

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

24 CFR PART 203

[Docket No. FR-5087-N-04]

RIN 2502-AI52

**Standards for Mortgagor's Investment in Mortgaged Property:
Additional Public Comment Period**

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

ACTION: Proposed Rule; Reopening of Comment Period.

SUMMARY: This notice provides additional background information and requests additional public comment for a period of 60 days on HUD's rulemaking on Standards for Mortgagor's Investment in Mortgaged Property.

DATES: Comment Due Date: **[Public comment deadline will be date that is 60 days after date of publication in the Federal Register. Please See June 16, 2008, edition of Federal Register].**

ADDRESSES: Interested persons are invited to submit comments regarding this rule to the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 Seventh Street, SW, Room 10276, Washington, DC 20410-0500. Communications should refer to the above docket number and title.

Comment by Mail. Please note that due to security measures at all federal agencies, submission of comments by mail often results in delayed delivery.

Electronic Submission of Comments. HUD now accepts comments electronically. Interested persons may now submit comments electronically through the Federal eRulemaking

Portal at www.regulations.gov. HUD *strongly encourages* commenters to submit comments electronically. Electronic submission allows the commenter maximum time to prepare and submit a comment, ensures timely receipt by HUD, and enables HUD to make them immediately available for public viewing. Commenters should follow the instructions provided at www.regulations.gov to submit comments electronically.

No Facsimile Comments. Facsimile (FAX) comments are not acceptable. In all cases, communications must refer to the docket number and title.

Public Inspection of Public Comments. All comments and communications submitted will be available, without revision, for inspection and downloading at www.regulations.gov. Comments are also available for public inspection and copying between 8 a.m. and 5 p.m. weekdays at the Regulations Division. Due to security measures at the HUD Headquarters building, please schedule an appointment to review the comments by calling the Regulations Division at (202) 708-3055 (this is not a toll-free number).

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

SUPPLEMENTARY INFORMATION:

With this notice, HUD is republishing, for public comment, a proposed rule that would amend HUD policy concerning downpayment assistance for Federal Housing Administration (FHA) borrowers. HUD's current policies in connection with downpayment assistance have given rise to a practice known informally as seller-funded downpayment assistance that has

resulted in disproportionately high borrower default and claim rates among FHA borrowers. Over time, the rate of defaults, foreclosures, and claims has increased so dramatically that the practice has significantly jeopardized FHA's ability to maintain the solvency, as discussed herein, of its insurance fund and to facilitate the provision of affordable home financing to millions of American families.

HUD's proposal, if implemented, will without question exact a major change in its downpayment assistance policy. It would eliminate a practice that has heretofore been allowable and that has been actively engaged in for many years. Even so, the conceptual basis for the change is consistent with a downpayment assistance policy that has been in existence from the inception of the FHA single family insurance program.

HUD's current policy disallows downpayment assistance directly from an entity, such as a seller of a home, that would derive a financial benefit from the sale. The basis for this policy is that such an entity, standing to derive a financial benefit from the sale transaction, may promote its own interest in the transaction to the detriment of the buyer. The current policy is aimed at ensuring that downpayment assistance is indeed a gift to the borrower and that it will not ultimately distort the economics of the transaction to the detriment of the borrower and HUD.

HUD's proposal to amend its regulation is based on this same premise, and seeks to disallow downpayment assistance from any entity that stands to derive a financial benefit from the sale transaction. The major proposed change to HUD's downpayment assistance policy is that it would apply this prohibition irrespective of whether that assistance is made directly or indirectly to the homebuyer. The data displayed in this notice clearly demonstrates the adverse impact of allowing the current policy to continue. HUD is concerned not only about the practice itself, but also about the consequences of the practice on homebuyers participating in FHA

insurance programs and on the FHA insurance fund that is there to serve those homebuyers. A practice simply cannot be tolerated when default rates and claim rates for more than a third of home purchase loans it insures range between 2 and 3 times those applicable to the norm. The counterargument that many people have been helped into homeownership by this practice, even if accepted at face value, pales in light of the damage done to homebuyers who have not been able to retain their homes and to FHA's ability to meet its mission of increasing access to *sustainable* homeownership.

Understanding that the current situation is untenable, HUD has grappled with the issue of how to best address the problem over a period of years. This is evidenced in actions, discussed in the text below, that include exploring rulemaking and legislative solutions that did not come to fruition. While HUD will consider alternative measures to eliminating the practice, piecemeal solutions do not cure but only postpone a viable solution, while extending the damage. In essence, borrowers are being harmed and the solution does not lie in spreading the damaging consequences among an even broader universe of borrowers. The FHA insurance fund is teetering on credit insolvency. Such a circumstance is never welcomed, but especially not when the FHA is trying to be a stabilizing force during the worst housing crisis in generations.

Therefore, HUD is proposing an action that would advance the interests of the public and is a reasonable exercise of agency discretion.

HUD's decision to publish this notice is responsive to court orders issued by the U.S. District Courts for the Eastern District of California, on February 29, 2008, and the District of Columbia, on March 5, 2008.

On October 1, 2007, HUD published a final rule entitled "Standards for Mortgagor's Investment in Mortgaged Property" (72 FR 56002). Like the rule repropoed for comment here,

that rule sought to eliminate the use of downpayment assistance from financially interested parties in FHA-insured single-family mortgages. The October 1, 2007, final rule was challenged in the U.S. District Court for the District of Columbia and in the U.S. District Court for the Eastern District of California by organizations that provide seller-funded downpayment assistance, as defined herein. On February 29, 2008, the U.S. District Court for the Eastern District of California set aside the final rule and remanded the matter to HUD for further action consistent with its order. *Nehemiah Corporation of America v. Jackson, et al.*, No. S-07-2056 (E.D. Cal.). The court found, among other things, that HUD failed forthrightly to explain that the rule reversed its prior practice of allowing seller-funded downpayment assistance (*Id.* at 19-20) and that HUD failed to respond adequately to certain categories of comments (*Id.* at 21-24). The court also disqualified then-HUD Secretary Alphonso Jackson from participating in the remanded proceedings.

After issuing an order on October 31, 2007, preliminarily enjoining HUD's enforcement of the final rule, on March 5, 2008, the U.S. District Court for the District of Columbia vacated the final rule and also remanded it to HUD for further proceedings consistent with that court's opinion. *Ameridream Inc., et al., v. Jackson*, No. 07-1752 (D.D.C. March 5, 2008) and *Penobscot Indian Nation, et al., v. HUD*, No. 07-1282-PLF (D.D.C. March 5, 2008). The court found, among other things, that HUD violated the Administrative Procedure Act by failing to allow comment on critical factual material and by failing to offer a rational explanation for the final rule. *Id.* at 6. The court held that an internal analysis of HUD's loan portfolio referenced only in the final rule constituted critical factual information that, with at least a summary of the specific data and methodology on which the analysis relied, should have been disclosed during the rulemaking proceeding. *Id.* at 11-12. The court also held that HUD's explanation for the

rule relied on sources that did not support its conclusions. *Id.* at 18.

Pursuant to the courts' orders, this publication provides notice that now former Secretary Jackson, who resigned effective April 18, 2008, has not participated in the further promulgation of the rule proposed on May 11, 2007, entitled "Standards for Mortgagor's Investment in Mortgaged Property" (72 FR 27048). HUD will separately publish a notice vacating the October 1, 2008 final rule. This publication also addresses the courts' concerns by acknowledging that the proposed rule marks a clear departure from HUD's prior practice. With respect to the concern that HUD previously had failed to provide critical factual information and otherwise provided an insufficient rationale for the rule, this notice provides additional explanation and data, including analyses of HUD's loan portfolio and access to the data on which those analyses rely. The Regulatory Flexibility Act section has been revised to address only the impact on entities that would be directly affected by the rule. This notice also reopens the comment period for 60 days for the submission of comments on that additional information and on the May 11, 2007, proposed rule, as revised by the October 1, 2007, rule. At the end of the comment period, HUD will review the comments and determine whether to issue a final rule, and will publish a response to significant comments as appropriate. To address the courts' concern with HUD's response to prior public comments, if HUD decides to issue a final rule, HUD will also provide additional responses to those significant comments submitted in response to the May 11, 2007, Notice of Proposed Rulemaking.

If, after reviewing the comments, HUD issues a final rule, it would be effective 180 days from the date of publication with regard to all insured mortgages involving properties for which contracts of sale are dated on or after the effective date.

I. The Proposed Rule

Section 203(b)(9) of the National Housing Act (12 U.S.C. 1709(b)(9)) requires, for a mortgage to be eligible for insurance by FHA, the mortgagor (with narrow exceptions) to pay on account of the property at least 3 percent of the cost of acquisition. The current implementing regulations at 24 CFR 203.19 are silent about permissible or impermissible sources of the mortgagor's investment, although some sources are specifically permitted under the statute.¹

Paragraph 2-10.C. of FHA's underwriting guidelines, HUD Handbook 4155.1, has long provided that the 3 percent cost of acquisition, i.e., the downpayment, may include an "outright gift" to the borrower from relatives, charitable organizations, government entities, and certain others. (HUD Handbook 4155.1 is available at <http://www.hud.gov/offices/adm/hudclips/handbooks/hsg/4155.1/index.cfm>.) It further provides, however, that gifts may not be made by any person or entity with an interest in the sale of the property. Such payments are considered self-interested inducements to purchase a particular property rather than true gifts for the borrower's personal investment. In other words, downpayment assistance from those who receive a financial benefit from the sale may promote the sale on any terms, even terms that may be adverse to the sustainability of the borrower's mortgage and homeownership. A disinterested gift of downpayment funds, on the other hand, does not distort the fundamental economics of the transaction and so does not conflict with the borrower's interest in achieving sustainable homeownership.

On May 11, 2007, HUD published a proposed rule to do two things: codify standards governing a mortgagor's investment in property with a mortgage insured by FHA, and specify prohibited sources for a mortgagor's investment. Specifically, the proposed rule would have

¹ For example, section 203(b)(9) of the National Housing Act permits family members to provide loans to other family members, and permits the mortgagor's downpayment to be paid by a corporation or person other than the mortgagor in certain circumstances, such as when the mortgagor is 60 years of age or older, or when the mortgage covers a housing unit in a homeownership program under the Homeownership and Opportunity Through HOPE Act (Title IV of Public Law 101-625, 104 Stat. 4148, approved November 28, 1990).

codified HUD's longstanding practice of allowing a mortgagor's investment to be derived from gifts by family members and certain organizations, but not from gifts by sellers or other persons that financially benefit from the transaction. It had also been HUD's practice to permit a mortgagor's investment to be derived from funds provided by charitable organizations that were ultimately reimbursed directly or indirectly by sellers of the properties involved in the transactions. The May 11, 2007, proposed rule marked a clear departure from this last-noted practice. The rule would have established that a prohibited source of downpayment assistance is a payment that consists, in whole or in part, of funds provided by any of the following parties before, during, or after closing of the property sale: (1) the seller, or any other person or entity that financially benefits from the transaction; or (2) any third party or entity that is reimbursed directly or indirectly by any of the parties listed in clause (1). Throughout this preamble, such a third-party payment as described in clause (2) is referred to as "seller-funded downpayment assistance" (SFDPA).

HUD concluded that this practice permits the seller or other party that financially benefits from the transaction to accomplish indirectly what could not be done directly. For example, when funds are advanced to the buyer by a downpayment assistance provider that is reimbursed by the seller, there is a *quid pro quo* between the homebuyer's purchase of the property and the seller's "contribution" to the downpayment assistance provider. This scheme facilitates the sale at terms potentially more favorable to the seller and, because funds are fungible, it is reasonable to conclude that the donor's funds are the equivalent of the seller's funds. Viewed in this way, it becomes apparent that a prohibited inducement to purchase is present in these transactions, and HUD has concluded that such payments amount to an impermissible gift provided by a person or entity that financially benefits from the transaction. In a transaction involving SFDPA, both the

seller, who is the ultimate source of the payment, and the entity that funnels or advances the payment for the seller to the homebuyer (and receives reimbursement and a fee from the seller for its role in the transaction) have an interest in the sale of the property that makes their payments an impermissible source of the buyer's equity investment.

HUD's conclusion is reinforced by a report of the Government Accountability Office (GAO), Report No. 06-24, *Mortgage Financing: Additional Action Needed to Manage Risks of FHA-Insured Loans with Down Payment Assistance* (November 2005) (hereinafter, November 2005 GAO Report). At the request of Congress, GAO examined the trends in the use of downpayment assistance with FHA-insured loans, its impact on purchase transactions and house prices, and how it influenced the performance of FHA-insured loans. GAO found that downpayment assistance from seller-funded entities alters the structure of the purchase transaction in important ways. First, it creates an indirect funding stream from property sellers to homebuyers that does not exist in other transactions, even those involving some other type of downpayment assistance. Second, property sellers who provided downpayment assistance through nonprofit organizations often raised the sales price of the homes involved in order to recover the required payments that went to the organizations. GAO's analyses of empirical data showed that FHA-insured homes bought with seller-funded downpayment assistance appraised at and sold for higher prices than comparable homes bought without such assistance, resulting in larger loans for the same collateral and higher effective loan-to-value (LTV) ratios. That is, homebuyers had less equity in the transaction than would otherwise be the case.²

The original 60-day comment period provided in the May 11, 2007, proposed rule was extended by notice (72 FR 37500; July 10, 2007) for an additional 30 days. When the public comment period ended on August 10, 2007, HUD had received approximately 15,000 public

² November 2005 GAO Report, pp. 3-4. This report can be found at <http://www.gao.gov/new.items/d0624.pdf>.)

comments on the proposed rule, mostly brief statements in similar format and wording that opposed the rule and urged HUD not to eliminate downpayment assistance in connection with FHA-insured mortgages.

On October 1, 2007, HUD promulgated the rule, with a few clarifying revisions, as a final rule to be effective October 31, 2007. The October 1, 2007, rule clarified that a tribal government or a tribally designated housing entity (TDHE), as defined at 25 U.S.C. 4103(21), is a permissible source of downpayment assistance if prerequisites in the rule were satisfied, and also more closely aligned the description of tax-exempt charitable organizations with the description used by the Internal Revenue Service (IRS) for such organizations. This rule never went into effect, however, since it was enjoined and then vacated by the courts.

II. Historical Policy Regarding Seller-Funded Downpayment Assistance

The issue of SFDPA came to HUD's attention in the late 1990s. When this funding scheme first came into being, some local HUD offices approved mortgages with SFDPA for FHA insurance, and other HUD offices did not. As a result, in 1997, a provider of this type of assistance brought a lawsuit against HUD (*Nehemiah Progressive Housing Development Corporation v. Cuomo, et al.*, No. S-97-2311-GEB/PAN (E.D. Cal.)) seeking consistent treatment. That suit was settled when the plaintiff's status was confirmed as a tax-exempt charitable organization under Internal Revenue Code (IRC) section 501(c)(3), a permissible source of assistance. HUD also acknowledged that based upon the program-specific information accompanying the plaintiff's submission to the IRS, the program complied with HUD's regulations and guidance pertaining to the source of funds for the borrowers' downpayments. Although downpayment assistance from charitable organizations is permitted, HUD continued to have concerns where the funds provided by an organization to the homebuyer were reimbursed

by the seller in the transaction when the seller made a contribution of funds to the charitable organization, often after loan closing.

HUD addressed the subject of prohibited sources of downpayment assistance in a 1999 proposed rule. (See HUD's proposed rule published on September 14, 1999, 64 FR 49956.) In 2001, HUD withdrew the 1999 proposed rule, which had received a large number of public comments critical of the proposal. (See January 12, 2001, notice of withdrawal of proposed rule at 66 FR 2851.) At the time, the volume of loans with such assistance and their potential impact were small. Also, because the payment to the buyers did not come directly from the sellers, it was not clear that inducements to purchase were present in the transactions. Moreover, while FHA had serious concerns about SFDPA, it lacked the historical data to substantiate its adverse effects.

By 2003, with the seller-funded downpayment assistance business growing exponentially, FHA had data tending to show that the performance of the loans made to borrowers relying on SFDPA was poor and that the program flaws could not be addressed with underwriting changes. FHA determined that the most feasible and appropriate solution was to create a new FHA insurance product to serve consumers who were unable to save funds for a downpayment, which would obviate the need for seller-funded downpayment assistance.

In early 2004, a bill was introduced in Congress that would provide FHA with authority to insure a 100 percent financing product.³ At the same time, FHA commissioned an independent research firm, Concentrance Consulting Group, Inc., to conduct a comprehensive examination of downpayment gift programs administered by nonprofit organizations. The report was the culmination of a 10-month effort, beginning in January 2004, to understand the influence

³ See H.R. 3755, Zero Downpayment Act of 2004, at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:h3755ih.txt.pdf.

of seller-funded nonproft downpayment assistance on FHA-insured home loans. The study involved travel to 10 cities and interviews of more than 400 persons involved in mortgage transactions—from homebuyers and sellers to realtors, appraisers, underwriters, loan officers, builders, and downpayment assistance providers. Published on March 1, 2005, the report focused on the operational aspects of the programs in an effort to understand the financial relationships between the various parties involved. It highlighted the harmful features of the programs and concluded that the programs create unsustainable homeownership arrangements.⁴ The report served as the basis for FHA’s strong push for new legislative authority to offer a 100 percent financing option to borrowers who might otherwise rely on a risky SFDPA program.

In June 2005, when Congress introduced another piece of Zero Down legislation, H.R. 3043,⁵ a reformulation of the previous bill, HUD supported the bill because an FHA Zero Down product would be a more affordable, yet still financially sound, alternative for families without savings for a downpayment.⁶

Also in 2005, the research arm of Congress, GAO, produced two reports concerning the risks associated with various proposed and existing FHA insurance products, including loans with zero downpayment and those with SFDPA.⁷ HUD agrees with the court, in *Ameridream, Inc., v. Jackson* and *Penobscot Indian Nation v. HUD*, that the first of these two reports (the

⁴ *An Examination of Downpayment Gift Programs Administered by Non-Profit Organizations*, Final Report, HUD Contract C-OPC-22550/M0001, March 1, 2005. Available at: www.hud.gov/offices/hsg/comp/rpts/dpassist/conmenu.cfm.

⁵ See H.R. 3043, Zero Downpayment Pilot Program Act of 2005, at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_bills&docid=f:h3043ih.txt.pdf.

⁶ An FHA zero downpayment product would not pose the credit risks associated with SFDPA, for a number of reasons. First, homebuyers would understand upfront that they are buying a home with no initial equity and would have a realistic view of their options for resale. Also, underwriting requirements and insurance pricing are more easily developed and enforced when tied to a loan product than when tied to variable downpayment sources. In addition, the zero downpayment option is not tied to a particular property whose seller participates in an SFDPA program so that homebuyers can shop and negotiate with any number of sellers with the same bargaining power as a buyer with a true equity investment, which would also help prevent the concentration of 100 percent LTV loans in weak housing markets.

⁷ See Report No. 05-194, Mortgage Financing: Actions Needed to Help FHA Manage Risks from New Mortgage Loan Products (February 2005); and November 2005 GAO Report.

February 2005 report discussing proposed FHA insurance products) provides little meaningful support for the current rule, which addresses the risks associated with SFDPA. However, the November 2005 GAO Report directly addressed the risks associated with loans with SFDPA and represents independent corroboration of the findings of HUD's internal data analyses and the Concentrance study.

The November 2005 GAO Report found that the problems associated with SFDPA loans (e.g., home price inflation and risk of defaults) are grave enough to merit an outright ban on SFDPA. The FHA Commissioner responded to the GAO's draft report in a letter dated October 25, 2005, which is incorporated in the final published report. The Commissioner acknowledged that GAO's findings confirmed FHA's own analysis and those of the Concentrance study, but expressed the agency's reasons for not pursuing GAO's recommended ban on SFDPA. The Commissioner expressed the agency's desire to provide safer financing without having to exclude traditional FHA borrowers, who are often in need of downpayment funds, and pointed to FHA's pursuit of a zero downpayment insurance product and higher insurance premiums as better alternatives to achieve those goals than banning SFDPA would be. The response to GAO also reiterated a legal opinion of HUD's Office of General Counsel that the structure and the timing of payments in SFDPA transactions did not violate the letter of HUD's underwriting guidelines.⁸

For the reasons noted in the October 25, 2005, response letter to GAO, HUD continued to tolerate SFDPA programs, even though HUD had an ongoing concern about the risks inherent in SFDPA-generated loans, especially given the ever-increasing proportion of these loans in FHA's portfolio.

In May 2006, the IRS issued Revenue Ruling 2006-27, which analyzed a model

⁸ See November 2005 GAO Report, pp. 89-91.

transaction typical of SFDPA programs and explained that organizations participating in such programs do not qualify as organizations described in IRC section 501(c)(3), because the assistance involved not a downpayment gift, but rather, “represents a rebate or purchase price reduction.” The Revenue Ruling stated that in these transactions, the so-called downpayment gifts “do not proceed from detached and disinterested generosity, but are in response to an anticipated economic benefit, namely facilitating the sale of a seller’s home.”

HUD acknowledges the court’s finding in *Ameridream, Inc., v. Jackson* and *Penobscot Indian Nation v. HUD* that IRS Revenue Ruling 2006-27 on its face does not prove that seller-funded downpayment assistance loans are inherently and unacceptably risky. Nevertheless, the Revenue Ruling reinforced HUD’s concerns with these transactions through its determination that they do not involve a gift, but a *quid pro quo*. The Revenue Ruling also highlighted an inconsistency in HUD’s prior interpretation of these transactions with those of other Executive Branch agencies.

HUD did not take regulatory action at any point in time from 1999 through 2006, because the agency was anticipating a legislative solution to the problem. During that time frame, the portion of borrowers relying on SFDPA grew to represent over a third of all home purchase loans insured by FHA. As a result of the growth in the business and the poor performance, these loans have increased risk to FHA’s fiscal soundness, a risk that threatens the opportunities of all (not just homeowners in need of downpayment assistance) to obtain single family FHA-insured financing. Because no legislative solution has yet materialized, HUD determined that the most prudent option was, and remains, to prohibit SFDPA through the rule that HUD initially proposed on May 11, 2007.

III. HUD’s Analysis of Its Loan Portfolio Data

A. HUD's Database

HUD, using information submitted by lenders, regularly monitors the performance of FHA-insured loans. Since the mid-1990s, FHA has maintained a Single Family Data Warehouse (SFDW), where data from its various program systems are uploaded on a monthly basis. At the present time, the SFDW contains 34,000,000 records, each capturing the characteristics and performance of a loan insured by FHA. Because each FHA program system uses the same case number for each insured loan, the SFDW is able to link more than 400 fields containing borrower demographic and loan application, origination, termination, and recovery data in one database. These data are used by an independent contractor to assess the performance of insured loans for the annual actuarial review of the Mutual Mortgage Insurance Fund (MMIF or Fund), FHA's largest insurance fund. These data are also used by HUD staff to calculate FHA's mortgage insurance liability for FHA's annual financial statements and to estimate credit subsidy for HUD's budget. For this reason, the data are audited by the independent auditor hired by HUD's Office of Inspector General and are closely reviewed by the Office of Management and Budget (OMB).

For the single-family portfolio, HUD's monitoring includes tracking performance by source of downpayment funds, such as the borrower's own funds, or funds provided by family members, government agencies, or nonprofit organizations, as reported to HUD by lenders. The "nonprofit" category source of downpayment funds consists of entities that hold the status of charitable organizations. Analysis of the data, however, indicates, by identifying the entities that provide the downpayment assistance, that more than 95 percent of the downpayment assistance provided under the "nonprofit" category is seller-funded.⁹ Therefore, the term "nonprofit," as

⁹ This comports with the November 2005 GAO Report indicating that about 93 percent of assistance from nonprofit organizations was funded by sellers. See November 2005 GAO Report, p. 14.

used in this preamble discussion and tables, refers to organizations that hold the status of charitable organizations and provided SFDPA. Though HUD does not publish information on performance by downpayment source in formal reports, the data are regularly reviewed internally by HUD, and they have been made available at various times to GAO, OMB, and Congress. As demonstrated by the discussion in this preamble and the related tables included in the Appendix to this publication, loan performance data maintained by HUD on FHA-insured mortgages has provided a consistent story over time: loans with nonprofit downpayment assistance, i.e., SFDPA, perform much worse than do other single family loans insured by FHA.

To give the public the opportunity to examine and comment fully on HUD's data analyses, HUD is making the underlying data available online during this additional comment period. The data files provide loan-level records that will enable interested parties to explore issues regarding downpayment assistance provided to homebuyers utilizing FHA insured mortgage financing. The files are compressed using standard protocols that should be readable by a wide variety of software. The particular software product used to create these files is WinZip 9.0 (SR-1). The URL for the FHA Purchase Loan Endorsement Data webpage is: <http://www.hud.gov/offices/hsg/comp/rpts/pled/pledmenu.cfm>.

B. Increase of Seller-Funded Downpayment Assistance Loans

The substantial increase over time of loans with downpayment assistance from nonprofit groups (nonprofit-assisted loans) in the FHA-insured single-family portfolio has dramatically changed the fundamental insurance risk of that portfolio. As can be seen in Table 1 in the Appendix to this rule, these loans in Fiscal Year (FY) 2007 made up more than 35 percent of all home purchase loans insured by FHA. In FY 2000, they were less than 2 percent of FHA's single family purchase loan activity.

As the discussion and data presented below demonstrate, the substantial increase over time of nonprofit-assisted loans has created a financially unsustainable situation for the FHA insurance fund. Table 1, as noted, and all the other Tables referenced in this preamble discussion appear in the Appendix at the end of this document.

C. Default and Claim Rate Comparisons for Loans with Nonprofit Downpayment

Assistance

1. Default Rates

Tables 2, 3, and 4 provide a summary of default rates on home purchase loans insured by FHA. Default is measured here as a loan that is at least 90 days in arrears. Since the 1980s, loan servicers have reported to HUD all 90-day default events for FHA-insured loans. Activity on each default episode is reported to HUD until there is a final resolution, be that a cure of the default, a foreclosure, or some other outcome.¹⁰ Three summary statistics are used here—the early default rate, the ever-defaulted rate, and the current default rate. Each one is calculated separately by source of downpayment funds used to purchase the home, and shown by year of insurance endorsement (i.e., an “insurance cohort”). The left half of each table lists the calculated default rates, and the right half provides a direct comparison of the performance of loans receiving each type of downpayment assistance with the performance of loans in which borrowers use their own funds for the downpayment. The comparisons in each table show that nonprofit downpayment-assisted loans have the highest default rates among all FHA-insured home-purchase loans.

The first default statistic, shown in Table 2, is the early default rate. It measures the share

¹⁰ Since October 2006, HUD has collected information on all loan defaults, starting at 30-days delinquency. Ninety-day delinquencies, however, are an industry standard for defining the point at which foreclosure (and insurance claim payment) become a significant concern. Therefore, HUD analysis of the potential risk of insurance claim payments continues to use 90-day delinquency as the defining metric of default.

of loans that experience a (90-day) default within the first 24 months of scheduled mortgage payments, and is calculated by dividing the number of such loans by the total number of insured loans in an insurance cohort. HUD uses this statistic as a first indication of the level of claim payments that might be expected from any given insurance cohort. The ratios found on the right-hand side of Table 2 are calculated by dividing the early-default rate for each type of downpayment assistance by the default rate for loans with borrower-funded downpayments, within each insurance cohort.

The early default rate of loans with nonprofit downpayment assistance has consistently been more than twice the rate found on loans with borrower-funded downpayments, with the average multiple across the FY 2000 – 2005 period being 2.43. The early default rate for loans with nonprofit downpayment assistance is also nearly twice that of loans with downpayments provided by a family member. These early default rate comparisons are a leading indicator of eventual foreclosure and claim rate patterns, as will be seen in Tables 5 and 6. Loans with nonprofit downpayment assistance have elevated foreclosure and claim rates commensurate with their elevated early default rates.

The second default statistic, found in Table 3, is the ever-defaulted rate. This measures the share of borrowers who have ever had a delinquency that extended beyond 90 days. It is calculated by dividing the number of borrowers with at least one (90-day) default since loan origination by the number of insured loans in an insurance cohort. The ratios on the right-hand side of Table 3 are calculated like those in Table 2. The ratio of the ever-defaulted rate for nonprofit downpayment-assisted homebuyers, to that of homebuyers with FHA-insured loans using their own downpayment funds, is at or above 2.00 for all insurance cohorts since FY 2003 and close to that mark for FY 2002. The FY 2007 insurance cohort shows the same pattern as

have earlier insurance cohorts. The second default statistic shows that, for loans endorsed from 2000 to 2005, between approximately 24 and 29 percent of loans with seller-funded assistance had experienced a 90-day delinquency, compared to approximately 11 to 16 percent of loans without downpayment assistance. This default statistic is consistent with GAO's findings in 2005 that loans with downpayment assistance from seller-funded nonprofit organizations do not perform as well as loans with downpayment assistance from other sources. GAO used samples of FHA-insured, single family purchase money loans endorsed in 2000, 2001, and 2002 and concluded that between 22 and 28 percent of loans with seller-funded assistance had experienced a 90-day delinquency, compared to 11 to 16 percent of loans with downpayment assistance from other sources and 8 to 12 percent of loans without downpayment assistance.¹¹

The last default statistic shown in the Appendix is the current default rate (Table 4). That measure is a snapshot at a point in time that focuses on all loans still active on a given date. The date used for this snapshot is February 29, 2008. The current default rate is computed by dividing the number of loans in default on that date by the number of loans active on the same date in an insurance cohort. The "Nonprofit" column in the right-hand side ("Ratios...") of Table 4 shows that the share of loans with nonprofit downpayment assistance that were in default on the snapshot date was near or above two times that of home-purchase loans with borrower-funded downpayments for all insurance cohorts since FY 2001. One will notice that the current-default-rate ratios for older insurance cohorts are somewhat smaller than those for new insurance cohorts. This difference is primarily due to the fact that the weakest loans in those older insurance cohorts have already gone to foreclosure and claim, leaving fewer weak loans to default in the present. When the entire nonprofit downpayment assistance portfolio is compared to the entire borrower-funded downpayment assistance portfolio, across all insurance cohort

¹¹ November 2005 GAO Report, pp. 26-27.

years, the default-rate ratio on February 29, 2008, was 1.80. The actual default rate for loans with nonprofit downpayment assistance shown on the left-hand side of Table 4 was 11.19 percent and that for borrower-funded purchase loans was 6.22 percent.

2. Historical Claim Rates

Table 5 focuses on the insurance claim-payment experience of FHA, comparing home purchase loans by source of downpayment funds and by year of insurance cohort. Claims generally are paid by FHA to lenders after a lender acquires title to a property, generally through a foreclosure process.¹² The metric used in the left-hand panel of Table 5 is the to-date claim rate, which measures the number of insurance claims paid as a percentage of all loans insured by FHA, as of a given date. The date used here is February 29, 2008. Insurance cohorts that are older will have had more time for borrowers whose defaults result in foreclosure and an FHA insurance claim. Consequently, to-date claim rates for the FY 2000 and FY 2001 insurance cohorts are greater than those for more recent insurance cohorts.

The data in Table 5 indicate that when nonprofit downpayment assistance is provided, borrowers, as a group, are less likely to sustain the financial responsibilities of a home mortgage than are borrowers receiving downpayment funds from other sources. With to-date claim rates that exceed three times those of borrower-funded purchase loans, the insurance risk is higher than FHA has ever considered acceptable. Such high claim rates cause significant harm to families who are displaced by foreclosures, and they also have the potential of destabilizing neighborhoods.

3. Projected Lifetime Claim Rates

Each year, HUD hires an independent contractor to perform a full actuarial study of its

¹² The lender/servicer bids at the foreclosure auction. Once the foreclosure has been completed, the lender/servicer, as the winning bidder, usually transfers title of the property to HUD. FHA then pays an insurance claim to the lender upon conveyance of acceptable title to HUD.

single family insured portfolio. That study, which is required by law, covers all insurance programs under the umbrella of the MMIF. The Fund encompasses around 90 percent of all FHA single family insurance activity. Loans not included are those for condominiums and section 203(k) purchase-and-rehabilitation loans, along with some minor targeted programs.¹³ The formal Actuarial Review published from the actuarial study measures to-date performance of each insurance cohort, and provides projections of ultimate claim rates over the 30-year life of each insurance cohort. That Actuarial Review is forwarded to Congress each year. The work of the independent contractor is also scrutinized each year by independent auditors hired by the Office of the Inspector General at HUD.

For the last 3 years, the actuarial study contractor has identified nonprofit downpayment assistance as adding an especially high risk factor to the FHA portfolio. First, in the FY 2005 Actuarial Review (available at <http://www.hud.gov/offices/hsg/comp/rpts/actr/2005actr.cfm>), statistical results were presented that showed the additional risk of claim in any given calendar quarter arising from various forms of downpayment assistance. The additional risk posed by nonprofit downpayment assistance was measured as three times that from family downpayment assistance, and 1.5 times that from government assistance.¹⁴ The FY 2006 Actuarial Review (available at <http://www.hud.gov/offices/hsg/comp/rpts/actr/2006actr.cfm>) alerted HUD that continued high concentrations of business coming from loans with nonprofit downpayment assistance would cause FHA to suffer net losses.¹⁵

The FY 2007 actuarial study and Actuarial Review provide a new level of analysis on expected claim rates over the life of FHA-insured loans. Since the statistical model that predicts claims now includes a factor for borrower credit scores, the actuarial study contractor was able to

¹³ These other loans are insured under the General and the Special Risk Insurance Funds.

¹⁴ See Exhibit A-2 on p. A-19 of the FY 2005 Actuarial Review.

¹⁵ See discussion on p. 49 of the FY 2006 Actuarial Review, and Exhibit V-5 on p. 50.

provide HUD with projections of lifetime claim rates by cross-sections of credit-score and loan-to-value (LTV) classes. Table 6 shows such cross-sections for loans insured in 3 recent years, FY 2005, FY 2006, and FY 2007. High-LTV loans are separated into those with nonprofit downpayment assistance, and those without. Only the high-LTV group (above 95% LTV) needs this separation because property sellers that participate in, and contribute to the nonprofit programs, generally provide only the minimum required 3 percent downpayment. The ratio of projected claim rates on nonprofit assisted loans to other above-95%-LTV loans is presented in the last column of Table 6.

Comparisons found in Table 6 show smaller differences in lifetime claim rates than might be inferred from differences in the to-date claim rates presented in Table 5. One reason for the difference is the comparison in Table 6 is made only on high-LTV loans, which have higher claim rates than do lower-LTV loans. Comparisons in Tables 2, 3, 4, and 5, however, are across all LTV ranges. Nevertheless, for all three insurance cohorts shown in Table 6, loans with nonprofit downpayment assistance are more than twice as likely to go to foreclosure and FHA insurance claim over their lifetime as all other high-LTV loans.

As claim rates rise for all loans insured during housing market downturns, such as FY 2007, the high insurance claim ratio for loans with nonprofit downpayment assistance and the large share of loans utilizing those downpayment assistance programs present a severe financial challenge to FHA. The expected lifetime claim rate on loans with nonprofit downpayment assistance in the FY 2005 insurance cohort is close to 17 percent, and for FY 2007 is above 28 percent. The 16.79 percent for FY 2005 contrasts with a 6.94 percent expected lifetime claim rate for other high-LTV loans insured during the same period. FY 2007 is a particularly challenging year as it starts with a decline in home prices across much of the nation. The 28.49

percent expected claim rate on loans with nonprofit downpayment assistance insured in FY 2007 contrasts with a 12.25 percent expected claim rate on all other high-LTV loans. It is not possible under current law to charge insurance premiums in an amount sufficient to cover this increased insurance claim risk, even if the maximum allowable insurance premiums were charged to all FHA-insured homebuyers.¹⁶

The claim rates shown in Table 6 are under the base case economic scenario of August 2007, which relied upon forecasts of house prices and interest rates provided by Global Insight Inc. Since that time, housing market conditions have deteriorated more than was expected, and the projected claim rates on the FY 2005 to FY 2007 insurance cohorts are now even higher than those shown in Table 6. Because the expected claim rates on loans with nonprofit downpayment assistance are well above the rate that can be supported by reasonable premium charges in normal economic conditions, the financial problems caused by these loans are only compounded during housing market downturns.

4. Higher Losses on Claims

An additional problem with loans with nonprofit downpayment assistance is that homes purchased using this form of assistance are often purchased at inflated prices. The price increase is made, or the seller refrains from accepting a lower price that would have been acceptable in an arms-length transaction, so that the seller can receive the same net proceeds from selling to the homebuyer needing downpayment assistance, as the seller would receive from a buyer without downpayment assistance. This business practice was confirmed in a field study performed for HUD by an independent contractor, and statistically validated in research performed by the GAO.¹⁷

¹⁶ See mortgage insurance premium rates at 12 U.S.C. 1709(c)(2).

¹⁷ The contractor study is that of Concentrance Consulting Group, Inc., *An Examination of Downpayment Gift*

In the November 2005 GAO Report, the GAO analyzed “a sample of FHA-insured loans settled in March 2005,” and found that “for loans with seller-funded down payment assistance, the appraised value and sales price were higher as compared with loans without such assistance.”¹⁸ The March 2005 study by Concentrance Consulting Group, commissioned by HUD, interviewed more than 400 persons involved in the mortgage industry and corroborates GAO’s assessment. The Concentrance study “found overwhelming evidence that the cost of the seller-funded down payment assistance is added to the sales price, which then increases the allowable FHA loan amount and eliminates any borrower equity in the property.”¹⁹ Such an inflated sale price does not represent the true value of the property and leads to a higher mortgage amount.

The effect on FHA, in addition to an increase in the amount of insurance claim payments, is increased net losses after disposing of foreclosed properties. Not only do loans with nonprofit assistance have significantly elevated insurance claim rates, 76 percent greater according to the same GAO study,²⁰ but FHA ultimately suffers greater losses on those claims. The FY 2006 Actuarial Review documents differentiate net loss rates—as a percentage of the unpaid loan balance at the time of default and claim—by loans having or not having nonprofit downpayment assistance (see Appendix B of the FY 2006 Actuarial Review).

D. FHA Insurance Fund Solvency

FHA program data is used by an independent contractor to conduct the annual actuarial review of the MMIF, FHA’s largest insurance fund. MMIF programs are required to be self-supporting and to generate sufficient receipts to fund a Capital Reserve Account in an amount

Programs Administered by Non-Profit Organizations, *ibid.* The GAO study is the November 2005 GAO Report.

¹⁸ November 2005 GAO Report, pp. 22-23.

¹⁹ Concentrance Consulting Group Report, p 6.

²⁰ November 2005 GAO Report, p. 32

equal to at least 2 percent of its outstanding insurance-in-force. (See 12 U.S.C. 1711(f).) This Account provides a vehicle for recording the balance of payments between MMIF programs and the federal budget over time. Growth of the Reserve Account occurs as MMIF programs generate budget receipts and as Account balances earn interest over time. Reserve Account balances fall when HUD needs to fund unexpected claims on outstanding loan guarantees. In its 74-year history, the MMIF has always been self-supporting and never required additional appropriations beyond its initial capitalization in 1934, which was paid back by FHA decades ago.

All funds associated with MMIF insurance program operations—including premium collections, claim payments, and proceeds from the sale of foreclosed properties—flow through a separate MMIF Financing Account. In accordance with the Federal Credit Reform Act of 1990, 2 U.S.C. 661, *et seq.*, which requires agencies to estimate the long-term cost to the government of guaranteeing credit (referred to as “the subsidy cost”), FHA must maintain a balance in the MMIF Financing Account for each insurance cohort (i.e., the loans endorsed in a single fiscal year) sufficient to cover the net cash outflows projected for the insurance cohort over its lifetime. Each year, in the course of preparing the President’s Budget, FHA estimates the subsidy cost for the upcoming insurance cohort. As long as expected premium revenues outweigh expected claim costs, HUD can fund the required Financing Account balance and provide net budget receipts that help build Capital Reserve Account balances. Were a situation to arise in which expected premium revenues could not cover expected claim costs, then FHA programs would require a budget appropriation from Congress to help fund the required Financing Account balance.

In order for FHA MMIF programs to both maintain required capital reserves and avoid

budgetary appropriations, they must be managed in such a way that generates what is called a “negative credit subsidy rate.” The credit subsidy rate (CSR) is the ratio of expected budget outlays or receipts to expected loan volumes. The CSR also is the government’s estimated long-term cost, excluding administrative costs, as a percentage of the amount of loans guaranteed. The rate is calculated on a net present value basis over the life of the loans guaranteed in a given fiscal year. The CSR is thus a helpful summary measure of actuarial soundness.

HUD currently has an internal target for a normal-economy CSR of around -1.00 percent for MMIF programs in an insurance cohort. The negative sign means negative outlays, which translates into positive budget receipts. Having such a target provides a cushion for economic downturns, minimizing the chance that the CSR could actually turn positive. Such a target, however, is impossible to achieve today with the resource drain caused by SFDPA. Taken as a whole, loans with SFDPA have a CSR of over +6.00 percent, which means that supporting them costs the FHA program 6 cents for every dollar of these insured loans. Current premium rates cannot cover the cost of such a large CSR for these downpayment-assisted loans. HUD is at the point where continuing to support loans with SFDPA will require budget appropriations for all of the FHA MMIF loans.

On the basis of the FY 2007 independent Actuarial Review, FHA has estimated its credit subsidy requirements for FY 2009. FHA has concluded that if it continued to charge the same 1.5 percent up-front and 50 basis point annual insurance premiums, and continued to serve the same mix of borrowers it served in FY 2007, including the same share using SFDPA, the MMIF program would have a positive credit subsidy rate of 1.12 percent. Assuming estimated loan-guarantee obligations of \$110 billion, the MMIF program would require a credit subsidy appropriation of \$1.4 billion in order to begin operations in FY 2009. To ward off this

eventuality, HUD is proposing to eliminate SFDPA.

E. Sustainable Cross-Subsidization

The data presented above in HUD's analysis of its loan portfolio shows the poor performance of loans with SFDPA relative to loans without such assistance. Due to this poor performance, borrowers with SFDPA require an unsustainable level of premium cross-subsidies from other borrowers. Any attempt to raise premiums to help to cover part of that cost could result in other borrowers being discouraged from using financing with FHA mortgage insurance by the high relative cost to them of providing cross-subsidies to the seller-funded portfolio. This phenomenon is known as "adverse selection" and results in the need to continually raise premiums when the pool of cross-subsidizing borrowers declines with each round of price/premium increases. By proposing to eliminate FHA insurance on loans with SFDPA, FHA is endeavoring to reestablish a sustainable level of cross-subsidization in its portfolio so that it can serve more homebuyers, including first-time and minority homebuyers, without the continual need for appropriations. Avoiding a general premium-rate increase is all the more important because lower-income borrowers, who benefit most from FHA's MMIF program, are concentrated in its *less* risky credit score and loan-to-value categories of borrowers, i.e., the categories that would be discouraged from using the program by higher premium rates. See Table 7.

Table 8 shows the distribution of FHA-insured purchase loans in FY 2007, over FICO²¹ and loan-to-value ratio categories. Purchase loans with SFDPA appear in the SFDPA row. In FY 2007, such homebuyers constituted over 33 percent of FHA-insured homebuyers (see Table 8).

Table 9 shows the expected lifetime claim rates for purchase loans in each of the FICO

²¹ FICO is a credit score developed by Fair Isaac Corporation and is an acronym for it.

and LTV categories defined in Table 8. Expected claim rates increase with increases in LTV and with decreases in FICO scores. That is, they rise as one moves from the upper left to the lower right of the table. Some of these groups of borrowers have excessively high claim rates—above 25 percent. HUD has determined that such high rates are incompatible with homeownership sustainability. In the worst case, borrowers with SFDPA who have FICO scores below 500 have expected claim rates of 61.4 percent. While these borrowers constituted only 0.6 percent of all purchase loans endorsed in FY 2007 (see Table 8), for all homebuyers with SFDPA, the weighted average expected claim rate was over 28 percent.

Even a small number of borrowers with very high expected claim rates places a substantial burden on the remaining borrowers who must provide premium revenues sufficient to cover losses incurred on the high claim-rate group. Table 10 shows credit subsidy rates calculated for loans in each FICO and LTV grouping. It shows that credit subsidy rates for different categories of borrowers vary between -2.95 percent and +20.41 percent. A credit subsidy rate of -2.0 percent generates \$2,000 in receipts on a \$100,000 loan and \$4,000 on a \$200,000 loan. On the other hand, a credit subsidy rate of +20.4 percent requires \$20,400 in subsidies—from some combination of higher premiums on all borrowers and direct budget appropriations—for a \$100,000 loan and \$40,800 in subsidies for a \$200,000 loan. With such high positive credit subsidy requirements, too many borrowers with good credit are needed to offset the cost of higher-risk, and frequently higher-income, borrowers. Under current law, FHA is prevented from raising up-front premiums above 2.25 percent or annual premiums above 55 basis points. (See 12 U.S.C. 1709(c)(2).) Nevertheless, one might ask whether it would be possible to charge sufficient premiums for loans with SFDPA so that they would not require cross-subsidization. Table 11 shows break-even up-front and annual premiums for SFDPA loans

by FICO score category. Except for borrowers with FICO scores greater than 680, up-front and annual premiums would have to be raised to very high levels—for example, 5.56 percent upfront and 0.55 percent annually for borrowers with FICO scores between 640 and 680, and 12.09 percent up-front and 2.0 percent annually for borrowers with FICO scores between 500 and 560. Therefore, under the current law, it is not possible to fully offset the risk of SFDPA simply by raising premiums. Even if there were no statutory cap on premium rates charged by FHA, however, it is unlikely that borrowers would opt for an FHA-insured mortgage if the insurance premiums were raised as high as needed to ensure the sustainability of the insurance fund in a scenario where SFDPA is allowed to continue. The large up-front premiums alone, when added to the initial loan balance, would increase expected claim rates even more, as borrowers could have to wait many years before they could sell their properties free-and-clear. Therefore, raising premium rates to extraordinary levels would not be a viable solution, even if the Congress were to authorize such.

IV. Downpayment Assistance From Nonprofits or Any Other Sources – Financial Benefit Prohibited.

Although the data and discussion above demonstrating the negative default, claim, and other adverse effects of SFDPA are focused on nonprofit organizations, the rule, if implemented, would have broader application. It would prohibit a mortgagor's required cash investment from consisting, in whole or part, of funds provided by the seller, or any other person or entity that financially benefits from the transaction, or any third party or entity reimbursed by the seller or other person or entity that financially benefits from the transaction. HUD has determined that this broader prohibition is appropriate and justified, as discussed below.

HUD is not singling out nonprofit organizations in proposing to prohibit SFDPA because

the same scheme of funneling or advancing funds for the seller, through an intermediary, to the homebuyer can be accomplished using any person or entity as the intermediary or using any number or layers of intermediaries. HUD's rule would apply to all such transactions. Whenever the funds for the homebuyer's required investment in the property are provided by a party that financially benefits from the sale of the property, the transaction is distorted by the provider's interest in inducing a purchase on any terms, in conflict with the borrower's and FHA's interest in achieving sustainable homeownership through a sustainable mortgage. This conflict is not abated when such funds are provided by an intermediary reimbursed by the party that financially benefits. It is present whether the seller provides the funds directly to the homebuyer or indirectly through an intermediary to the homebuyer.

Further, when the source of downpayment funds financially benefits from the transaction, the downpayment amount is likely to be added to the sales price to ensure that the funder's net benefit is not diminished. Any cost to the buyer added to the transaction adds to the long-term financial burden to the mortgagor and increases the loan amount insured by HUD, thereby increasing HUD's risk exposure in the event of an insurance claim.

While it is not certain that the downpayment funder's cost will be added dollar for dollar to the transaction in every instance, it would be an extreme administrative burden to HUD, if not an outright impossibility, to ensure that the addition of cost has not occurred. Even if the cost is not added to the sales price, and the property is sold for its appraised value, it may be deduced that the seller has refrained from accepting a lower price that would have otherwise been acceptable in an arms-length transaction. Therefore, the rule would prohibit downpayment assistance from any sources that financially benefit from the transaction in order to eliminate, not only the conflict of interest, but the potential for additional financial burden imposed upon the

mortgagor and added insurance risk to HUD.

HUD considers it reasonable to conclude that the problems associated with SFDPA from nonprofit organizations would appear in connection with seller- (or other financial beneficiary-) funded downpayment assistance from any other sources. The potential for problems to arise is not related to the nature of the intermediary that serves as the conduit for the assistance but to the *quid pro quo* relationship between the funding of a downpayment and the funder's receipt of a financial benefit. Thus, for example, although the rule generally permits a gift from a family member to be used by the mortgagor to meet the minimum investment requirement, a payment from a family member who is reimbursed by the seller, or by another party that financially benefits from the transaction, would not be permitted by the rule. The same outcome would result if the payment to the mortgagor came from a nonprofit organization, a government agency, a tribal government, or any other intermediary; if the intermediary that serves as the conduit for the payment is reimbursed by the seller or other party that financially benefits, the payment would not be permitted. A transaction-distorting conflict of interest with the potential for adding an above-market burden on the borrower and increased risk to the FHA fund is present in each such instance.

This rule would not disturb the programs of direct homeownership assistance that are administered by private, charitable organizations or state, local, and tribal governments that are not dependent upon payment or reimbursement of the assistance by a seller or other party that benefits financially from a transaction. Programs acceptable to HUD do not contain the conflict of interest inherent in programs and transactions in which downpayment assistance is linked to a payment or reimbursement by the seller or other entity that financially benefits from the transaction. For these reasons, HUD would continue to allow programs in which the

downpayment assistance is not linked to a payment or reimbursement by the seller or other entity that benefits financially from the transaction.

V. Findings and Certifications

Regulatory Planning and Review

The Office of Management and Budget (OMB) reviewed the rule under Executive Order 12866, Regulatory Planning and Review. OMB determined that the rule is a “significant regulatory action,” as defined in section 3(f) of the Order (although not an economically significant regulatory action under the Order). The docket file is available for public inspection in the Regulations Division, Office of General Counsel, 451 Seventh Street, SW, Room 10276, Washington, DC 20410-0500.

Environmental Review

A Finding of No Significant Impact was not required for the proposed rule. Under 24 CFR 50.19(b)(6), the rule is categorically excluded from the requirements of the National Environmental Policy Act (42 U.S.C. 4332 et seq.) and that categorical exclusion continues to apply.

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.

The entities directly affected by this rule are FHA-approved “direct endorsement” (DE) lenders, i.e., mortgage lenders that are approved to underwrite and endorse their loans for FHA insurance, that must follow FHA requirements to have a loan insured by the FHA, and that are

the party “insured” by FHA. While other types of entities may be indirectly affected by this rule, the RFA does not cover such indirect effects.

As a result of this rule, DE lenders would no longer be able to obtain FHA insurance for loans with seller-funded downpayment assistance. Therefore, the economic impact, if any, of the rule on regulated entities may be estimated by attempting to determine what proportion of DE lenders’ loan volume will be affected by the rule (i.e., what proportion consists of FHA-insured loans with seller-funded downpayment assistance) and how much, if any, revenue and profit DE lenders would forgo as a result of FHA no longer being able to insure that particular category of loans.

A. Estimating the Number of Small Entities Potentially Affected

To determine if the rule would have a significant economic impact on a substantial number of small entities, HUD first identified the total number of DE lenders, large or small, with current FHA loan activity. According to HUD’s records, there were 1,487 DE lenders that were actively underwriting FHA-insured loans in 2007. The next step in the analysis was to estimate how many of these 1,487 DE lenders would be considered “small entities.” Under the applicable industry classifications, banks and other depository institutions are considered “small entities” if they have \$165 million or less in assets; non-bank mortgage lenders are considered “small” if they have \$6.5 million or less in annual revenues.²² To begin narrowing the field, HUD attempted to identify the subset of DE lenders whose annual revenue from FHA-insured loans was \$6.5 million or less. This was done by multiplying the total dollar volume of FHA-insured loans made by a lender, information that HUD collects on an annual basis, by a factor of

²² U.S. Small Business Administration, Table of Small Business Size Standards Matched to North American Industry Classification System Codes; available at http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sstd_tablepdf.pdf.

four percent, which represents a per-loan revenue estimate typically quoted by FHA lenders. Out of the original universe of 1,487, HUD identified 74 DE lenders whose estimated annual revenue from FHA-insured loans was \$6.5 million or less. This number still overstates the number of DE lenders who actually meet the “small entity test,” because FHA-insured loans typically are not the only line of business or income stream for a DE lender. However, it serves the useful purpose of flagging the subset of DE lenders that potentially fall within the “small entity” definition and thus require further analysis.

The next step in the analysis was to ascertain how many of the 74 flagged DE lenders actually meet the applicable test for “small entity.” As noted above, the test is different depending on whether the entity is a bank or other depository institution, on the one hand, or a non-bank mortgage lender on the other. Sixty-two of the 74 flagged DE lenders were non-bank mortgage lenders; 12 were banks or other depository institutions. With respect to non-bank mortgage lenders, HUD has access to their annual audited financial statements, which they must submit to HUD on-line via the Lender Assessment Sub-System (LASS) in order to renew their FHA lender approval. Of the 62 flagged non-bank mortgage lenders, 36 reported annual revenue that would qualify them as “small entities” under the applicable less-than-\$6.5 million-annual-revenue test.

As noted above, banks and other depository institutions are considered “small entities” if they have \$165 million or less in assets. DE lenders that are banking institutions are not required to supply financial statements through HUD’s LASS. From publicly available annual reports, however, HUD was able to ascertain that none of the 12 flagged banking institutions met this test. Thus, 36 of the 74 flagged DE lenders are small entities subject to this regulation.

B. Estimating the Number of Small Entities That Would Be Significantly Impacted by the Rule

The foregoing discussion demonstrated that there are 36 DE lenders that qualify as “small entities” under the applicable tests. The next step in the analysis is to determine whether the rule is likely to have a significant economic impact on a substantial number of these 36 small entities. In the RFA context, a 10 percent loss of profits is commonly used as a measure of significant impact. HUD does not have access to sufficient data to perform a 10 percent loss-of-profits analysis directly. However, HUD can approximate a 10 percent loss-of-profits analysis by determining whether a DE lender’s total portfolio of FHA-insured loans consists of 10 percent or more loans with seller-funded downpayment assistance. This methodology is more conservative than a straightforward 10 percent loss-of-profits approach, since a 10 percent loss of FHA-insured loan business likely represents a lesser percent of an entity’s overall business. HUD is not aware of any FHA-approved lender whose business consists exclusively of FHA-insured loans; thus, even if a lender’s FHA-insured loan volume fell by a margin of 10 percent or more, its overall profits from all segments of its business would not necessarily be affected by the same margin. Although HUD is unaware of any other institution, public or private, that will insure loans with seller-funded downpayment assistance, the regulation’s impact could be further mitigated to the extent that other SFDPA-loan insurers exist.

Only five of the 36 identified small DE lenders had FY 2007 FHA-insured loan portfolios consisting of at least 10 percent loans with nonprofit downpayment assistance.²³ Therefore, the maximum number of small entities that might be significantly affected by the regulation is 5 out of a field of 36 small DE lenders. Most likely, not even all of these 5 will be significantly

²³ Ninety-two percent of all loans with nonprofit downpayment assistance were made by 5 lenders that are not small entities.

affected, because to the extent they have any revenue-generating activities other than FHA-insured loans, SFDPA FHA-insured loans may well comprise under 10 percent of the entity's total business even if they comprise more than 10 percent of the entity's FHA-insured loan business. In any event, even 5 economically impacted small entities is not in itself a substantial number; nor is it a substantial portion of the total number of small entities in the field.²⁴

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

Executive Order 12612, Federalism

Executive Order 12612 (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 impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order. This rule solely addresses requirements under HUD's FHA mortgage insurance programs.

Unfunded Mandates Reform Act

²⁴ Moreover, when the total number of small entities in the whole relevant industry is considered, including mortgage lenders that are not approved to underwrite FHA loans and are therefore not affected by the regulation, the figure of five small entities that may be significantly impacted becomes even more insubstantial. Based on data provided in the preamble to a rule proposed earlier this year by the Board of Governors of the Federal Reserve System, of the 17,618 depository institutions reporting data to the Board, more than 10,000 were small mortgage lenders. See Truth in Lending: Proposed Rule, 73 Fed. Reg. 1671, 1719 (January 9, 2008). Including small, non-depository mortgage lenders would only increase that universe beyond 10,000.

Title II of the Unfunded Mandates Reform Act of 1995 (Pub. L. 104-4, approved March 22, 1995) established requirements for federal agencies to assess the effects of their regulatory actions on state, local, and tribal governments, and the private sector. This rule does not impose any federal mandates on any state, local, or tribal governments or the private sector within the meaning of the Unfunded Mandates Reform Act of 1995.

Catalog of Federal Domestic Assistance

The Catalog of Federal Domestic Assistance Number for the principal FHA single family mortgage insurance program is 14.117. This rule also applies through cross-referencing to FHA mortgage insurance for condominium units (14.133), and other smaller single family programs.

List of Subjects in 24 CFR Part 203

Loan programs--housing and community development, Mortgage insurance, Reporting and recordkeeping requirements.

Accordingly, the Department amends 24 CFR part 203, as follows:

PART 203--SINGLE FAMILY MORTGAGE INSURANCE

1. The authority citation for part 203 continues to read as follows:

Authority: 12 U.S.C. 1709, 1710, 1715b, 1715z-16, and 1715u; 42 U.S.C. 3535(d).

2. Section 203.19 is revised to read as follows:

§ 203.19 Mortgagor's investment in the property.

(a) Required funds. The mortgagor must have available funds equal to the difference between:

(1) The cost of acquisition, which is the sum of the purchase price of the home and settlement costs acceptable to the Secretary; and

(2) The amount of the insured mortgage.

(b) Mortgagor's minimum cash investment. The required funds under paragraph (a) of this section must include an investment in the property by the mortgagor, in cash or cash equivalent, equal to at least 3 percent of the cost of acquisition, as determined by the Secretary, unless the mortgagor is:

(1) A veteran meeting the requirements of § 203.18(b); or

(2) A disaster victim meeting the requirements of § 203.18(e).

(c) Restrictions on seller funding. Notwithstanding paragraphs (e) and (f) of this section, the funds required by paragraph (a) of this section shall not consist, in whole or in part, of funds provided by any of the following parties before, during, or after closing of the property sale:

(1) The seller or any other person or entity that financially benefits from the transaction;

or

(2) Any third party or entity that is reimbursed, directly or indirectly, by any of the parties described in paragraph (c)(1) of this section.

(d) Gifts and loans usually prohibited for minimum cash investment. A mortgagor may not use funds for any part of the minimum cash investment under paragraph (b) of this section if the funds were obtained through a loan or a gift from any person, except as provided in paragraphs (e) and (f) of this section, respectively.

(e) Permissible sources of loans.

(1) Statutory authorization needed. A statute must authorize a loan as a source of the mortgagor's minimum cash investment under paragraph (b) of this section.

(2) Examples. The following loans are authorized by statute as a source for the minimum investment:

(i) A loan from a family member, a loan to a mortgagor who is at least 60 years old when the mortgage is accepted for insurance, or a loan that is otherwise expressly authorized by section 203(b)(9) of the National Housing Act;

(ii) A loan made or held by, or insured by, a federal, state, or local government agency or instrumentality under terms and conditions approved by the Secretary;

(iii) A loan made or held by, or insured by, a tribal government or an agency or instrumentality thereof, including a tribally designated housing entity as defined at 25 U.S.C. 4103(21), which is treated as a state or local government under applicable state or local law, under terms and conditions approved by the Secretary; and

(iv) A federal disaster relief loan.

(f) Permissible sources of gifts. The following are permissible sources of gifts or grants used for the mortgagor's minimum investment under paragraph (b) of this section:

(1) Family members and governmental agencies and instrumentalities eligible under paragraphs (e)(2)(i) and (ii) of this section;

(2) A tribal government or an agency or instrumentality thereof, including a tribally designated housing entity, as defined at 25 U.S.C. 4103(21);

(3) An employer or labor union of the mortgagor;

(4) Organizations described in section 501(c)(3) and exempt from taxation under section 501(a) of the Internal Revenue Code of 1986;

(5) Disaster relief grants; and

(6) Other sources as may be approved by the Secretary on a case-by-case basis.

Dated: _____

Brian D. Montgomery, Assistant Secretary for Housing—
Federal Housing Commissioner

[FR-5087-N-04]

APPENDIX – TABLES
(This Appendix will not be codified)

Table 1. FHA Single-Family Purchase Loan Endorsements, Shares by Downpayment Source Type and Fiscal Year					
Fiscal Year	Source of Downpayment Funds				
	Borrower	Family	Nonprofit	Govt Agency	Employer
2000	75.75%	20.28%	1.74%	2.14%	0.09%
2001	77.52	15.64	4.92	1.83	0.10
2002	74.95	13.75	9.18	2.04	0.09
2003	63.53	15.25	18.40	2.70	0.12
2004	53.97	15.59	27.19	3.12	0.12
2005	48.44	14.18	33.09	4.17	0.12
2006	48.73	12.93	32.78	5.43	0.13
2007	47.52	12.02	35.09	5.25	0.12
2008 ^a	46.05	12.25	37.30	4.32	0.09

^aData for five months, October through February

Source: U.S. Department of Housing and Urban Development.

Table 2. Early Default Rate Comparisons on FHA-Insured Home Purchase Loans by Source of Downpayment Funds and Fiscal Year of Insurance Endorsement									
Fiscal Year of Insurance Endorsement	Early Default Rates					Ratios to “Borrower” Early Default Rates			
	Borrower	Family	Nonprofit	Govt Agency	Employer	Family	Nonprofit	Govt Agency	Employer
2000	3.89	5.26	7.98	6.76	4.37	1.36	2.05	1.74	1.12
2001	7.43	9.10	16.32	13.17	8.51	1.22	2.20	1.77	1.15
2002	6.99	8.56	15.22	12.62	11.93	1.23	2.18	1.81	1.71
2003	5.79	7.34	13.90	12.17	9.28	1.27	2.40	2.10	1.60
2004	5.84	7.79	14.33	12.36	10.42	1.33	2.46	2.12	1.78
2005	7.08	9.24	16.43	12.81	9.95	1.30	2.32	1.81	1.41
2000-2005	6.08	7.57	14.80	11.56	9.00	1.24	2.43	1.90	1.48

Source: HUD.

Notes: FHA-insured home-purchase loans; early default is defined as a 90-day (3 month) delinquency within the first 2 years of scheduled payments on the mortgage.

Table 3. Ever-Defaulted Rate Comparisons on FHA-Insured Home Purchase Loans by Source of Downpayment Funds and Fiscal Year of Insurance Endorsement									
Fiscal Year of Insurance Endorsement	Ever-Defaulted Rates					Ratios to “Borrower” Ever-Defaulted Rates			
	Borrower	Family	Nonprofit	Govt Agency	Employer	Family	Nonprofit	Govt Agency	Employer
2000	16.40%	21.39%	28.69%	27.79%	21.83%	1.30	1.75	1.69	1.33
2001	15.28	18.36	28.38	28.40	19.70	1.20	1.86	1.86	1.29
2002	13.24	15.30	25.30	24.47	17.30	1.16	1.91	1.85	1.31
2003	11.86	14.26	25.05	23.68	17.53	1.20	2.11	2.00	1.48
2004	10.60	13.57	23.94	20.88	17.92	1.28	2.26	1.97	1.69

2005	10.75	13.80	23.28	18.46	15.40	1.28	2.16	1.72	1.43
2006	8.16	10.59	17.67	12.31	16.22	1.30	2.16	1.51	1.99
2007	4.13	5.26	9.90	5.70	4.22	1.27	2.40	1.38	1.02

Source: HUD; FHA-insured home-purchase loans; data as of February 29, 2008.

Notes: Default is defined as a 90-day (3 month) delinquency; ever-defaulted represents having had at least one default episode.

Table 4. Current Default Rate Comparisons on FHA-Insured Home Purchase Loans
by Source of Downpayment Funds and Fiscal Year of Insurance Endorsement

Fiscal Year of Insurance Endorsement	Current Default Rates					Ratios to "Borrower" Current Default Rates			
	Borrower	Family	Nonprofit	Govt Agency	Employer	Family	Nonprofit	Govt Agency	Employer
2000	11.83%	14.80%	17.33%	13.50%	19.12%	1.25	1.46	1.14	1.62
2001	10.69	12.75	19.51	13.65	21.69	1.19	1.82	1.28	2.03
2002	8.23	10.01	15.97	11.83	4.20	1.22	1.94	1.44	0.51
2003	5.63	6.92	11.64	9.26	8.18	1.23	2.07	1.65	1.45
2004	5.36	7.41	12.33	8.64	10.92	1.38	2.30	1.61	2.04
2005	5.55	7.43	12.64	8.76	9.43	1.34	2.28	1.58	1.70
2006	4.94	6.46	10.97	6.98	9.81	1.31	2.22	1.41	1.99
2007	2.86	3.78	7.47	3.92	3.05	1.32	2.61	1.37	1.07
All Years	6.22%	7.68%	11.19%	8.07%	9.02	1.24	1.80	1.30	1.45

Source: HUD.

Note: Data are as of February 29, 2008.

Table 5. To-Date Claim Rate Comparisons on FHA-Insured Home Purchase Loans
by Source of Downpayment Funds and Fiscal Year of Insurance Endorsement

Fiscal Year of Insurance Endorsement	To-Date Claim Rates					Ratios to "Borrower" To-Date Claim Rates			
	Borrower	Family	Nonprofit	Govt Agency	Employer	Family	Nonprofit	Govt Agency	Employer
2000	6.29%	8.38%	16.07%	13.58%	9.52%	1.33	2.56	2.16	1.51
2001	5.67	6.68	16.23	13.34	7.24	1.18	2.86	2.35	1.28
2002	4.45	4.58	13.27	10.72	6.16	1.03	2.98	2.41	1.38
2003	3.31	3.58	11.22	8.84	4.57	1.08	3.39	2.67	1.38
2004	2.21	2.77	8.89	5.80	3.75	1.25	4.02	2.62	1.69
2005	1.61	1.88	6.29	3.81	2.61	1.17	3.91	2.36	1.62
2006	0.73	0.85	2.91	1.60	2.21	1.17	3.99	2.19	3.03
2007	0.08	0.09	0.41	0.17	0.00	1.12	5.07	2.14	0.00

Source: HUD; claims paid as of February 29, 2008.

Table 6. Expected Lifetime Claim Rates on Recent FHA Insurance Endorsements, by Credit Score, LTV, and Nonprofit Downpayment Assistance Fixed-Rate, 30-Year Mortgages					
Credit Score Ranges	Loan-To-Value Ranges				Ratio of Nonprofit to Other Above-95% Claim Rates
	Up to 90%	90.1 - 95%	Above 95%		
			Other Downpayment Funds	Nonprofit Assisted	
<i>FY 2005 Insurance Endorsements</i>					
680-850	2.74%	3.19%	3.37%	6.69%	1.99
640-679	4.32	5.56	6.23	13.02	2.09
620-639	4.54	5.89	6.59	13.36	2.03
580-619	6.44	9.17	10.57	21.58	2.04
540-579	7.74	12.80	13.52	26.20	1.94
500-539	10.56	17.53	17.49	32.92	1.88
300-499	13.56	12.21	21.33	46.63	2.19
None	6.81	9.66	11.04	23.80	2.16
All	5.60%	6.90%	6.94%	16.79%	2.42
<i>FY 2006 Insurance Endorsements</i>					
680-850	2.05%	3.07%	3.80%	9.13%	2.40
640-679	4.04	6.92	8.73	19.25	2.21
620-639	3.93	7.22	9.20	20.00	2.17
580-619	6.14	12.24	15.21	31.81	2.09
540-579	7.41	15.53	19.00	37.34	1.97
500-539	10.56	19.54	25.03	46.67	1.86
300-499	16.11	27.04	34.47	59.09	1.71
None	7.91	12.89	16.21	37.02	2.28
All	5.22%	8.21%	9.24%	23.21%	2.51
<i>FY 2007 Insurance Endorsements</i>					
680-850	2.14%	3.75%	4.90%	11.54%	2.36
640-679	4.45	8.10	11.15	23.78	2.13
620-639	4.43	8.68	11.54	24.57	2.13
580-619	7.43	14.28	19.47	38.49	1.98
540-579	8.71	18.71	24.01	45.03	1.88
500-539	10.51	22.73	30.86	53.80	1.74
300-499	16.09	33.68	40.82	68.31	1.67
None	9.21	15.73	21.14	42.85	2.03
All	6.05%	10.01%	12.25%	28.49%	2.33

Source: Special aggregations performed by Integrated Financial Engineering, Inc., from the FY 2007 actuarial study of the FHA Mutual Mortgage Insurance Fund (available at <http://www.hud.gov/offices/hsg/comp/rpts/actr/2007actr.cfm>). Lifetime claim rate predictions use base case economic forecasts provided by Global Insight, Inc.

Loan-to-Value Ratio	FICO Score Range								Row
	850-680	679-640	639-620	619-600	599-560	559-500	499-300	None	
LE 90	\$43,404	42,906	43,290	44,550	48,180	52,068	49,200	32,232	44,688
91-95	47,388	49,338	49,800	51,420	53,724	54,984	55,170	37,440	49,920
96-97	49,512	52,506	53,208	54,996	55,068	55,500	52,824	39,000	51,996
SFDPA*	48,432	50,754	51,024	51,672	51,618	51,732	52,008	36,900	50,136
Column	48,756	51,372	51,936	52,752	53,004	53,388	51,996	37,440	50,760

*Loans with seller-funded downpayment assistance.

Loan-to-Value Ratio	FICO Score Range								LTV Sum
	850-680	679-640	639-620	619-600	599-560	559-500	499-300	None	
LE 90	1.7%	1.4%	1.0%	1.0%	1.9%	1.3%	0.2%	0.6%	9.1%
91-95	1.7%	1.6%	1.0%	1.0%	1.3%	0.7%	0.1%	0.3%	7.8%
96-97	14.3%	10.1%	5.6%	5.6%	7.8%	3.8%	0.4%	2.4%	49.9%
SFDPA*	5.0%	5.5%	4.1%	4.1%	7.4%	4.8%	0.6%	1.6%	33.2%
FICO Sum	22.8%	18.7%	11.7%	11.7%	18.5%	10.6%	1.2%	5.0%	100.0%

*Loans with seller-funded downpayment assistance.

Loan-to-Value Ratio	FICO Score Range							
	850-680	679-640	639-620	619-600	599-560	559-500	499-300	None
LE 90	2.2	4.7	4.5	7.7	8.7	10.2	15.3	9.6
91-95	3.1	6.7	7.0	11.6	14.6	18.3	26.0	13.4
96-97	3.9	8.9	9.3	15.5	19.0	25.3	36.2	17.7
SFDPA*	8.9	18.6	19.4	31.7	36.8	47.0	61.4	34.7

*Loans with seller-funded downpayment assistance.

Loan-to-Value Ratio	FICO Score Range							
	850-680	679-640	639-620	619-600	599-560	559-500	499-300	None
LE 90	-2.95	-1.89	-2.00	-0.69	-0.54	-0.01	2.41	0.10
90-95	-2.56	-1.08	-0.94	0.90	1.26	2.62	6.70	1.65
95-97	-2.22	-0.18	-0.04	2.49	2.88	4.80	10.74	3.37
SFDPA*	-0.20	3.73	4.07	8.97	9.57	12.63	20.41	10.12

*Loans with seller-funded downpayment assistance.

Table 11. Breakeven Up-front and Annual Insurance Premiums for Seller-Funded Downpayment Assistance Loans								
	FICO Score Range							
	850-680	679-640	639-620	619-600	599-560	559-500	499-300	None
Up-front Premium	0.95%	5.56%	5.99%	5.92%	6.88%	12.09%	28.95%	7.77%
Annual Premium	0.55%	0.55%	0.55%	2.00%	2.00%	2.00%	2.00%	2.00%