

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**24 CFR Part 202**

[Docket No. FR-4625-F-03]

RIN 2502-AH60

Revisions to FHA Credit Watch Termination Initiative

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

ACTION: Final rule.

SUMMARY: On December 17, 2004, HUD published an interim rule implementing certain regulations for the Federal Housing Administration (FHA) Credit Watch Termination Initiative. Under the initiative, FHA systematically reviews the early default and claim rates of mortgagees that have been approved to participate in the FHA single family mortgage insurance programs. Mortgagees with excessive default and claim rates are considered to be on Credit Watch status and, in cases of more severe performance deficiencies, HUD may terminate the mortgagee's loan origination approval authority. Credit Watch status constitutes a warning to a mortgagee that its default and claim rates are in excess of permissible levels and that failure to achieve improvement may lead to the termination of its origination approval agreement. The final rule follows publication of the December 17, 2004, interim rule, takes into consideration the public comments received on the interim rule, and makes no changes at this final rule stage.

DATES: *Effective Date:* March 1, 2006.

FOR FURTHER INFORMATION CONTACT: Phillip Murray, Director, Office of Lender Activities and Program Compliance, Office of Housing, Department of Housing and Urban Development, 451 Seventh Street, SW., Room B-133, Washington, DC 20410-8000; telephone (202) 708-1515 (this is not a toll-free number). Persons with hearing or speech impairments may access this number via TTY by calling the toll-free Federal Information Relay Service at 1-800-877-8339.

SUPPLEMENTARY INFORMATION:**I. Background**

On April 1, 2003, HUD published a proposed rule (68 FR 15906) to amend the regulations for the Federal Housing Administration (FHA) Credit Watch Termination Initiative. Under the initiative, FHA systematically reviews the early default and claim rates of mortgagees that have been approved to

participate in the FHA single family mortgage insurance programs. Mortgagees with excessive default and claim rates are considered to be on Credit Watch status and, in cases of more severe performance deficiencies, HUD may terminate the mortgagee's loan origination approval authority. Credit Watch status constitutes a warning to a mortgagee that its default and claim rates are in excess of permissible levels and that failure to achieve improvement may lead to the termination of its origination approval agreement. The termination of a mortgagee's origination approval agreement is separate and apart from any action taken by HUD's Mortgagee Review Board for violations of FHA requirements under 24 CFR part 25.

The regulations for the Credit Watch Termination Initiative are contained in 24 CFR 202.3.

The April 1, 2003, rule proposed various amendments to the regulations for the Credit Watch Termination Initiative. Specifically, the April 1, 2003, rule proposed to: (1) Establish a fully computerized Credit Watch status notification process through use of the FHA Neighborhood Watch Early Warning System; (2) remove the regulatory "cap" on the default and claim rate for placing a mortgagee on Credit Watch status; (3) prohibit a mortgagee that has received a notice of proposed termination from establishing a new branch in the lending area covered by the proposed termination; (4) provide that the default and claim thresholds underlying the Credit Watch Termination Initiative apply to both underwriting and originating mortgagees; (5) codify the definition of "underserved area" that is currently used under the Credit Watch Termination Initiative; (6) provide that the date of mortgage origination will be considered to be the date the loan transaction commences amortization, rather than the date of endorsement for FHA mortgage insurance; (7) specify the timeframes for the informal conference that may be requested by a mortgagee prior to termination; and (8) describe the procedures a terminated mortgagee must follow to have its origination approval agreement reinstated.

The proposed regulatory changes were designed to improve the Credit Watch Termination Initiative, thereby strengthening HUD's capacity to safeguard the FHA mortgage insurance fund. The preamble to the April 1, 2003, proposed rule provides additional details regarding the proposed regulatory changes to 24 CFR 202.3.

On December 17, 2004 (69 FR 75802), HUD published an interim rule that

considered the comments received on the proposed rule and made effective the proposed changes to the Credit Watch program contained in the April 1, 2003, proposed rule. In response to the public comments requesting that HUD clarify the applicability of the Credit Watch Termination to underwriting mortgagees, HUD revised the rule to provide for separate regulatory language that specifically addresses underwriting mortgagees. The regulatory language did not alter the substance of the proposals, but rather provided greater clarity on how the performance of underwriting mortgagees would be subject to evaluation under the Credit Watch Termination Initiative. The regulatory provisions of the December 17, 2004, interim rule took effect on January 18, 2005. However, in order to provide for public comment on the regulatory provisions regarding underwriting mortgagees, HUD invited public comments on that aspect of the interim rule for a period of 60 days.

II. This Final Rule

This final rule follows publication of the December 17, 2004, interim rule and takes into consideration the public comments received on the interim rule. After careful consideration of the public comments on the new language concerning the applicability of the Credit Watch Termination Initiative to underwriting mortgagees, HUD has decided to adopt the December 17, 2004, rule as final without change.

III. Discussion of the Public Comments on the December 17, 2004, Interim Rule

The public comment period for the interim rule closed on February 15, 2005. HUD received three public comments. Comments were received from two mortgage lenders and a national association representing mortgage bankers. This section of the preamble presents a summary of the significant issues raised by the public commenters on the December 17, 2004, interim rule and HUD's responses to those issues.

Comment: Before HUD terminates underwriting authority, HUD should take into consideration the lender's overall national default/claim rate. One commenter wrote that nationwide lenders could be unfairly penalized by a termination action if a localized fraud scheme or unexpected local economic downturn increases a lender's default rate above HUD's termination threshold.

HUD Response. HUD's Credit Watch Termination Initiative focuses on a mortgagee's performance within a HUD field office jurisdiction. A mortgagee's default and claim rate within a HUD

field office jurisdiction is compared to the overall default and claim rate of the entire HUD field office jurisdiction. Before HUD terminates the underwriting authority, it will consider mitigating issues raised by a mortgagee during its informal conference and in its written response. HUD's evaluation of mortgagees on the basis of HUD field office jurisdiction coincides with the manner in which FHA approves mortgagees to operate. This method of evaluation recognizes that local market conditions and events may contribute to higher defaults and claims.

Comment: HUD should develop guidelines that take into account potential difficulties for underwriting mortgagees to comply due to shifting local averages. One commenter wrote that because a mortgagee's defaults are compared to the average rate in a local area, a lender could be terminated either due to a shift in the overall credit quality of a HUD local area, or by the gradual decline of a HUD local area's average default and claim rate, rather than due to the quality of the loans the lender is originating.

HUD Response. HUD believes that the compare ratio for all lenders within a HUD field office jurisdiction would be equally affected by a shift in the overall credit quality or by the gradual decline of a HUD field office area's average default and claim rate. Furthermore, once a lender is terminated, while it cannot originate new FHA-insured loans, the lender's previously insured and defaulted cases are still included in the universe that makes up the compare ratio. Lenders are subject to termination when their claim and default ratio indicate that they pose a greater risk to the FHA insurance fund than other lenders in the field office area. Additionally, the compare ratio for each round of Credit Watch Termination is based on a specific 24-month period. Therefore, based on a loan being insured and the beginning amortization date, loans are added and removed from the counts for each successive round of Credit Watch Termination. Finally, as mentioned in the interim rule's preamble, HUD will periodically review the normal rate to determine whether the thresholds should be adjusted to reflect overall improvement in the FHA portfolio.

Comment: HUD should provide adequate time and opportunity after the initial lender notification, yet prior to public notification of termination in the **Federal Register**, for the lender to be granted an informal conference with HUD to explain the reasons for the increased default/claims rate.

HUD Response. As provided in 24 CFR 202.3(c)(1)(ii) of the Credit Watch regulations, a mortgagee may request an informal conference after receiving a proposed termination letter. Mortgagees are provided the opportunity at the informal conference to fully explain the reasons for the mortgagee's increased defaults and claims. The regulation provides that HUD must receive a request for the informal conference no later than 30 calendar days after the receipt date of the proposed termination letter from HUD, and that the conference must be held no later than 60 days after the date of the proposed termination notice. HUD will not publish an announcement in the **Federal Register** that a mortgagee has had its origination approval agreement terminated until after the requested informal conference is held, after HUD has considered all relevant reasons and factors, and after HUD has upheld its decision to terminate a lender's approval agreement.

Comment: HUD should broaden and specify mitigation factors it will consider in making its termination decision. One commenter wrote that because of the severity of the penalty to the lender, the regulation should provide HUD with the ability to consider other mitigating factors in making its termination decision, such as: (1) The lender's overall risk management plan and performance; (2) prior proactive lender notification to HUD of fraud or other significant issues the lender has discovered; (3) prior action the lender has taken against a correspondent who has contributed to the high default rate, such as terminating the lender's relationship with the correspondent; and (4) prior action such as termination or other disciplinary action against the lender's employees responsible for a high default/claim rate.

Another commenter wrote that HUD should broaden and specify the factors that FHA will review in deciding not to terminate the direct endorsement approval of a mortgagee and communicate these circumstances to direct endorsement lenders. This commenter wrote that mortgagees have had little success in convincing FHA that particular circumstances justify the withdrawal of a termination notice. The commenter continued by writing that there are many factors beyond poor underwriting or lending in underserved areas that can cause a higher default rate from one lender to another. The commenter wrote that lenders specializing in a particular product or that service a particular borrower type may be at a disadvantage in the general

FHA market in a given area due to the greater risk inherent in these products. Finally, the commenter wrote that if the FHA holds underwriting mortgagees accountable in the same manner as originating mortgagees, underwriting mortgagees may avoid doing business with certain originators based on product type and not on origination quality. The commenter wrote that lenders should be encouraged to adopt new, and potentially riskier, FHA products, and lenders should not be penalized for this.

HUD Response. HUD appreciates the comments and the suggested mitigation factors. However, HUD believes that the current regulations address the concerns raised by the commenters and that a regulatory change is therefore unnecessary. HUD will notify a mortgagee that its origination approval agreement will terminate if the mortgagee's default and claim rates are in excess of permissible levels. As mentioned above in this preamble, mortgagees that have received a proposed termination notice may request an informal conference at which the designated official will consider other relevant reasons and factors beyond the mortgagee's control that contributed to the mortgagee's high default and claim rate. Mortgagees will have the opportunity at the informal conference to present mitigating information, such as the actions identified by the commenters.

Comment: HUD should take action only against a lender's specific division responsible for the high default and claim rate. One commenter requested that HUD provide the flexibility to separately analyze a lender's retail and correspondent divisions. The commenter suggested that when it can be determined that the claim and default rate is attributable to only one division, HUD should take action only against the division responsible for the high rate of defaults and claims.

HUD Response. The current regulations already provide HUD with the flexibility to implement Credit Watch Termination actions against retail and correspondent divisions separately. Specifically, 24 CFR 202.3(c)(2) provides that HUD may "review the insured mortgage performance of a mortgagee's branch offices individually and may terminate the authority of the branch or the authority of the mortgagee's overall operation."

Comment: HUD should phase in the threshold for underwriting approval termination from 300 percent to 200 percent over a year or more. One commenter wrote that FHA should follow the same process it used in

originally introducing Credit Watch; that is, FHA should start with a compare ratio of 300 percent for a given time period and then, if concerns are addressed, the compare ratio threshold should be lowered quarterly by 25 percent to arrive at a 200 percent compare ratio. The commenter explained that gradual implementation is important because Credit Watch covers loans made over a two-year period, and lenders will thus be evaluated for loans that were underwritten prior to the need to consider the consequences of Credit Watch. The commenter wrote that the goal of Credit Watch is not to terminate a lender's underwriting authority, but rather to prompt lenders to change their policies where the compare ratios are far above the norm—and implementing the threshold gradually from 300 percent to 200 percent will allow lenders to do this.

HUD Response. At this time, HUD will not phase in Credit Watch thresholds. Should HUD decide to change and/or phase in the Credit Watch thresholds for underwriting mortgagees, it will announce this policy determination through Mortgagee Letter, **Federal Register** notice, or other means, as appropriate.

Comment: Originating lenders should not be held responsible for defaults of which it has no knowledge. One commenter wrote that mortgages are often sold and transferred to new servicers, and that once the transfer takes place, the originating company gets virtually no information with regard to payments until the servicer seeks to impose a penalty or ask for repurchase of that loan.

HUD Response. As announced in Mortgagee Letter 00-20, dated June 2, 2000, the Neighborhood Watch Early Warning system provides lenders with loan performance data via the FHA Internet Connection. Mortgagees that have received a proposed termination notice may request an informal conference at which a designated official will consider other relevant reasons and factors beyond the mortgagee's control that contributed to the mortgagee's high default and claim rate. Mortgagees will have the opportunity at the informal conference to present mitigating information.

IV. Small Business Concerns Related to Credit Watch Termination Initiative

With respect to termination of the mortgagee's origination approval agreement, or taking other appropriate enforcement action against a mortgagee, HUD is cognizant that section 222 of the Small Business Regulatory Enforcement

Fairness Act of 1996 (Pub. L. 104-121) (SBREFA) requires the Small Business and Agriculture Regulatory Enforcement Ombudsman to "work with each agency with regulatory authority over small businesses to ensure that small business concerns that receive or are subject to an audit, on-site inspection, compliance assistance effort, or other enforcement related communication or contact by agency personnel are provided with a means to comment on the enforcement activity conducted by this personnel." To implement this statutory provision, the Small Business Administration has requested that agencies include the following language on agency publications and notices that are provided to small business concerns at the time the enforcement action is undertaken. The language is as follows:

Your Comments Are Important

The Small Business and Agriculture Regulatory Enforcement Ombudsman and 10 Regional Fairness Boards were established to receive comments from small businesses about federal agency enforcement actions. The Ombudsman will annually evaluate the enforcement activities and rate each agency's responsiveness to small business. If you wish to comment on the enforcement actions of [insert agency name], you will find the necessary comment forms at <http://www.sba.gov.ombudsman> or call 1-888-REG-FAIR (1-888-734-3247).

In accordance with its notice describing HUD's actions on the implementation of SBREFA, which was published on May 21, 1998 (63 FR 28214), HUD will work with the Small Business Administration to provide small entities with information on the Fairness Boards and National Ombudsman program, at the time enforcement actions are taken, to ensure that small entities have the full means to comment on the enforcement activity conducted by HUD.

V. Findings and Certifications

Regulatory Planning and Review

The Office of Management and Budget (OMB) reviewed this rule under Executive Order 12866 (entitled "Regulatory Planning and Review"). OMB determined that this rule is a "significant regulatory action" as defined in section 3(f) of the Order (although not economically significant, as provided in section 3(f)(1) of the Order). The docket file 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 Seventh Street, SW., Room 10276, Washington, DC 20410-0500. Due to security measures

at the HUD Headquarters building, an advance appointment to review the docket file must be scheduled by calling the Regulations Division at (202) 708-3055.

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 rule subject to notice and comment rulemaking requirements unless the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities. This final rule follows publication of a December 17, 2004, interim rule that made several amendments to HUD's regulations for the FHA Credit Watch Termination Initiative and solicited additional public comment on those provisions regarding underwriting mortgagees.

The final rule provides that the default and claim thresholds underlying the Credit Watch Termination Initiative apply to both underwriting and originating mortgagees. This amendment will ensure that the performance of all mortgagees involved in FHA-insured mortgage transactions is evaluated. To the extent that the change will have an economic impact on small underwriting mortgagees that are presently not covered by Credit Watch Termination, it will be as a result of actions taken by the mortgagees themselves—that is, failure to undertake the sound business practices necessary to maintain default and claim rates at an acceptable level.

The final rule also provides for a fully computerized Credit Watch notification process through use of the FHA Neighborhood Watch Early Warning System. This change will provide for a streamlined and more effective method of monitoring mortgagee performance and for notifying poor performing mortgagees that are in danger of having their origination approval agreements terminated by HUD. The change will not impose an undue burden on small entities, since it merely codifies a HUD policy that was previously announced through a Mortgagee Letter. Further, the majority of mortgagees (small and large) participating in the FHA mortgage insurance programs currently have access to the FHA Internet Connection that is used to provide such notification.

The rule also removes the regulatory cap on the Credit Watch default and claim rates, and provides that a mortgagee will be considered to be on Credit Watch Status if it has a default and claim rate on insured mortgages that exceeds 150 percent of the normal rate and its origination approval

agreement has not been terminated. This revision will not impose a significant economic impact on small entities, since the entities that will be affected by this change are poorly performing mortgagees that are already subject to termination of their origination approval agreements.

The rule also prohibits a mortgagee that has received a notice of proposed termination of its origination approval agreement from establishing a new branch in the lending area covered by the proposed termination. The mortgagees to which this change will be applicable are those that already have been notified by HUD that their default and claim rates exceed an acceptable standard in specified geographic areas and that they are at risk of having their FHA mortgage origination approvals terminated. The rule closes a loophole previously used by mortgagees to evade HUD's existing procedure for reviewing losses to the FHA mortgage insurance fund.

The final rule also provides that, for purposes of the Credit Watch Termination evaluation, the date of mortgage origination will be considered to be the date the loan transaction commences amortization, rather than the date of endorsement for FHA mortgage insurance. This change will not impose any economic burden on small mortgagees; rather, the change will improve the accuracy of Credit Watch Termination evaluations by conforming HUD's definition of the mortgage origination date to the beginning amortization date used to report defaults. Finally, the final rule will codify the existing definition of the

term "underserved area" for purposes of Credit Watch Termination determinations. This amendment merely codifies existing policy and will, therefore, not impose any new economic burden on mortgagees.

Accordingly, the undersigned certifies that this rule will not have a significant economic impact on a substantial number of small entities.

Environmental Impact

This final rule will not direct, provide for assistance or loan and mortgage insurance for, or otherwise govern or regulate, real property acquisition, disposition, leasing, rehabilitation, alteration, demolition, or new construction, or establish, revise, or provide for standards for construction or construction materials, manufactured housing, or occupancy. Accordingly, under 24 CFR 50.19(c)(1), this final rule is categorically excluded from the requirements of the National Environmental Policy Act (42 U.S.C. 4321 *et seq.*).

Executive Order 13132, Federalism

Executive Order 13132 (entitled "Federalism") prohibits, to the extent practicable and permitted by law, an agency from promulgating a regulation that has federalism implications and either imposes substantial direct compliance costs on state and local governments and is not required by statute or preempts state law, unless the relevant requirements of section 6 of the Executive Order are met. This rule does not have federalism implications and does 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 the private sector. This final rule does not impose any Federal mandates on any state, local, or tribal government or the private sector within the meaning of UMRA.

Catalog of Federal Domestic Assistance

The Catalog of Federal Domestic Assistance Program number applicable to 24 CFR part 202 is 14.20.

List of Subjects in 24 CFR Part 202

Administrative practice and procedure, Home improvement, manufactured homes, Mortgage insurance, Reporting and recordkeeping requirements.

■ Accordingly, for the reasons stated in the preamble, the interim rule for part 202 of Title 24 of the Code of Federal Regulations, amending § 202.3(c)(2) and adding § 202.3(e), published on December 17, 2004, at 69 FR 75802, is promulgated as final, without change.

Dated: January 20, 2006.

Frank L. Davis,

General Deputy Assistant Secretary for Housing.

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