measures at the HUD Headquarters building, please schedule an appointment to review the FONSI by calling the Regulations Division at 202–708–3055 (this is not a toll-free number). Individuals with speech or hearing impairments may access this number via TTY by calling the Federal Information Relay Service at 800–877–8339.

Executive Order 13132, Federalism

Executive Order 13132 (entitled ''Federalism'') prohibits an agency from publishing any document that has federalism implications if the document either imposes substantial direct compliance costs on state and local governments and is not required by statute, or the document preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This document would not have federalism implications and would not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 (2 U.S.C. 1531–1538) (UMRA) establishes requirements for federal agencies to assess the effects of their regulatory actions on state, local, and tribal governments, and on the private sector. This document would not impose any federal mandates on any state, local, or tribal governments, or on the private sector, within the meaning of the UMRA.

Dated: December 3, 2013.

Carol J. Galante,

Assistant Secretary for Housing—Federal Housing Commissioner.

[FR Doc. 2013–29170 Filed 12–10–13; 8:45 am]

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DEPARTMENT OF DEFENSE

Office of the Secretary

32 CFR Part 199

[Docket ID: DoD–2013–HA–0085]

RIN 0720–AB60

Civilian Health and Medical Program of the Uniformed Services (CHAMPUS)/TRICARE: Pilot Program for Refills of Maintenance Medications for TRICARE for Life Beneficiaries Through the TRICARE Mail Order Program

AGENCY: Office of the Secretary, Department of Defense (DoD).

ACTION: Interim final rule.

SUMMARY: This interim final rule implements Section 716 of the National Defense Authorization Act for Fiscal Year 2013 which establishes a five year pilot program that would generally require TRICARE for Life beneficiaries to obtain all refill prescriptions for covered maintenance medications from the TRICARE mail order program or military treatment facility pharmacies. Covered maintenance medications are those that involve recurring prescriptions for chronic conditions, but do not include medications to treat acute conditions. Beneficiaries may opt out of the pilot program after one year of participation. This rule includes procedures to assist beneficiaries in transferring covered prescriptions to the mail order pharmacy program. This regulation is being issued as an interim final rule in order to comply with the express statutory intent that the program begin early in calendar year 2013. Public comments, however, are invited and will be considered for possible revisions to this rule for the second year of the program.

DATES: This rule is effective February 14, 2014. Written comments received at the address indicated below by February 10, 2014 will be considered and addressed in the final rule.

ADDRESSES: You may submit comments, identified by docket number and/or RIN number and title, by any of the following methods:

Federal eRulemaking Portal: http://www.regulations.gov.
Follow the instructions for submitting comments.

Mail: Federal Docket Management System Office, 4800 Mark Center Drive, Suite 02G09, Alexandria, VA 22350.

Instructions: All submissions received must include the agency name and docket number or Regulatory Information Number (RIN) for this Federal Register document. The general policy for comments and other submissions from members of the public is to make these submissions available for public viewing on the Internet at *http://www.regulations.gov* as they are received without change, including any personal identifiers or contact information.

FOR FURTHER INFORMATION CONTACT: Rear Admiral Thomas McGinnis, Chief, Pharmacy Operations Directorate, TRICARE Management Activity, telephone 703–681–2890.

SUPPLEMENTARY INFORMATION:

A. Executive Summary

1. Purpose

This interim final rule implements section 716 of the National Defense Authorization Act for Fiscal Year 2013, which establishes a five year pilot program requiring TRICARE for Life beneficiaries to obtain all prescription refills for select maintenance medications from the TRICARE mail order program or military treatment facilities.