



## Credit scores, not income, to govern FHA insurance rates

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DALLAS -- Who have better credit scores on average -- home buyers with higher or lower incomes?

Inside the country's fastest-growing home mortgage program, the surprising answer is: People with lower incomes have slightly higher FICO scores.

That finding, which emerged from a statistical analysis of all approved mortgages insured by the Federal Housing Administration during its 2007 fiscal year, is now buttressing a forthcoming major policy switch that could affect thousands of buyers and refinancers.

FHA, which for decades has used a one-size-fits-all approach to pricing its insurance on home loans, plans to shift to a "risk-based" system keyed to FICO scores and down payments, beginning as early as mid-July. Private sector lenders and insurers have priced interest rates and premiums using sliding scales of FICO scores and down-payment amounts since the mid-1990s.

FHA's move, which will cover all new applications including "jumbo" loans up to \$729,750 in high-cost markets through December, will bring the agency in line with the private sector's predominant approach.

Brian D. Montgomery, FHA's top official, outlined the impending change in a speech here May 8 to the annual conference of the National Association of Real Estate Editors. Under the old approach, he noted, buyers with stellar FICO scores paid the same premiums as borrowers with poor scores. That amounted to a pricing inequity for applicants who presented low risk of default on their loans, and an inappropriate subsidy of applicants who were likely to default.

A study of an entire year's applications turned up the additional fact that FHA's lower-income borrowers typically had higher FICO scores than buyers with larger incomes.

"Is it counterintuitive? Yes," said Montgomery. According to the study, applicants with FICO scores of 680 to 850 had median incomes of \$48,756 last year, while those with low scores of 500 to 559 had median incomes of \$53,388. Fair Isaac Corp.'s FICO scores range from about 300 to 850 -- the higher the better -- and are predictive of future defaults and foreclosures.

Even at rock-bottom down-payment levels of 3 percent, applicants with lower incomes had higher credit scores than applicants with bigger incomes making similar-size down payments.

All of which underlines the key reason for making the switch to risk-based pricing: Why should people who have demonstrated superior credit -- irrespective of their income levels -- pay the same mortgage insurance premiums as loan applicants who have seriously flawed credit histories?

Under the new system, according to FHA's outline of its plan, "a larger number of low-income borrowers (will) benefit from premium reductions than ... moderate-, middle- and upper-income borrowers combined." On 30-year loans with down payments of 10 percent or more, applicants with FICO scores above 680 will qualify for the lowest premiums -- 1.25 percent of the loan amount up front and annual renewal premium payments of 0.5 percent. Borrowers with down payments under 5 percent and poor credit scores -- FICOs ranging from 500 to 559 -- will be charged premiums of 2.25 percent up front and 0.55 percent annually. All borrowers will continue to receive the same market-based interest rate. Under the current system, borrowers pay uniform 1.5 percent premiums up front, and 0.5 percent annually.

To set premium rates by credit standing, FHA plans to use the middle score of an applicant's three FICOs generated

by the national credit bureaus -- Equifax, Experian and TransUnion. If only two scores are available, it will use the lower. For applicants with thin or "nontraditional" credit histories on file at the bureaus, FHA will underwrite and price the loans without reference to FICOs, with heavier emphasis on rent and utility payments among other measures of creditworthiness.

Though FHA mortgage volume has more than doubled in the past year, the move to risk-based pricing is expected to make it more attractive to buyers and refinancers. During the housing boom years, FHA lost much of its business to subprime lenders and insurers who offered zero-down, low- or no-documentation loans at high interest rates and fees, including prepayment penalties. FHA, by contrast, always has required at least a 3 percent down payment, full documentation of income and assets, but has never permitted prepayment penalties.

Since taking over as FHA commissioner in 2005, Montgomery has emphasized "modernizing" FHA and winning back market share. That has included pushing for higher loan limits to serve greater numbers of borrowers in high-cost areas such as California and along the East Coast. FHA also is now the government's key vehicle for refinancing borrowers stuck with unaffordable -- and often toxic -- subprime mortgages.

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