

# The FHA's Move to Risk-Based Pricing

The agency's mortgage-insurance premiums are now based on credit score and downpayment

By **Christopher Doyle**, loan officer, American Alliance Mortgage Co.

**M**ANY MORTGAGE PROGRAMS underwent dramatic changes as the market has tightened, and the Federal Housing Administration (FHA) is no exception.

This past July 14, the FHA started using borrowers' credit scores and downpayments to price mortgage-insurance premiums for its mortgages. The agency has moved from charging the same percentages for upfront and annual premiums for all borrowers to this riskbased pricing.

Mortgage brokers who are FHA-approved or who are considering working toward approval to offer FHA loans should understand why the agency made these changes and what the new guidelines entail.

## Why the change?

The FHA made this change for a number of reasons. One is to protect the financial solvency of its Mutual Mortgage Insurance Fund, which insures lenders if a borrower defaults on an FHA-insured mortgage. The FHA also feels that the previous system of one-size-fits-all premiums, where all borrowers were charged the same premium regardless of credit risk, was unsustainable.

Another reason FHA has turned to risk-based pricing is to respond to the changes in the market and to serve more borrowers.

Risk-based pricing, in which borrowers' mortgage-insurance premiums are a function of their credit risk, will allow the FHA to move away from a system in which premiums that stronger borrowers paid essentially subsidized those for weaker borrowers.

According to the FHA, with the previous system, lower-risk borrowers paid too much for

insurance relative to their risk and higher-risk borrowers paid too little. If it hadn't turned to risk-based pricing, the FHA states that it would have had to increase premiums for all borrowers and impose new underwriting restrictions.

## The details

Previously, on a 30-year purchase mortgage, borrowers were charged a one-time, upfront mortgage-insurance premium of 1.5 percent of their base loan amount, which is typically financed into the mortgage. They also were charged an annual premium of 50 basis points, which is included in their monthly payment. These premiums were assessed equally for all borrowers.

With the new risk-based pricing system, however, the FHA now bases the premiums on the middle of borrowers' credit scores with the three chief credit-ratings agencies. If there are two or more applicants on the mortgage, the lowest of all the middle scores will be used to determine the premium.

Until now, the FHA has never had a minimum-credit-score requirement. These changes, however, will allow applicants to be denied based on credit score. For example, applicants with a credit score less than 500 and a downpayment less than 10 percent will automatically be ineligible for FHA financing.

Some lenders that offer FHA financing have added their own minimum-credit-score thresholds, typically 580. The lenders set these thresholds themselves to determine interest-rate and program eligibility; the limits typically are overlays of FHA guidelines.

Here are examples of some of the changes:

■ **For borrowers with scores of 600 or greater and a downpayment of at least 10 percent**, the upfront premium will drop 25 basis points to 1.25 percent of the base-loan amount. A borrower taking out a \$200,000 mortgage with a 6-percent rate would therefore pay \$3 less per month than with the old system.

■ **Borrowers with downpayments of less than 10 percent and scores less than 560** will see

their upfront premiums increase 25 basis points to 1.75 percent.

■ **Borrowers who put between 5 percent and 10 percent down and who have credit scores less than 600** will pay premiums based on 1.75 percent, and those with scores between 500 and 559 will pay premiums based on 2 percent of the base loan amount.

■ **Borrowers with downpayments less than 5 percent** will see annual premiums increase from 50 to 55 basis points across all credit-score bands. Borrowers whose scores are 600 to 639 will pay a 1.75-percent upfront premium; those with scores of 560 to 599 will pay 2 percent; and borrowers with scores of 500 to 559 will pay 2.25 percent. First-time homebuyers with scores between 500 and 559 and who take U.S. Department of Housing and Urban Development-approved counseling can have their premiums reduced by 25 basis points to 2 percent. Borrowers taking out a \$200,000 mortgage at a 6-percent rate with a decision score of 559 (without counseling) would pay \$17.33 per month more than they would have with the old system.

■ **Streamline refinances of existing FHA loans** for which case numbers were assigned before July 14 will have an upfront premium of 1 percent of the base loan amount and an annual premium of 50 basis points.

## Manual underwriting

FHA loans not approved by the automated underwriting system can go to an underwriter for manual review of compensating factors. The underwriter can review the file for acceptable risk and issue a manual approval.

With its switch to risk-based pricing, the FHA still allows manually underwritten mortgages in cases where borrowers lack enough credit to generate a valid credit score.

These borrowers' mortgage-insurance premiums will be priced on the nontraditional category, which bases premiums on the level of downpayment. Borrowers will be required to provide nontraditional credit records, such as

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## Risk-Based Pricing

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rent and nonreporting trade lines such as utilities, to establish a willingness to pay.



The FHA hopes that adopting risk-based pricing will help it reach out to higher-risk borrowers without having to raise premiums for everyone. Risk-based pricing also should go a long way toward ensuring the future financial solvency of this cornerstone of the mortgage industry. **!**

### On the Web

To read more about the new rules and to see the Federal Housing Administration's new risk-based upfront and annual mortgage-insurance premiums, see U.S. Department of Housing and Urban Development Docket No. FR-5171-N-02 at [tinyurl.com/5wnzgc](http://tinyurl.com/5wnzgc).