

## DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

### 24 CFR Part 202

[Docket No. FR-4625-I-02; HUD-2004-0014]

RIN 2502-AH60

### Revisions to FHA Credit Watch Termination Initiative

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

**ACTION:** Interim rule.

**SUMMARY:** On April 1, 2003, HUD published a proposed rule to amend the regulations for the Federal Housing Administration (FHA) Credit Watch Termination Initiative. Specifically, HUD proposed to provide for a fully computerized Credit Watch status notification process through use of the FHA Neighborhood Watch Early Warning System; remove the regulatory “cap” on the default and claim rates for placing a mortgagee on Credit Watch status; 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; provide that the default and claim thresholds underlying the Credit Watch Termination Initiative apply to both underwriting and originating mortgagees; codify the definition of “underserved area” that is currently used under the Credit Watch Termination Initiative; 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; specify the timeframes for the informal conference that may be requested by a mortgagee prior to termination; and describe the procedures a terminated mortgagee must follow to have its origination approval agreement reinstated. This interim rule follows publication of the April 1, 2003, proposed rule, and takes into consideration the public comments on the proposed rule. In addition, this rule further clarifies the applicability of the Credit Watch Termination Initiative to underwriting mortgagees, and requests comments on the regulatory provisions regarding underwriting mortgagees.

**DATES:** Effective Date: January 18, 2005.

*Comments Due Date:* February 15, 2005.

**ADDRESSES:** Interested persons are invited to submit comments regarding this rule to the Regulations Division, Office of General Counsel, Room 10276,

Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410-0500. Electronic comments may be submitted through either:

- The Federal eRulemaking Portal at <http://www.regulations.gov>; or
- The HUD electronic Web site at <http://www.epa.gov/feddocket>. Follow the link entitled “View Open HUD Dockets.” Commenters should follow the instructions provided on that site to submit comments electronically.

Facsimile (FAX) comments are not acceptable. In all cases, communications must refer to the docket number and title. All comments and communications submitted will be available for public inspection and copying between 8 a.m. and 5 p.m. weekdays at the above address. Copies are also available for inspection and downloading at <http://www.epa.gov/feddocket>.

#### 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—HUD’s April 1, 2003, Proposed Rule

On April 1, 2003 (68 FR 15906), HUD published a proposed rule to amend the regulations for the Federal Housing Administration (FHA) Credit Watch Termination Initiative. Through the Credit Watch Termination 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 Mortgage 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 to make 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.

#### II. Significant Differences Between this Interim Rule and the April 1, 2003, Proposed Rule

This interim rule follows publication of the April 1, 2003, proposed rule, and takes into consideration the public comments received on the proposed rule. The changes made to the April 1, 2003, proposed rule in response to public comment are as follows:

1. *Clarification of applicability to underwriting mortgagees.* In response to several comments, this interim rule clarifies the applicability of the Credit Watch Termination Initiative to underwriting mortgagees. The April 1, 2003, proposed rule made clear that underwriting mortgagees would be included within the scope of the Credit Watch Termination Initiative. However,

HUD agrees that additional clarification would be helpful regarding the effects of Credit Watch Termination evaluations on the ability of mortgagees with direct endorsement approval to underwrite FHA-insured mortgage loans.

Accordingly, HUD has revised the rule to provide for separate regulatory language that specifically addresses underwriting mortgagees. For example, the rule now clarifies that the Secretary may terminate an underwriting mortgagee's direct endorsement approval under 24 CFR part 203 to underwrite FHA-insured mortgages if the mortgagee has a rate of defaults and claims on insured mortgages underwritten in an area that exceeds the established Credit Watch Termination thresholds. The termination of a mortgagee's direct endorsement approval under the Credit Watch Termination Initiative is separate and apart from the termination of a mortgagee's direct endorsement approval under 24 CFR part 203.

The new regulatory language does not alter the substance of the proposals contained in the April 1, 2003, proposed rule but, rather, provides greater clarity on how the performance of underwriting mortgagees would be subject to evaluation under the Credit Watch Termination Initiative. Although the language of the proposed rule did not explicitly reference termination of a mortgagee's direct endorsement approval, the preamble to the proposed rule made clear that the regulatory amendments were designed to "emphasize HUD's authority to terminate the ability of a mortgagee to originate or underwrite FHA-insured single family mortgages where the mortgagee has demonstrated an unacceptably high default and claim rate" (see 68 FR 15906, at 15907, third column). The ability of a mortgagee to underwrite FHA-insured mortgages is provided by its direct endorsement approval and, therefore, the termination of a mortgagee's direct endorsement approval was contemplated by the proposed rule.

Because the new regulatory language was not part of the April 1, 2003, proposed rule, HUD is issuing these changes on an interim basis and soliciting public comment for a period of 60 days. HUD will issue a follow-up final rule addressing the significant issues raised by the public commenters on the new language concerning the applicability of the Credit Watch Termination Initiative to underwriting mortgagees. HUD will not consider public comments submitted in response to other provisions of this interim rule. These provisions were contained in the

April 1, 2003, proposed rule and, therefore, have already been the subject of public comments. A discussion of the significant issues raised by the public commenters on the April 1, 2003, proposed rule and HUD's responses to these comments is located in section III of this preamble.

2. *Removal of last sentence of proposed § 202.3(c)(2)(ii).* For purposes of clarity, and at the request of a public commenter, HUD has removed the last sentence of proposed § 202.3(c)(2)(ii), which provided that a "poor performing mortgagee on Credit Watch status is in danger of having its origination approval agreement terminated by HUD."

3. *Other clarifying changes.* HUD has also taken the opportunity afforded by this interim rule to make several non-substantive changes to enhance the clarity of the Credit Watch regulations (for example, revising the headings of certain paragraphs).

### III. Discussion of the Public Comments on the April 1, 2003, Proposed Rule

The public comment period for the proposed rule closed on June 1, 2003. HUD received four public comments on the proposed rule. Comments were received from a city, a national association representing mortgage bankers, a mortgage lender, and a national community development organization. The comments were generally supportive of the proposed rule, but also requested clarification of some of the proposed regulatory changes and offered suggestions for improving the rule. This section of the preamble presents a summary of the significant issues raised by the public commenters on the April 1, 2003, proposed rule, and HUD's responses to these issues.

#### A. Comments Regarding Use of the FHA Neighborhood Watch Early Warning System

*Comment: Support for electronic notification of Credit Watch status.* The commenter wrote that "[h]aving the Credit Watch notification information available online would enhance [the commenter's] ability to monitor its own and its FHA correspondents' production on an ongoing, live basis."

*HUD response.* HUD appreciates the commenter's support. The interim rule adopts these provisions of the proposed rule without change. HUD agrees that a fully computerized Credit Watch notification system provides a streamlined and more effective method of monitoring mortgagee performance.

#### B. Comments Regarding Removal of the Regulatory "Cap" on the Credit Watch Default and Claim Rate

*Comment: Support for removal of regulatory cap.* Two commenters wrote that HUD's clarification that a lender will be considered to be on Credit Watch status if its rate of defaults and claims exceeds 150 percent of the normal rate will strengthen the Credit Watch Termination Initiative.

*HUD response.* HUD appreciates the support expressed by the commenters. HUD has adopted the proposed regulatory amendment without change. The amendment will strengthen the Credit Watch Termination Initiative by eliminating the need for regulatory waivers to authorize placement of mortgagees with default and claims rates greater than 200 percent on Credit Watch status.

*Comment: HUD should clarify the threshold for termination of a mortgagee's origination approval agreement.* One commenter requested that the rule provide clarification regarding the threshold claim and default rate that may trigger termination of a mortgagee's origination approval agreement. The commenter was uncertain about the impact of the last sentence of proposed § 202.3(c)(2)(ii), which provides that a "poor performing mortgagee on Credit Watch status is in danger of having its origination approval agreement terminated by HUD." The commenter wrote that this sentence implies that the default and claim ratio required for placement on Credit Watch status (150%) would suffice to terminate a mortgagee's origination approval agreement. The commenter wrote that this would contradict both the language of § 202.3(c)(2)(iii) and the policy stated in Mortgagee Letter 2002-20 that a mortgagee's origination approval agreement may be terminated only if its rate of default and claims exceeds 200% of the normal rate and the national default and claim rate for insured mortgages. The commenter wrote that "the current 200% termination threshold is sufficient for FHA to monitor lenders with excessive claim and default rates," and suggested that HUD remove the last sentence of proposed § 202.3(c)(2)(ii).

*HUD response.* For purposes of clarity, HUD has adopted the commenter's suggestion and removed the last sentence of proposed § 202.3(c)(2)(ii). The proposed regulatory language was not intended to imply that a mortgagee placed on Credit Watch status with a default and claim rate of less than 200% of the normal rate

is subject to termination. As the commenter notes, the regulations are clear that a mortgagee is subject to termination only if its rate of defaults and claims exceeds 200 percent of the normal rate and also exceeds the national default and claim rate for insured mortgages. The language of the proposed rule was designed to remind a poor performing mortgagee that placement on Credit Watch status is a warning that its default and claim rate is unacceptable and, that unless corrective action is taken, the rate may soon rise to a level triggering possible termination of its origination approval agreement.

*Comment: HUD should not establish a firm threshold for placement on Credit Watch status.* One commenter made this suggestion. The commenter wrote that, over time, as mortgagees manage their portfolio, the "normal rate" band will narrow, and make it more difficult for mortgagees to operate below this threshold on an ongoing basis.

*HUD response.* HUD adopted the proposed regulatory amendment without change. However, 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 conduct national Credit Watch evaluations for mortgagees that operate on a national basis.* One commenter expressed concerns over HUD's conducting Credit Watch evaluations on a regional basis. The commenter suggested that for mortgagees operating on a national basis, HUD's review should consider the mortgagee's national default and claim rate, not just defaults and claims in one region.

*HUD 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.

#### *C. Comments on Limitations on the Establishment of New Branches*

*Comment: Support for limitation on the establishment of new branch offices.* Two commenters wrote that elimination of this loophole in the current regulations would strengthen the Credit Watch Termination Initiative and promote access to affordable loans for underserved communities.

*HUD response.* HUD appreciates the support expressed by the commenters. This interim rule adopts the proposed regulatory amendment without change.

*Comment: Objection to the mandatory prohibition of new branch offices in the lending area covered by a proposed termination.* One commenter wrote that before imposing such a prohibition, HUD should consider the mortgagee's national rate of defaults and claims, and the risk management process and internal controls that the mortgagee has implemented to manage the rate of defaults and claims at the local level.

*HUD response.* HUD's review analyzes the performance of every FHA approved mortgagee branch in each geographic area served by a HUD field office. HUD's regulations permit HUD to terminate the origination approval agreement with any mortgagee having a default and claim rate that exceeds 200 percent of the default and claim rate within the geographic area served by a HUD field office, and also exceeds the national default and claim rate. Since HUD's Credit Watch Termination Initiative is based on statistics, a mortgagee's risk management processes and internal controls would not be considered prior to prohibiting a mortgagee from establishing new branches. Further, a mortgagee with significant risk management processes and internal controls will be less likely to receive a termination letter from HUD.

#### *D. Comments on Inclusion of Underwriting Mortgagees*

*Comment: Support for inclusion of underwriting mortgagees.* Two commenters wrote that the inclusion of underwriting mortgagees would promote increased access to affordable loans for underserved communities and strengthen the Credit Watch Termination Initiative.

*HUD response.* HUD appreciates the support expressed by the commenters. The inclusion of underwriting mortgagees will help to ensure that the performance of all mortgagees involved in FHA-insured mortgage transactions is properly evaluated. As noted above in this preamble, HUD has revised the rule to provide for separate regulatory language that specifically addresses underwriting mortgagees. HUD is issuing these changes on an interim basis and soliciting public comment for a period of 60 days. HUD will issue a follow-up final rule addressing the significant issues raised by the public commenters on the new language regarding underwriting mortgagees.

*Comment: HUD should "phase-in" the Credit Watch termination thresholds for underwriting mortgagees.* One commenter wrote that this would provide underwriting sponsors with time to implement the necessary

changes to internal procedures and to educate their FHA correspondents of the pending changes. The commenter suggested that the thresholds be "phased-in" in a manner similar to that used by HUD for loan originators under Mortgagee Letter 99-15.

*HUD response.* HUD has not adopted the change requested by the commenter. However, HUD has revised the rule to clarify the requirements applicable to underwriting mortgagees and is requesting public comments on the new regulatory language. Further, prior to implementation of the regulatory changes made by this interim rule, HUD will issue guidance (such as a Mortgagee Letter) that will provide additional information to assist underwriting mortgagees in their compliance efforts.

*Comment: HUD should take into consideration proactive measures taken by sponsors against unscrupulous loan correspondents.* Two commenters wrote that underwriting sponsor mortgagees are removed from the mortgage origination process, and sometimes the victims of fraud perpetuated by unscrupulous loan correspondents. Accordingly, the commenters suggested that the rule should exclude default and claim performance numbers from the Credit Watch evaluation of sponsor mortgagees where the sponsor discovers and reports fraud committed by a correspondent, or where the sponsor has terminated the correspondent.

*HUD response.* Since HUD's Credit Watch Termination Initiative is based on statistical data, it would not be possible to exclude the default and claim numbers of sponsoring mortgagees where the sponsor discovers and reports fraud. However, HUD would consider these issues if the mortgagee received a termination letter and presented those issues to HUD.

*Comment: HUD should provide guidance to sponsors on the evaluation and the performance of their loan correspondents using the Neighborhood Watch Early Warning System.* One commenter made this recommendation. The commenter wrote that HUD should provide sponsors with formal descriptions of the factors taken into consideration when evaluating the performance of FHA correspondents, in order to assist the sponsors in proactively managing the performance of their correspondents. Further, the commenter recommended that HUD develop a system to notify sponsors of audit results, Credit Watch actions, and other actions taken against FHA correspondents. The commenter wrote that HUD could provide a web-link where actions against FHA

correspondents are outlined and updated monthly.

**HUD response.** As noted above, HUD has revised the rule to clarify the new requirements applicable to underwriting mortgagees and is requesting public comments on this new regulatory language. Further, HUD will issue guidance to assist mortgagees in the implementation of the new requirements established by this interim rule. In addition, HUD's Internet site at: <http://www.hud.gov/offices/hsg/sfh/lender/lendterm.cfm> includes a list of all lenders whose origination approval agreements have been terminated as a result of the Credit Watch Termination Initiative. HUD also notes that the causes and descriptions of administrative actions taken by HUD's Mortgage Review Board against HUD-approved mortgagees are regularly published in the **Federal Register**. HUD suggests that sponsors also require that loan correspondents provide them with audit reports or other actions taken by HUD.

**Comment:** *The rule should permit FHA to look at mitigating factors underlying the default and claim rates of an underwriting mortgagee.* One commenter made this suggestion. The commenter wrote that a mortgagee operating in an urban area, or primarily serving first-time homebuyers, might experience a higher default and claim rate than a mortgagee operating in a suburban area or primarily working on refinances.

**HUD response.** HUD regulations permit a mortgagee to request an informal conference with the Deputy Assistant Secretary for Single Family Housing, or that official's designee, prior to the termination of its origination approval agreement. During the informal conference, the mortgagee has the opportunity to present HUD with explanations for its high default and claim rate. However, the mortgagee must be able to explain how the issues presented caused it to have a default and claim rate higher than the average for the area.

**Comment:** *The rule should clarify how the Credit Watch Termination Initiative will apply to sponsoring mortgagees.* One commenter made this suggestion. The commenter was unsure how the placement on Credit Watch status would affect an underwriting sponsor mortgagee. For example, the commenter asked whether a sponsor mortgagee terminated in a given HUD office area would be prohibited from underwriting loans in that area.

**HUD response.** HUD agrees with the commenters. As noted above, this rule clarifies the applicability of the new

regulatory requirements to underwriting mortgagees. Specifically, HUD has revised the rule to provide for separate regulatory language to specifically address the applicability of the Credit Watch Termination Initiative to underwriting mortgagees. Because the new regulatory language was not part of the April 1, 2003, proposed rule, HUD is issuing these changes on an interim basis and is requesting public comments for a period of 60 days. HUD will issue a follow-up final rule addressing the significant issues raised by the commenters on the new language concerning underwriting mortgagees.

#### *E. Comments Regarding Mortgage Origination Date*

**Comment:** *The Credit Watch Termination Initiative should continue to use the FHA endorsement date as the mortgage origination date.* One commenter made this suggestion. The commenter wrote that since the primary purpose of the Credit Watch Termination Initiative is to mitigate risk to the FHA mortgage insurance fund, the date of FHA endorsement should be the starting point for evaluation of a mortgagee's performance. The commenter wrote that until a loan is endorsed, there is no risk to the FHA mortgage insurance fund and the mortgagee bears all of the risk.

**HUD response.** HUD has not adopted the suggestion made by the commenter. HUD currently evaluates performance based on loans that have been endorsed. HUD's regulations at § 203.255(b) require that lenders submit loans to HUD for endorsement within 60 days from loan closing. However, there may be a gap in time from the origination date (beginning amortization date) and the endorsement date based on the period of time after closing in which a mortgagee submits a loan for insurance to HUD. Additional time may elapse if the mortgagee has failed to provide HUD with all of the required documents. These time gaps have resulted in inconsistencies among the starting dates used by HUD to evaluate mortgagee loan performance. Using the beginning amortization date instead of the endorsement date provides a uniform starting date for HUD's analysis. Further, since the beginning amortization date is now used throughout HUD for loan performance analysis, this interim rule has the added benefit of conforming the Credit Watch procedures to other HUD loan performance evaluation procedures.

**Comment:** *Support for use of the amortization date as the mortgage origination date.* In contrast to the preceding comment, one commenter

supported the use of the amortization date to determine the date of mortgage origination under the Credit Watch Termination Initiative. The commenter wrote that the amortization date is easier to track and would be a more consistent starting date between loans.

**HUD response.** Use of the amortization date provides a more uniform starting date for Credit Watch evaluations, and improve the accuracy of these evaluations. Accordingly, this interim rule adopts the proposed regulatory amendment without change.

#### *F. Comments Regarding Informal Conference Prior to Termination*

**Comment:** *HUD should establish a more detailed process for reviewing mortgagee performance prior to termination.* One commenter made this suggestion. The commenter suggested that a mortgagee should be permitted to initiate the formal review and present mitigating information, such as the number of loans in underserved areas and the number of loans that were streamlined refinances involving minimal underwriting. The commenter wrote that the mortgagee should also have the opportunity to present a risk-management plan pertaining to the branch, and that HUD should terminate the mortgagee only if the improvement plan is not met.

**HUD response.** HUD has decided not to revise the rule in response to this comment. HUD undertakes a comprehensive review of mortgagee performance prior to sending a proposed termination notice. For example, HUD analyzes a mortgagee's portfolio by insurance fund (*i.e.*, Mutual Mortgage, General, and Special Risk), and by census tract designation (*i.e.*, served, underserved and undesignated). HUD also evaluates the impact of streamline-refinanced loans for each mortgagee prior to issuing a proposed termination notice. HUD also notes that each mortgagee is required to have a quality control plan and to perform regular quality control reviews that will bring potential problems to its attention. In addition, mortgagees should use HUD's Neighborhood Watch Early Warning System to monitor the performance of their branches and take prompt corrective action before receipt of a proposed termination letter from HUD.

**Comment:** *HUD should establish a process to allow the public to comment on the FHA lending performance of questionable mortgagees.* One commenter made this suggestion, writing that community groups and neighborhood residents have first-hand knowledge of mortgagee operations that

the mortgagee will not volunteer in a process only involving HUD and the mortgagee. The commenter wrote that HUD should publicize any requests for an informal conference on HUD's Web site and invite community groups to comment during the conference. Further, the commenter advocated that HUD also solicit public comments as part of the reinstatement process for a mortgagee that has been terminated. The commenter suggested that HUD provide the public with the mortgagee's corrective action plan and require that the mortgagee meet with the public to discuss their comments on the plan.

**HUD response.** HUD's Credit Watch Termination Initiative is based on statistical data, rather than fact-finding. Soliciting the involvement of community groups in the informal conference process and in the reinstatement process would change the essence of Credit Watch Termination to more of a fact-finding initiative. However, if community groups are aware of concerns regarding FHA approved mortgagees, they should notify the quality assurance division directors in FHA's four Homeownership Centers (HOCs). HUD publishes a list of mortgagees that have had their origination approval agreements terminated in the **Federal Register** and on HUD's Internet site.

#### *G. Comments Regarding the Definition of Underserved Area*

**Comment:** *Concerns about the definition of "underserved area."* One commenter wrote that defining the term "underserved area" through the use of census tracts would perpetuate abuses. The commenter wrote that a mortgagee that is the predominant lender in a census tract would never be penalized if the benchmark default rate used for determining possible termination is the default rate of the census tract in question.

**HUD response.** HUD has not revised the rule in response to this comment. HUD's data analysis of a mortgagee's performance by census tract involves aggregating the loans for all census tracts that are identified as being underserved, served, or undesignated within the jurisdiction of a HUD office. Mortgagee performance within specific census tracts is not analyzed.

**Comment:** *HUD should not consider the servicing of underserved areas in evaluating a mortgagee's performance.* One commenter wrote that under the current regulations, it is permissible for a mortgagee to have a default and claim rate higher than 200% of the normal rate, if the mortgagee primarily serves lower-income underserved areas. The

commenter wrote that HUD's apparent tolerance of higher default rates for mortgagees doing business in underserved areas might perpetuate property flipping and other FHA program abuses leading to higher rates of default in these areas. To avoid this adverse outcome, the commenter recommended that HUD either: (1) Apply its default rates uniformly regardless of the neighborhoods served by the mortgagee; or (2) perform the Credit Watch analysis at a geographical level smaller than the HUD Field Office level. Under the second option, if a mortgagee primarily focused on the inner city, the default rate analysis would be performed on the level of the city, instead of the HUD Field Office level. The commenter wrote that since a HUD Field Office encompasses a number of metropolitan areas and rural parts of a state, a smaller geographical unit, such as a metropolitan area, a county and/or a city, may be a more appropriate comparison.

**HUD response.** HUD considers a mortgagee's default and claim rate by census tract designation (*i.e.*, underserved, served, and undesignated). Mortgagee Letter 99-15 further clarifies that if a mortgagee's rate of defaults and claims does not exceed 200% of the HUD field office's rate of defaults and claims in underserved census tracts, then the mortgagee's performance is acceptable in underserved tracts. Therefore, HUD does apply its default rates uniformly regardless of the census tract designation served by the mortgagee.

HUD's evaluation of mortgagee branch performance by HUD field office designation is consistent with the method used by FHA to approve mortgagees to operate. However, HUD will consider the issue of a lender's business being concentrated in a smaller area if presented by the mortgagee in response to a proposed termination notice.

#### **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). Any changes made to the rule subsequent to its submission to OMB are identified in the docket file, which is available for public inspection in the Regulations Division, Room 10276, Office of General Counsel, Department of Housing and Urban Development, 451 Seventh Street, SW., Washington, DC 20410-0500.

##### *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 rule makes several amendments to HUD's regulations for the FHA Credit Watch Termination Initiative. First, consistent with the goals of the Administration regarding the increased use of technology in government, the interim rule 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 existing HUD policy 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 they are at risk of having their FHA mortgage origination approvals terminated. The intent of this rulemaking is to close a loophole used by mortgagees to evade HUD's existing procedure for reviewing losses to the FHA mortgage insurance fund.

The interim rule also 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 who 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 interim 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 interim rule will codify the existing definition of the term "underserved area" for purposes of Credit Watch Termination determinations. This amendment will merely codify 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. Notwithstanding HUD's determination that this rule will not have a significant economic impact on a substantial number of small entities, HUD specifically invites comments regarding less burdensome alternatives to this rule that will meet HUD's objectives as described in this preamble.

#### *Environmental Impact*

This interim 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), this interim rule is categorically excluded from the requirements of the National Environmental Policy Act (42 U.S.C. 4332 *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 interim 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 described in the preamble, HUD amends 24 CFR part 202 as follows:

#### **PART 202—APPROVAL OF LENDING INSTITUTIONS AND MORTGAGEES**

■ 1. The authority citation for 24 CFR part 202 continues to read as follows:

**Authority:** 12 U.S.C. 1703, 1709, and 1715b; 42 U.S.C. 3535(d).

■ 2. In § 202.3, revise paragraph (c)(2) and add paragraph (e) to read as follows:

#### **§ 202.3 Approval status for lenders and mortgagees.**

\* \* \* \* \*

(c) \* \* \*

(2) *Credit Watch Termination.* (i) *Scope and frequency of review.* The Secretary will review, on an ongoing basis, the number of defaults and claims on mortgages originated, underwritten, or both, by each mortgagee in the geographic area served by a HUD field office. HUD will make this rate information available to mortgagees and the public through electronic means and will issue instructions for accessing this information through a Mortgagee Letter.

For this purpose, and for all purposes under paragraph (c) of this section, a mortgage is considered to be originated in the same federal fiscal year in which its amortization commences. The Secretary may also 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.

(ii) *Credit Watch Status.* Mortgagees are responsible for monitoring their default and claim rate performance. A mortgagee is considered to be on Credit Watch Status if, at any time, the mortgagee has a rate of defaults and claims on insured mortgages originated, underwritten, or both, in an area which exceeds 150 percent of the normal rate and its origination approval agreement has not been terminated.

(iii) *Notice of termination.* (A) *Notice of termination of origination approval agreement.* The Secretary may notify a mortgagee that its origination approval agreement will terminate 60 days after notice is given, if the mortgagee had a rate of defaults and claims on insured mortgages originated in an area which exceeded 200 percent of the normal rate and exceeded the national default and claim rate for insured mortgages.

(B) *Notice of termination of direct endorsement approval.* The Secretary may notify a mortgagee that its direct endorsement approval under 24 CFR part 203 will terminate 60 days after notice is given, if the mortgagee had a rate of defaults and claims on insured mortgages underwritten in an area which exceeded 200 percent of the normal rate and exceeded the national default and claim rate for insured mortgages. The termination of a mortgagee's direct endorsement approval pursuant to this section is separate and apart from the termination of a mortgagee's direct endorsement approval under 24 CFR part 203.

(C) *No need for prior action by Mortgage Review Board.* The termination notices described in paragraphs (c)(2)(ii)(A) and (B) of this section may be given without prior action by the Mortgage Review Board.

(D) *Underserved areas.* Before the Secretary sends the termination notice, the Secretary shall review the Census tract concentrations of the defaults and claims. If the Secretary determines that the excessive rate is the result of mortgage lending in underserved areas, as defined in 24 CFR 81.2, the Secretary may determine not to terminate the mortgagee's origination approval agreement and/or direct endorsement approval.

(iv) *Request for informal conference.* Prior to termination the mortgagee may submit a written request for an informal conference with the Deputy Assistant Secretary for Single Family Housing or that official's designee. HUD must receive the written request no later than 30 calendar days after the date of the proposed termination notice. Unless HUD grants an extension, the informal conference must be held no later than 60 calendar days after the date of the proposed termination notice. After considering relevant reasons and factors beyond the mortgagee's control that contributed to the excessive default and claim rates, the Deputy Assistant Secretary for Single Family Housing or designee may withdraw the termination notice.

(v) *Limitation on the establishment of new branches.* Upon receipt of a proposed termination notice of its origination approval agreement, the mortgagee shall not establish a new branch or new branches for the origination of FHA-insured mortgages in the area or areas that are covered by the proposed termination notice. As of January 18, 2005, a mortgagee that is in receipt of a notice of proposed termination may not establish any new branch in the location or locations cited in the proposed termination notice until either:

(A) The proposed termination notice is withdrawn or

(B) The Secretary reinstates the mortgagee's origination approval agreement, in accordance with paragraph (e) of this section.

(vi) *Effects of termination.* (A) *Termination of origination approval agreement.* If a mortgagee's origination approval agreement is terminated, it may not originate single family insured mortgages unless the origination approval agreement is reinstated by the Secretary in accordance with paragraph (e) of this section, notwithstanding any other provision of this part except § 202.3(c)(2)(vii)(A).

(B) *Termination of direct endorsement approval.* If a mortgagee's direct endorsement approval is terminated, it may not underwrite single family insured mortgages for the area(s) identified in the termination notice, unless the direct endorsement approval is reinstated by the Secretary in accordance with paragraph (e) of this section, notwithstanding any other provision of this part except § 202.3(c)(2)(vii)(A).

(vii) *Rights and obligations in the event of termination.* Termination of the origination approval agreement and/or direct endorsement approval shall not affect:

(A) The eligibility of the mortgage for insurance, absent fraud or misrepresentation, if the mortgagor and all terms and conditions of the mortgage had been approved before the termination by the Direct Endorsement or Lender Insurance mortgagee or were covered by a firm commitment issued by the Secretary; however, no other mortgages originated or underwritten after the date of termination by the mortgagee shall be insured unless the mortgagee's origination approval agreement and/or direct endorsement approval is reinstated by the Secretary;

(B) The right of a mortgagee whose direct endorsement approval has been terminated to transfer cases to another mortgagee with direct endorsement approval for the area covered by the termination.

(C) A mortgagee's obligation to continue to pay insurance premiums and meet all other obligations, including servicing, associated with insured mortgages;

(D) A mortgagee's right to apply for reinstatement of the origination approval agreement and/or direct endorsement approval in accordance with paragraph (e) of this section; or

(E) A mortgagee's right to purchase insured mortgages or to service its own portfolio or the portfolios of other mortgagees with which it has a servicing contract.

\* \* \* \* \*

(e) *Reinstatement.* (1) *General.* A mortgagee whose origination approval agreement and/or direct endorsement approval has been terminated under paragraph (c) of this section may apply for reinstatement if:

(i) The origination approval agreement and/or direct endorsement approval for the affected branch or branches has been terminated for at least six months; and

(ii) The mortgagee continues to be an approved mortgagee meeting the general standards of § 202.5 and the specific requirements of §§ 202.6, 202.7, 202.8 or 202.10, and 202.12.

(2) *Application for reinstatement.* The mortgagee's application for reinstatement must:

(i) Be in a format prescribed by the Secretary and signed by the mortgagee;

(ii) Be accompanied by an independent analysis of the terminated office's operations and identifying the underlying cause of the mortgagee's unacceptable default and claim rate. The independent analysis must be prepared by an independent Certified Public Accountant (CPA) qualified to perform audits under the government auditing standards issued by the General Accounting Office; and

(iii) Be accompanied by a corrective action plan addressing each of the issues identified in the independent analysis described in paragraph (e)(2)(ii) of this section, along with evidence demonstrating that the mortgagee has implemented the corrective action plan.

(3) *HUD action on reinstatement application.* The Secretary will grant the mortgagee's application for reinstatement if the mortgagee's application is complete and the Secretary determines that the underlying causes for the termination have been satisfactorily remedied.

Dated: October 28, 2004.

**John C. Weicher,**

*Assistant Secretary for Housing-Federal Housing Commissioner.*

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